



22 September 2008
Mantra on Northbourne, Canberra

Cloning and Splitting Discretionary Trusts

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1 INTRODUCTION

Trust '**cloning**' or '**replication**¹' and trust '**splitting**' are currently very popular mechanisms for family succession planning. Ostensibly they are quite straightforward. However, there are significant tax and trust law traps for the unwary.

References in this paper are commonly made to:

- the *Income Tax Assessment Act 1936* (Cth) ('**the 1936 Act**');
- the *Income Tax Assessment Act 1997* (Cth) ('**the 1997 Act**'); and
- *A New Tax System (Goods and Services Tax) Act 1999* (Cth) ('**the GST Act**').

Reference is also generally made (where relevant) to the legislation of the Australian Capital Territory, New South Wales, Victoria and Queensland. References to the legislation of other States is made (where relevant) in footnotes only.

This paper considers not only the taxation issues arising from splitting and cloning but also:

- the financial exposure arising;
- the trust law issues eg. fiduciary obligations;
- other issues i.e. family provision legislation.

It commences with an analysis of splitting transactions rather than cloning because in splitting there is no need to rely on the exceptions to CGT events E1 and E2, the issues are more strictly trust law matters and not tax matters as such.

In this paper:

- '**splitting**' means maintaining the one trust relationship but appointing separate trustees for different assets of that one trust. The trust obligations are undertaken according to the trust relationship spelled out in the trust deed establishing the trust;
- '**cloning**' involves the establishment of a new trust relationship in respect of assets held by the trustee. That trust relationship may come about by settling the asset on the new trustee or bringing into existence a new trust relationship and transferring the asset to the trustee of that new trust relationship.

2 WHY SPLIT OR CLONE?

During the latter part of the 20th century and early 21st century the use of trusts and, in particular, family discretionary trusts, has proliferated. Tax laws have to an extent driven small to medium business operators away from using corporate vehicles as such². However, very often the second or third generations are left with trust structures that do not provide appropriate family succession outcomes.

Some of the things that lead to this conclusion are:

- the family members may be incapable of making joint decisions;
- family members may vary greatly in business acumen, intellect, risk adversity and time opportunities;
- second and third marriages can lead to imperfectly blended families;

¹ The term '**cloning**' will be used in this paper.

² The overwhelming factor in selecting a discretionary trust (or unit trust) structure rather than a corporate structure is the availability of the 50% CGT discount where the business assets are sold rather than the ownership interests in the entity. A capital gain made by a company in its own right is not a discount capital gain: section 115-10 1997 Act.

- family members will often have different financial needs eg. accumulation vs. present consumption;
- it may be desirable to separate assets to more fully protect some of them from potential creditors' claims.

The splitting and cloning approaches are generally played out in the context of the one family relationship. Overwhelmingly discretionary trusts are established for the one family, the members of which may wish to go their separate ways (for the reasons discussed above). On rare occasions a discretionary trust is established for separate family groups (it is ill advised to do so) and splitting or cloning may have application. However, if family trust elections have been made (or interposed entity elections are required to be made) the transactions become problematical. The writer's experience has been that splitting and cloning of discretionary trusts is inevitably about single-family relationships but often with the added complexity of children from multiple marriages who owe allegiances to different parts of the family.

Unit trusts are commonly used for business (or investment) joint ventures by unrelated family groups. Cloning or splitting unit trusts have their own unique issues in this context and these are addressed briefly below.

Cloning and splitting hybrid style trusts also have their own unique problems. Often such hybrid trusts will involve members of completely different families. These issues are also considered but briefly in this paper.

2.1 Splitting – The Drivers

Splitting in the way described above rather than cloning is very often driven by stamp duty outcomes. It delivers imperfect separation of control and financial exposure for family members. Why stamp duty? The stamp duties legislation in all jurisdictions will exempt (or impose nominal duty only) on the replacement of a trustee, addition of a trustee or retirement of a trustee.

In the Australian Capital Territory, subsection 54(2) of the Duties Act 1999 (ACT) provides:

'(2) Duty of \$20 is chargeable in respect of a transfer of dutiable property to a person as a consequence of the retirement of a trustee or the appointment of a new trustee, if the Commissioner is satisfied that, as the case may be –

(a) except for a responsible entity of a managed investment scheme—none of the continuing trustees remaining after the retirement of a trustee is or can become a beneficiary under the trust; and

(b) except for a responsible entity of a managed investment scheme—none of the trustees of the trust after the appointment of a new trustee is or can become a beneficiary under the trust; and

(c) except if a responsible entity of a managed investment scheme acquires a beneficial interest in the managed investment scheme solely as a consequence of its appointment as the responsible entity—the transfer is not part of a scheme for conferring an interest, in relation to the trust property, on a new trustee or any other person, whether as a beneficiary or otherwise, to the detriment of the beneficial interest or potential beneficial interest of any person; and

(d) the transfer is not made in connection with a tax avoidance scheme;

and, if the Commissioner is not so satisfied, the transfer is chargeable with the same duty as a transfer to a beneficiary under and in conformity with the trusts subject to which the property is held.'

In New South Wales subsection 54(3) of the Duties Act 1997 (NSW) provides:

'Duty of \$10 is chargeable in respect of a transfer of dutiable property to a person other than a special trustee as a consequence of the retirement of a trustee or the appointment of a new trustee, if the Chief Commissioner is satisfied that, as the case may be:

(a) none of the continuing trustees remaining after the retirement of a trustee is or can become a beneficiary under the trust; and

(b) none of the trustees of the trust after the appointment of a new trustee is or can become a beneficiary under the trust; and

(c) the transfer is not a part of a scheme for conferring an interest in relation to the trust property, on a new trustee or any other person, whether as a beneficiary or otherwise, to the detriment of the beneficial interest or potential beneficial interest of any person.

If the Chief Commissioner is not so satisfied, the transfer is chargeable with the same duty as a transfer to a beneficiary under and in conformity with the trusts subject to which the property is held, unless subsection 3A applies.³

Subsection 33(3) of the *Duties Act 2000* (Vic) provides that:

'No duty is chargeable under this Chapter in respect of a transfer of dutiable property to a person other than a special trustee if the Commissioner is satisfied that the transfer is made solely:

(a) because of the retirement of a trustee or the appointment of a new trustee or other change in trustee; and

(b) in order to vest the property in the trustee for the time being entitled to hold it.'

In Queensland Section 117 of the *Duties Act 2001* (Qld) provides the exemption:

'Transfer duty is not imposed on a dutiable transaction for the sole purpose of giving effect to a change of trustee if:

(a) the transaction is not part of an arrangement:

(i) involving a change in the rights or interest of a beneficiary of the trust; or

(ii) terminating the trust; and

(b) transfer duty has been paid on all trust requisitions for which transfer duty is imposed for the trust before the transaction.'

These provisions contemplate nominal or no duty if the transfer of dutiable property is to give effect to the retirement of a trustee or the appointment of a new trustee. Both provisions require there to be no conferring of an interest in the trust property on the new trustee or any other person to the detriment of the beneficial interest or potential beneficial interest of any other person.

In Victoria the legislation is interpreted in a slightly different way in that under subsection 33(3) of the *Duties Act 2000* (Vic) the Commissioner must be satisfied that the transfer is made solely because of the appointment of a new trustee and in order to vest the property in the trustee⁴. In Revenue Ruling DA030 the State Revenue Office suggests that the Commissioner will not be satisfied if the transfer forms part of a transaction or series of transactions that have a separate commercial objective whether or not the transaction has the effect of avoiding the payment of duty. It is not clear what is meant by 'a separate commercial objective'. A splitting of a family trust arrangement has no commercial objective. It is a family arrangement.

All of the other stamp duty legislations have provisions, which exclude transfers to effect a mere change of trustee⁵. Most of them have similar anti-avoidance aspects.

In a land rich context Australian Capital Territory⁶, New South Wales⁷, Victoria⁸ and Queensland⁹ exempt changes of trustees.

³ subsection 54(3A) is not relevant in the circumstances.

⁴ a 'new trustee' is 'a trustee appointed in substitution for a trustee or trustees or a trustee appointed in addition to a trustee or trustees': subsection 33(1) *Duties Act 2000* (Vic).

⁵ NT — Item 6 in Schedule 2 *Stamp Duty Act*
TAS — section 37 *Duties Act 2001*
WA — paragraph 73AA(1)(a) *Stamp Act 1921*.

From a stamp duty perspective extreme care needs to be taken that the express words of the exemption are complied with. There is a view about that it is necessary to appoint a co-trustee in respect of all of the assets of the trust and then have the original trustee resign (and presumably the new trustee resign in respect of those assets to be exclusively held by the old trustee) from their position in relation to those assets which are to be under the exclusive control of the new trustee. This is a reaction to the perceived disjunction between retirement of a trustee and appointment of a new trustee. This may be an over-reaction.

The requirement that the arrangements do not confer a benefit in relation to the trust property on the new trustee or any other person must be at least considered in the light of the decision of the High Court in *CPT Custodian*¹⁰. The High Court has made it plain that the trustee has an equitable interest in the trust property and the beneficiaries' interest is subject to the priority of that interest. When a new trustee is appointed that trustee obtains a right to be indemnified – *'the right of the trustee under the general law to reimbursement or exoneration for the discharge of liabilities incurred in the administration of the trust'*¹¹.

If, as is commonplace, the old trustee assigns its right to be indemnified out of the trust assets the new trustee will obtain a benefit in relation to the trust property. However, the potential for that benefit to eliminate the exemption is itself excluded by the requirement that there be a detriment in relation to the beneficial interest of some other person. No beneficial interest, save that of the retiring trustee, is altered detrimentally by the acquisition by the new trustee of a claim in respect of the trust assets. The retiring trustee does not suffer a detriment because the claims against it must be reduced as a result of its retirement (or it has a right to be indemnified by the continuing trustee).

Ordinarily this should not pose a problem but, again, great care needs to be taken with respect to the precise requirements of the relevant provision.

3 SPLITTING – IS THERE A RESETTLEMENT?

This subject can be described in this way — can a transfer of assets to another trustee, but subject to the precise terms of the trust instrument, bring into existence a different trust relationship? The argument that this is a new trust derives out of the rationale that a trust is a personal relationship in regard to property subject of the trust instrument between the trustee, the settlor and the beneficiaries. It follows in this argument that, if there is a new trustee, there must be a new trust relationship. This approach emphasises the relationship between the parties as the hallmark of a trust. The alternative view is that the true character of a trust relationship is to be found in the nature of the beneficial entitlements and the identity of the trustee is irrelevant. The writer prefers this latter approach – an appointment of a new trustee in respect of particular assets of the trust but adhering to the terms and conditions is not a new trust relationship but a continuation of the old relationship. Whether or not there is a resettlement turns on the question whether there is an alteration to the substratum of the trust sufficient to constitute it a new trust relationship. The observations of Megarry J in *Re Ball's Settlement*¹² are telling in this regard:

'If an arrangement changes the whole substratum of the trust then it may well be that it cannot be regarded merely as varying that trust. But if an arrangement, while leaving the substratum, effects the purpose of the original trust by other means, it may still be possible to regard that arrangement as merely varying the original trusts, even though that means employed are wholly different and even though the form is completely changed.'

⁶ Section 91 imposes a nominal duty to interests that are subject to landholder duty under Part 3.2 of the *Duties Act 1999* (ACT) that is acquired under section 54 (change in trustee).

⁷ Land rich duty under Chapter 4A of the *Duties Act 1997* (NSW) will not apply if the provisions of section 54 would have imposed nominal duty of \$10 only: para. 163ZB(1)(i).

⁸ Subsection 85(1) *Stamp Duties Act 2000* (Vic) exempts the acquisition of an interest in a land rich entity if the transaction, had it taken place in relation to the underlying land, would have been exempt.

⁹ Section 191 of the *Duties Act 2001* (Qld) excludes land rich duty if the relevant acquisition is for the sole purpose of giving effect to a change of trustee, if the acquisition is not part of an arrangement involving a change in the rights or interests of a beneficiary of the trust or terminating the trust, the acquisition is not part of an arrangement to avoid the imposition of duty and transfer duty has been paid on all trust acquisitions for which transfer duty is imposed for the trust before the acquisition.

¹⁰ *CPT Custodian Pty Ltd v. Commissioner of State Revenue (Vic)* [2005] HCA 53.

¹¹ [2005] HCA 53 at p.20.

¹² (1968) WLR 899 at 905.

The question is whether the changes, which have been made, constitute 'a new charter of future rights and obligations' as observed by the High Court in *Davidson v. Chimside*¹³.

In *Roome v. Edwards (Inspector of Taxes)*¹⁴ it was said:

'There are a number of obvious indicia which may help to show whether a settlement, or a settlement separate from another settlement exists. One might expect to find separate and defined property, separate trusts and separate trustees. One might also expect to find a separate disposition bring the separate settlement into existence. These indicia may be helpful, but they are not decisive.'

The fact that a trustee newly appointed to the trust property declares that it holds the property subject to the terms of the original trust should not in the usual case be a resettlement ie. in Lord Wilberforce's words 'a settlement separate from another settlement'. This was the outcome in *Farrar's Case*¹⁵ where a declaration was found to be a mere acknowledgment of a pre-existing trust in a New South Wales stamp duty context.

In many jurisdictions the particular provision in the *Trustee Act* allowing appointment of separate trustees prima facie contemplates that the trust property will be held on separate and distinct trusts.

In the Australian Capital Territory subsections 6(1), 6(5), 6(6) and 6(9) *Trustee Act 1925 (ACT)* provide:

'(1) A new trustee may by registered deed be appointed in place of a trustee, either original or substituted, and whether appointed by the Supreme Court or otherwise.

...

(5) The appointment may be made for the whole or any part of the trust property.

(6) The following provisions apply to appointments under subsection (1):

- (a) 2 or more trustees may be appointed concurrently;*
- (b) the number of trustees may be increased up to 4;*
- (c) a separate set of up to 4 trustees may be appointed for any distinct part of the trust property held on trusts that are distinct from those relating to any other part of the trust property even if a new trustee is not to be appointed for the other part;*
- (d) any existing trustee may be appointed or remain one of the separate set of trustees;*
- (e) if only 1 trustee was originally appointed – a separate trustee may be appointed for the distinct part;*
- (f) it is not necessary to appoint more than 1 new trustee if only 1 trustee was originally appointed or to fill up the original number of trustees if more than 2 trustees were originally appointed.*

...

(9) Every new trustee appointed under this section, as well before as after all the trust property becomes by law or by conveyance or otherwise vested in him or her, shall have the same powers and discretions, and may in all respects act as if he or she had been originally appointed a trustee by the trust instrument.'

In New South Wales subsections 6(1), 6(5) and 6(8) *Trustee Act 1925 (NSW)* provide:

'(1) A new trustee may by registered deed be appointed in place of a trustee, either original or substituted and whether appointed by the Court or otherwise.

¹³ [1908] HCA 65.

¹⁴ [1982] AC 279 at 292-293 per Lord Wilberforce.

¹⁵ *Farrar v. Commissioner of Stamp Duties (NSW)* (1975) 5 ATR 364.

...

(5) *The appointment may be made for the whole or any part of the trust property, and on the appointment:*

- (a) *two or more trustees may be appointed concurrently;*
- (b) *the number of trustees may be increased, but not beyond four;*
- (c) *a separate set of trustees may be appointed for any distinct part of the trust property, that is to say, for any part for the time being held on trusts distinct from those relating to any other part or parts, notwithstanding that no new trustees or trustee are or is to be appointed for other parts, provided that the number of trustees in any separate set shall not exceed four;*
- (d) *any existing trustee may be appointed or remain one of the separate set of trustees.*

...

(8) *Every new trustee appointed under this section as well before as after all the trust property becomes by law or by conveyance or otherwise vested in the new trustee, shall have the same powers, authorities and discretions, and may in all respects act as if the new trustee had been originally appointed a trustee by the instrument, if any, creating the trust.'*

Subsection 12(2) *Trusts Act 1973 (QLD)* provides:

'On the appointment of a trustee or trustees for the whole or any part of the trust property:

...

(b) a separate set of trustees may be appointed for any part of the trust property held on trusts distinct from those relating to any other part and whether or not new trustees are or are to be appointed for any other part of the trust property; and any existing trustee may be appointed or remain 1 of the separate set of trustees or if only 1 trustee were originally appointed then 1 separate trustee may be so appointed for the part of the trust first in this paragraph mentioned.'

Section 42 of the *Trustee Act 1958 (Vic)* provides:

'On the appointment of a trustee for the whole or any part of trust property:

- (a) *the number of trustees may, subject to the restrictions imposed by this Act on the number of trustees, be increased; and*
- (b) *a separate set of trustees, not exceeding four, may be appointed for any part of the trust property held on trusts distinct from those relating to any other part or parts of the trust property, notwithstanding that no new trustees or trustee are or is to be appointed for other parts of the trust property, and any existing trustee may be appointed or remain one of such separate set of trustees, or, if only one trustee was originally appointed, then, save as hereinafter provided, one separate trustee may be so appointed.'*

The references to *'trusts distinct from those relating to any other part'* (Qld) and *'held on trust distinct from those relating to any other part'* (ACT, NSW and Victoria) raise concerns about whether the trust deed has to specifically provide for separate and distinct trusts before there can be separate trustees appointed in respect of separate trust assets. In the writer's view this appears to be an unjustifiable conclusion. It may be that the provisions simply require the particular trust property to be discernibly held subject to the terms of the trust. However as a surfeit of caution if a split is to be pursued the necessary provisions should be set out in the trust deed.

Subsection 6(15) of the *Trustee Act 1925 (ACT)* provides:

'This section applies to a trust except so far as the contrary intention appears in the trust instrument.'

Subsection 6(13) of the *Trustee Act 1925 (NSW)* provides:

'Except as otherwise provided in subsection (12), this section applies only if and as far as a contrary intention is not expressed in the instrument, if any, creating the trust, and shall have effect subject to the terms of that instrument and to the provisions therein contained.'

There is no specific exclusion in Victoria and Queensland. Those in pursuit of an effective split will want to make sure that the trust deed specifically allows a separate trustee to be appointed in respect of specific assets held subject to the trusts.¹⁶

3.1 Varying the Deed to Allow Separate Trustees

Can the power of amendment be used to allow for appointment of separate trustees where no such power existed or does the amendment amount to a resettlement. Common sense suggests, no (unless there is something in the deed which provides that a single trustee was an absolute requirement or that separation of assets and trustees was prohibited by the deed). Based on the views of Brightman J in *Hart v. Briscoe*¹⁷, Lord Wilberforce in *Roome v. Edwards*¹⁸ and Mahoney J in *Kearns v. Hill*¹⁹ the use of a power of amendment set out in the trust deed (and without any relevant imbedded limitations being breached) to allow the appointment of separate trustees to the trust assets is unlikely to be a resettlement so that a new trust estate comes into existence.

As David Raphael has observed²⁰:

'Despite Kearns v. Hill and Re Lancedale Holdings case there is a body of law to the effect that a power of amendment is not likely to be held to extend to vary the trust in a way which would destroy its substratum: see Re Dwyer (1935) VLR 273; Re Ball's Settlement Trusts (1968) 1 WLR 899 at 904. The underlying purpose for the furtherance of which the power was initially created or conferred will be paramount: see Duke of Bedford v. Marquess of Abercom (1836) 11 My and Ca 312.

However, this general principle is unlikely to be an appropriate consideration where the evident purpose of the power is to ensure maximum flexibility such as would be the case in most modern superannuation funds or discretionary trusts or unit trusts. Indeed the converse is the case. Nonetheless, as I have said in relation to the Tax Acts, it is more likely than not that Re Ball's Settlement will be followed.'

3.2 Appointment of Separate Appointer

It is suggested immediately above that the segregation of assets to be held by separate trustees is unlikely to be a resettlement. What if the trust deed has an office of appointor and the deed is amended to provide for different appointors in respect of the different trustees. Would such an amendment be a resettlement?

The power of appointor is a fiduciary power, which must be exercised in the interests of the beneficiaries²¹. It gives the appointor no interest in the trust property.

An appointor has, simply by holding that office and wielding the power attached, no interest in the property of the trust²². This is notwithstanding that a Court might conclude for special purposes that the appointor is the 'owner' of property of the trust²³.

Provided the trust deed allows sufficient flexibility or it can be introduced by amendment the introduction of an appointor with powers restricted to appointing the trustee of say Parcel 2 assets while the limitation of the power of the original appointor to the appointment of the trustee to Parcel 1 assets appears to the writer to be an administrative matter not going to the substratum of the trust. It should not, either by using

¹⁶ The legislation in Northern Territory and Western Australia is similar. It should be noted that in all States and Territories except NT, SA and TAS the number of trustees for a private unit trust is limited to four.

¹⁷ [1978] 1 All ER 791.

¹⁸ [1982] AC 279.

¹⁹ (1990) 21 NSWLR 107.

²⁰ D Raphael: 'Variation & Resettlement of Trusts' paper presented at a seminar conducted by the Taxation Institute of Australia: NSW Division on 7 April 2004 particularly at paras. 26 and 27.

²¹ *Re Wiley v. Burton* [1994] FCA 1146 and *Gilbert v. Stanton* [1905] HCA 1.

²² See *Edwards v. Klaville Pty Ltd* [1996] FCA 411.

²³ As in the case of Section 1323 of the *Corporations Act 2001* and ASIC: *In the Matter of Richstar Enterprises Pty Ltd ACN 099 071 968 (No. 9) v. Carey* [2006] FCA 1242.

powers that already exist in the deed or by amending the deed, effect a resettlement of the trust property. The principles are the same as discussed above.

David Raphael also points out that many trust deeds will not empower the trustee to amend the deed so as to affect the appointor's power or to allow further appointors to be engaged. This is because many trust deeds provide the trustee with the power to amend the trusts but not the powers granted by the deed.

3.3 Splitting and Family Trust Elections

The relationship between the two trustees and the trust assets remains the one trust estate. If the trustee of the trust has made a family trust election pursuant to section 272-80 (Schedule 2F) of the 1936 Act that should continue to be effective notwithstanding the fact that an additional trustee has been appointed. The ramifications of having made a family trust election (or interposed entity election) flow from actions taken by the trustee of the trust from time to time notwithstanding the fact that the trustee is not the same person as the trustee that made the election²⁴.

3.4 The CGT Events

When the original trustee disposes of a CGT asset to the additional trustee there is a change in legal title i.e. a change of ownership for the purposes of subsection 104-10(2) of the 1997 Act. However, the change of ownership does not occur if it happens '*merely because of a change of trustee*'.

CGT event E1 will not happen if no trust is created by declaration or settlement²⁵. All of the reasoning above has been to the effect that there will be no declaration of trust by merely appointing a new trustee or no resettlement. CGT event E2 is not relevant because there is no other existing trust to which the CGT assets are transferred.

CGT event E3 is not relevant. CGT event E4 could be relevant in the context of a unit trust or hybrid trust.

CGT event E5 operates on the basis of a beneficiary becoming absolutely entitled as against the trustee. In the splitting approach no beneficiary becomes absolutely entitled to a CGT asset of the trust.

CGT events E6, E7 and E8 are not relevant to a splitting.

Subject to there being no resettlement triggering a CGT event E1 there should be no relevant CGT event arising on a splitting.

4 SPLITTING – TRACING ASSETS

This is really an asset protection topic. What if the trustee in relation to Parcel 1 assets falls into financial difficulty (for example, experiences a call on its margin lending facility against its share portfolio). Is the trustee of Parcel 2 assets protected against the claims of the creditors of the original trustee?

If the creditors arose in respect of debts incurred by trustee 1 after the Parcel 2 assets were transferred to trustee 2 the answer appears to be reasonably clear. Unless there are special circumstances eg. misrepresentation or fraud, there is no right to recover. The trustee's right to indemnity from trust assets comes into existence when the liabilities are incurred. If trustee 1 incurs liabilities after the Parcel 2 assets have been transferred to trustee 2 the creditors have no right to be subrogated to claim against assets that trustee 1 no longer has legal title to nor had at the time the liability was incurred.

A trustee is only liable for its own acts and liabilities incurred. The Trustee Acts make this plain²⁶:

- Section 59(2) of the *Trustee Act 1925* (ACT) provides:

'A trustee shall be answerable and accountable only for his or her own acts, receipts, neglects, or defaults, and not for those of any other trustee, nor for any bank, broker, or other person with

²⁴ For example, a tax liability for family trust distributions tax arises when 'the trust confers a present entitlement to, or makes a distribution of income or capital of the trust': subsection 27-15 1936 Act.

²⁵ Subsection 104-55(1).

²⁶ See also: NT – section 26 *Trustee Act* (NT); SA – section 35 *Trustee Act 1958* (SA); TAS – section 27 *Trustee Act 1898* (Tas); WA – section 70 *Trustee Act 1962* (WA).

*whom any trust money or securities may be deposited, nor for the insufficiency or deficiency of any securities, nor for any other loss, unless the same happens through his or her own wilful neglect or default.*²⁷

- Subsection 59(2) of the *Trustee Act 1925* (NSW) provides:

*'A trustee shall be answerable and accountable only for the trustee's own acts, receipts, neglects, or defaults, and not for those of any other trustee, nor for any banker, broker, or other person with whom any trust moneys or securities may be deposited, nor for the insufficiency or deficiency of any securities, nor for any other loss, unless the same happens through the trustees own wilful neglect or default.'*²⁸

- Subsection 36(1) of the *Trustee Act 1958* (Vic) provides:

'A trustee shall be chargeable only for money and securities actually received by him notwithstanding his signing any receipt for the sake of conformity, and shall be answerable and accountable only for his own acts, receipts, neglects or defaults, and not for those of any other trustee, nor for any banker, broker or other person with whom any trust money or securities may be deposited, nor for the insufficiency or deficiency of any securities, nor for any other loss unless the same happens through his own wilful default.'

- Section 71 of the *Trusts Act 1973* (Qld) provides:

'A trustee shall be chargeable only for money and securities actually received by the trustee, notwithstanding the trustee signing any receipt for the sake of conformity; and shall be answerable and accountable only for the trustee's own acts, receipts, neglects or defaults, and not for those of any other trustee, nor those of any financial institution, broker or other person with whom any trust money or securities may be deposited, nor for the insufficiency or deficiency of any securities, nor for any other loss, unless the insufficiency, deficiency or loss occurs through the trustee's own default.'

As Dr John Glover has put it²⁹:

'If the trust deed so provides, the powers of multiple trustees can be exercised without the concurrence of all or a majority of their number, or alternatively can be exercised by co-trustees acting unilaterally. Not infrequently one out of a body of co-trustees is given the sole responsibility for conducting a business and is made the sole signatory who can enter agreements on the business's behalf. Co-trustees, ordinarily, are not liable for the exercise of powers by other trustees to whom those powers have been exclusively allocated'

A trustee has an equitable lien over the assets of the trust as they existed at the time the trustee incurred liabilities on behalf of the trust. That lien continues notwithstanding the fact that the person is no longer the trustee but has been replaced. In *Coates v. Mclnerney*³⁰ it was argued that the right of indemnity was lost when the trustee was removed from office. Anderson J observed:

'It is said that under this clause only the trustee actually in office is indemnified. However, I must disagree. Any right of indemnity would arise upon the liability arising and the question is whether that right of indemnity, arising at that time, that is to say, during the holding of the office by the trustee who held office at the time that the liability was incurred, is then lost by subsequent loss of office.

*There is abundant authority that it is not so lost. I do not need to refer to all of the authorities. It is, I think, sufficient to refer to *Kemtron v. Commissioner of Stamp Duties* (1984) 15 ACR 627 at 634. The question is whether there is anything in clause 12 which would affect the general equitable doctrine*

²⁷ This provision is expressly subject to the term of the trust deed: subsection 59(3) *Trustee Act 1925* (ACT).

²⁸ This provision is expressly subject to the term of the trust deed: subsection 59(3) *Trustee Act 1925* (NSW).

²⁹ Dr John Glover: *'Dissecting Trusts and Trusteeships: Capital Gains and State Taxation Consequences'*: paper presented to Taxation Institute of Australia's 7th Annual States Taxation Conference (July 2007) at p.4 and also *'Dissecting Trusts and Trusteeships: CGT and Stamp Duty Consequences'* Vol. 36 No. 4 ATR (Nov 2007) p.201 at 203-204.

³⁰ (1992) 6 ACCR 748.

that loss of office does not terminate the right of indemnity. In my view there is nothing in clause 12 which would modify the general equitable doctrine.³¹

In *Rothmore Farms Mansfield J*, when confronted with the same issue, found that the trust assets secured the indemnity as they existed from time to time. Mansfield J appears to have allowed equitable tracing into the hands of those in whom the assets were ultimately vested³². Equitable tracing is a very difficult topic and beyond the scope of this paper.

The reference in the decision of Anderson J in *Coates v. McInerney* to clause 12 of the deed raises issues about whether the trust deed can by its terms oust the right to indemnity. In South Australia the indemnity cannot be excluded³³. In New South Wales the better view is that it cannot be excluded³⁴. In Victoria the right to be indemnified can be excluded by the terms of the trust deed³⁵. This is why it may be possible according to the terms of the trust deed to limit the right of the trustee to follow assets over which the trustee might otherwise have a lien³⁶.

Notwithstanding whether or not a trustee may have a lien, the assets which trustee 1 held at the time the liability was incurred and then transferred to trustee 2 may be recoverable by the creditors of trustee 1 for a number of reasons:

- the creditors held security directly over those assets and the transfer was a breach of that security;
- trustee 2 knew that the Parcel 2 assets were depended upon by creditors for the advance of funds and was equitably bound to disgorge them when the claim was made against trustee 1;
- trustee 2 undertook to indemnify trustee 1 when the Parcel 2 assets were transferred;
- trustee 1 is an individual and the provisions of section 120 and 121 of the *Bankruptcy Act 1966* (Cth) could apply to allow the trustee in bankruptcy of trustee 1 to recover assets transferred for less than market value consideration³⁷ or where trustee 1 transferred the assets for the main purpose of avoiding the assets becoming available to meet creditors' claims;
- in the case of a corporate trustee the *Corporations Act 2001* (Cth) becomes relevant. Section 588FC, in relation to insolvent transactions (the company being insolvent at the time of the transaction), subsection 588FE(4) in relation to uncommercial transactions and subsection 588FE(5) in relation to avoiding creditors are the most relevant.

A liquidator of trustee 1 (a corporate trustee) may be successful in clawing back property transferred to trustee 2.

The position of a corporate trustee in relation to an undervalue transaction differs from that of an individual acting as a trustee because the '**uncommercial transaction**'³⁸ must have been entered into when the company was insolvent or was a transaction which caused it to become insolvent. By contrast an individual acting as a trustee is exposed for up to 4 years regardless of their state of solvency where the transfer is to an associate³⁹.

In relation to transactions intended to defeat creditors an individual is exposed forever⁴⁰. By contrast a company is exposed only for 10 years⁴¹.

³¹ at p.749-750 of 6 ACSR 748. See also *Rothmore Farms Pty Ltd v. Belgravia Pty Ltd* [1999] FCA 745; *Moyes v. J&L Developments Pty Ltd (No. 2)* [2007] SASC 261 and *Collie v. Merlaw Nominees Pty Ltd* [2001] VSC.

³² [1999] FCA 745 at paras. 182 and 184.

³³ per Debelle J in *Moyes v. J&L Developments Pty Ltd (No. 2)* [2007] SASC 261 at paras. 37 to 48.

³⁴ *JA Pty Ltd v. Jonco Holdings Pty Ltd* (2000) 33 ACSR 691 per Santow J at paras. 50 and 67. See also *Jacobs' Law of Trusts in Australia* (7th Ed) at p.2106.

³⁵ *RWG Management Ltd v. Commissioner for Corporate Affairs* [1985] VR 385 at 394-5.

³⁶ *Tindon Pty Ltd v. Adams and Window Concepts Pty Ltd* [2006] VSC 172.

³⁷ subsection 120 will allow the trustee in bankruptcy to recover back an asset transferred by way of a undervalue transaction to a related entity for a period of up to four years from the date on which the bankruptcy commenced.

³⁸ an '*uncommercial transaction*' is one that it might be expected a reasonable person in the company's circumstances would not have entered into having regard to the matters set out in subsection 588FB(1) of the *Corporations Act*.

³⁹ it is only beyond 4 years to 5 years that insolvency becomes an issue extending the clawback period.

⁴⁰ see *Trustees of the Property of John Daniel Cummins v. Cummins* [2006] HCA 6.

Trustee 2 may have a defence to the claim of the liquidator if it can show:

- it became a party to the transaction in good faith;
- there was no objective grounds for suspecting that trustee 1 was insolvent or about to become insolvent; and
- trustee 2 provided valuable consideration or changed its position in reliance on the transaction⁴².

As the controlling mind of trustee 2 is likely to be that of trustee 1 or they will be closely associated it is unlikely that this defence can be made out. It is possible that the third point could be satisfied if trustee 2 undertook the liabilities of trustee 1 associated with Parcel 2 assets. However, this may not be sufficient if the effect of the transfer is to make trustee 1 insolvent in any event.

The potential impact of section 197 of the *Corporations Act* needs to be considered. This provision imposes joint and several liability on Directors in respect of liabilities incurred by a corporate trustee when the trustee is not entitled to be fully indemnified out of trust assets because of:

- a breach of trust by the company;
- the company acting outside the scope of its powers as trustee;
- a term of the trust denying or limiting, the company's right to be indemnified against the liability.

In the case of a split of a trust none of these things is likely to occur. In transferring assets to the new trustee, trustee 1 will be acting within the terms of the trust deed (perhaps as amended). Nothing in the terms of the trust deed need limit the recourse of trustee 1 to the assets of the trust. However, if there is an explicit provision in the deed that does limit the right to be indemnified to those assets and there is no recourse to the assets held by trustee 2 there might be potential application of section 197. Arguably, however, the right to indemnity is limited as a matter of the general law to the assets actually held by trustee 1. If this is the case then it is the fact of transfer of the assets that has limited the recourse and not the terms of the trust deed.

5 TRUSTEE'S DUTIES

All trustees are subject to duties. In the case of a trustee of a discretionary trust that duty is to:

- consider the exercise of discretion from time to time or as required by the trust deed⁴³;
- not act arbitrarily or in capricious disregard of the trustees' power;
- not to delegate the decision making but exercise it personally;
- not act dishonestly or to commit a fraud on its power.

Nothing more is required of the trustee. It is not possible to conceive of a transfer of assets from trustee 1 to trustee 2 pursuant to the terms of the trust deed in itself as in any way in breach of the trustee's duties bearing in mind that it is the one trust relationship.

In any event beneficiaries of discretionary trusts have great difficulty in establishing standing to take action against trustees.⁴⁴

⁴¹ subsection 588FE(5) *Corporations Act*.

⁴² subsection 588FG(1) *Corporations Act*.

⁴³ I J Hardingham & R. Baxt 'Discretionary Trusts': (1st Ed) Butterworths (1975) pp.92-114.

⁴⁴ See generally: K. Schurgott: '*Some Trust Oddities*', paper delivered to the Taxation Institute of Australia's 20th National Convention (March 2004 Perth) pp.29-37 and also C. Call: '*Trusts in the Court*' paper delivered to the Taxation Institute of Australia's (NSW Division) Trust Intensive (November 2005) pp.50-62.

5.1 The Tax Return

One of the minor irritants of trust splitting is the need to have the trustees lodge an income tax return and BAS. The question also arises as to whether or not the trustees need separately to be registered for GST (if that is relevant in the circumstances).

Subsection 161(1) of the 1936 Act requires every 'person' to lodge a return of income when required to do so by the Commissioner. A 'person' is defined to include 'a person in the capacity of trustee of a trust estate'. This appears to require/allow each trustee to lodge a return of income in respect of the income derived from assets it holds in relation to the trust.

Notwithstanding this possibility nothing will happen without a tax file number. Can each of the trustees acquire its own individual tax file number?

Section 202B of the 1936 Act provides that a 'person' may apply to the Commissioner for issue of a tax file number. Based on the definition of 'person' each trustee appears to be entitled to apply. If the Commissioner is satisfied that the person's identity has been established the Commissioner 'shall issue' a tax file number to the applicant subject only to:

- the Commissioner being satisfied that the person already has a tax file number;
- there not being an interim notice.⁴⁵

It would appear that it is mandatory for the Commissioner to issue a tax file number if satisfied as to the applicant's identity. The exceptions should not apply. The legislation would appear to allow the separate trustee to obtain its own tax file number in respect of its role as trustee of the trust.

Are the trustees required to be separately registered for GST? An 'entity' includes a 'trust'⁴⁶. The trustee of a trust is taken to be an entity consisting of the person who is the trustee, or the persons who are the trustees, at any given time⁴⁷. An entity carrying on an enterprise that meets the registration turnover is required to be registered⁴⁸.

It would appear that the split trustees cannot be split for GST purposes. This would appear to be in contrast to the position for income tax. It poses a considerable difficulty for complying with the lodgement requirements in respect of BAS. From a practical perspective the Commissioner is likely not to complain if the trustees individually register.

6 SPLITTING DIFFERENT TYPES OF TRUSTS

6.1 Splitting Unit Trusts

Splitting works well for a discretionary trust because both trustees retain their discretion over the assets they hold and are able to distribute income or capital across the objects of the trust. They may, of course, acting properly and appropriately but not capriciously distribute in preference to one part of the family rather than another.

Splitting a unit trust is otiose. It gets you nowhere as there is no ability in a fixed interest unit trust to do anything other than distribute to the unitholders. If the unitholders and trustee agree to staple assets to particular units it is likely that there will be a resettlement or a CGT event will occur in respect of the asset or perhaps there will be a value shift with taxation consequences. This type of transaction is different to a split in the sense described above and raises many issues beyond the scope of this paper.

6.2 Splitting Hybrid Trusts

Hybrid trusts come in many shapes and forms. Broadly it can be said that there will be fixed entitlements (often expressed as unit entitlements) and non-fixed (discretionary) interests. What has been said about

⁴⁵ section 202BA 1936 Act.

⁴⁶ paragraph 184-1(1)(g) GST Act.

⁴⁷ subsection 184-1(2) GST Act.

⁴⁸ section 23-5 GST Act.

discretionary trusts applies with equal force to the discretionary entitlements. The fixed entitlements suffer from the same issues as those, which apply to unit trusts.

Because hybrid trusts vary enormously great care must be taken if applying the splitting procedure to such arrangements. Each case needs to be fully thought through.

Acts in all jurisdictions contemplate that trustees may be changed and indeed that different trustees may be appointed in relation to different assets of a single trust relationship⁴⁹.

7 CLONING – E1 AND E2 EVENTS

CGT event E1 happens when you create a trust over a CGT asset by declaration or settlement⁵⁰.

CGT event E2 happens if you transfer an asset to an existing trust⁵¹.

If the trustee of an existing discretionary trust seeks to split the trust by transferring an asset to be held by a co-trustee but in so doing effects a resettlement of the trust CGT event E1 will happen in respect of the asset so transferred. If the trustee seeks to effect a cloning by transferring the asset to another existing trust but fails to satisfy the provisions of subsection 104-60(5) then CGT event E2 will happen in respect of the asset transferred⁵².

7.1 The E1 and E2 Exceptions

CGT event E1 does not happen if the trust is created by transferring the asset from another trust, and the beneficiaries and terms of both trusts are the same⁵³.

CGT event E2 does not happen if 'you transferred the asset from another trust and the beneficiaries and terms of both trusts are the same'⁵⁴.

In the context of a cloning it is necessary to satisfy these requirements. The Commissioner of Taxation in his ruling TR 2006/4 *Meaning of the words, the beneficiaries and terms of both trusts are the same in paragraphs 104-55(5)(b) and 104-60(5)(b)* ('**the Ruling**') has concluded that these things do not have to be the same:

- the trustee;
- the name;
- the commencement date;
- the settlor;
- the trust property.

In the Commissioner's view the '**same**' means '**identical**'⁵⁵. However, the ruling rationalises the position of a different trustee and settlor on the grounds that if these changes were not possible effect could not be given to the provisions⁵⁶.

⁴⁹ ACT — subsection 6(5) Trustee Act 1925 (ACT)
 NSW — subsection 6(5) Trustee Act 1925 (NSW)
 NT — subsection 11(2)(b) Trustee Act (NT)
 QLD — subsection 12(2) Trusts Act 1973 (Qld)
 SA — subsection 14(2) and section 14A Trustee Act 1936 (SA)
 TAS — subsection 13(2) Trustee Act 1898 (Tas)
 VIC — subsection 42(1) Trustee Act 1958 WA - subsection 7(2) Trustees Act 1962 (Vic).

⁵⁰ subsection 104-55(1) 1997 Act.

⁵¹ subsection 104-60(1) 1997 Act.

⁵² In both cases the effect is to treat all of the property of the trust to new beneficiaries: *Buzza v. Comptroller of Stamps* (1951) 83 CLR 286 per Dixon J at 299-300 and see generally Dr M L Robertson: *Instruments of Variation of Beneficiaries: The Revenue has Tripped over Lord Simond's Foot* 25 Aus.TR (March 1996) 19 at pp.32-33.

⁵³ paragraph 104-55(5)(b) 1997 Act.

⁵⁴ paragraph 104-60(5)(b) 1997 Act.

⁵⁵ paragraph 104 TR 2006/4.

The contentious issues in the Ruling are about whether:

- the guardian or appointor need to be the same; and
- if the trustee of the original trust has made a family trust election or an interposed entity election the trustee of the new trust (the clone) must do likewise.

7.2 Guardian and Appointor

The Commissioner's view is that the identity of the appointor and successors must be the same for both trusts. This flows on to guardians and protectors if they are provided for in the deed⁵⁷.

The Commissioner quite rightly in the writer's view explains that a term of the trust is something which governs the relationship between trustee and beneficiaries⁵⁸. The Commissioner concludes that the identity of the appointor is an ingredient of the terms. He acknowledges the alternative view⁵⁹ but argues that enabling the appointor to differ is contrary to the purpose or object underlying the exceptions to CGT events E1 and E2. The Commissioner's rationale in this regard i.e. his grounds for restrictively interpreting the exceptions is discussed in detail below.

The writer believes that the alternative view is much to be preferred, and the identity of the appointor, is irrelevant to these considerations.

7.3 The Terms are the Same

The Commissioner expresses the view in the Ruling that 'same' in regard to the terms means that the terms of the trusts must have the same '*meaning and effect*'. It follows from this that the terms do not necessarily need to be identical i.e. copy tying will not necessarily work. Rather, the outcome from applying those terms must be the same. The same meaning '*identical or alike in all material respects*'. Whether two trust deeds have the same meaning and effect is a matter of interpretation of the deeds.

It can be expected that when a cloning approach is taken the two trust deeds will be so closely identical so as to be practically copy typed. However, it is critical to read and understanding the effect of the deed of the trust that is to be cloned and not simply assume that identical words means identical outcomes. Most often it will but it is not necessarily the case.

7.4 The Beneficiaries are the Same

An assumption that the words of the objects clause are the same means that the beneficiaries are the same is even more problematical. In particular, most discretionary trust deeds will have excluded beneficiaries or excluded classes of beneficiaries. These must be carefully considered as to the interplay between the two deeds. For example, it is commonplace in the Australian Capital Territory and New South Wales to exclude the trustee or trustees after there has been a change of trustees in order not to fail, one of the requirements of subsection 54(2) of the *Duties Act 1999* (ACT) and subsection 54(3) of the *Duties Act 1997* (NSW)⁶⁰.

By way of illustration, the trustee of Trust No. 1 is X Co and it is excluded as a beneficiary when an additional trustee is appointed. It will be necessary for the Deed of Trust No. 2 to exclude the trustee of Trust 1 as a beneficiary of Trust 2 subject to the contingencies occurring in respect of Trust 1. That is, if an additional trustee is appointed to be a trustee of Trust 1 then the trustees of Trust 1 from time to time cannot be beneficiaries of Trust 2.

At the same time Trust 2 will have an identical exclusion clause as that in Trust 1. Accordingly, it will be necessary to amend the Deed of Trust 1 to exclude the trustee of Trust 2 from time to time subject to the contingencies occurring in relation to Trust 2.

⁵⁶ paragraphs 150 and 183 to 187 TR2006/4.

⁵⁷ paragraph 19 TR2006/4 and Examples 10 and 11.

⁵⁸ paragraphs 146 to 151.

⁵⁹ paragraphs 192 to 192.

⁶⁰ nominal duty will not be applied if the beneficiaries include the continuing trustees remaining after the retirement of a trustee; or the trustees after the appointment of a new trustee.

These interplays can be torturous. None more so than the issue signalled by the Commissioner in his document called '*Trust Cloning*' released on 4 December 2007 foreshadowing an addendum to TR2006/4.

Three passages from that document require careful analysis:

'One example shows how careful practitioners must be in 'cloning' trusts that exclude a particular office holder from benefiting under the trust. For example, if the original trust excludes the trustee from benefiting and the new or cloned trust does likewise, but the two trusts have different trustees, then the two trusts are not the same and therefore the exception does not apply. See A TO Interpretative Decision ATO ID 2006/318.

Another example shows the difficulties of 'cloning' a discretionary trust with a widely- drawn beneficiary clause. For example, it may not be possible to clone a trust with named beneficiaries and a clause that also includes as a beneficiary any trust in which a named beneficiary has an interest (including as a potential object). Including this same clause in both trusts will result in the trustee of the new or 'cloned' trust being a beneficiary of the original trust; and the trustee of the original trust being a beneficiary of the new trust.

Therefore, the beneficiaries of the original trust will be the named beneficiaries and trustee of the new trust; and the beneficiaries of the new trust will be the named beneficiaries and the trustee of the original trust. But because it is not possible for a trust to be a beneficiary of itself, the two trusts do not have exactly the same beneficiaries and the exception therefore would apply.'

The fact situation set out in Interpretative Decision 2006/318 is a simpler example of beneficiary exclusion than that described above i.e. one necessary to deal with the New South Wales stamp duty issue.

In ATO ID 2006/318 the settlors of both trusts were excluded as beneficiaries of their respective trusts. The Commissioner is correct in his conclusion that the trust objects are not the same (he expresses it as the terms not being the same) because the settlor of Trust 1 can be a beneficiary of Trust 2 and vice versa. It would be necessary to exclude the settlors of the respective trusts from the objects clauses of both trusts.

The Commissioner makes the observation:

'... the outcome would have been different if, for example, the trust deed or the second trust had omitted the exclusion clause and added a clause excluding the father from taking any benefit under the trust including by loan or any other indirect means. In that case the beneficiaries and terms of both trusts would have been the same because the father would have been excluded from both and the mother from neither.'

This 'advice' might be correct if it was not for other reasons necessary in relation to Trust 2 to exclude the settlor (as with the stamp duty example described above). In any event it is a simple example because the identity of the settlor is fixed unlike that of the trustee, who may be a different person from time to time.

The second instance mentioned in the Trust Cloning document is much more difficult. If the Commissioner's view is correct it could mean that it is never possible to clone a discretionary trust which has the usual wide range of objects.

The reasoning goes like this – the beneficiaries of Trust 1 must include all of those persons and entities that can benefit under Trust 2. The beneficiaries of Trust 2 must include all of those persons who can benefit under Trust 1. Trust 1 cannot be a beneficiary of itself nor can Trust 2 be a beneficiary of itself. Consequently, Trust 1 and Trust 2 do not have the same beneficiaries as each other.

Reductio ad absurdum is logical reasoning whereby an assumption leads to a formally absurd result demonstrating that the original premise was false. The Commissioner's reasoning does not quite arrive at a formal contradiction but it is heading that way. If this result is correct Parliament must have intended that the relief provided by paragraphs 10458(5)(b) would have been limited to discretionary trusts with only individuals and companies as objects. Parliament must be taken to have known that modern discretionary trust deeds are drafted with the utmost flexibility in mind. Consequently, if it was intended to give effect to this limitation the legislation might be expected to address it squarely rather than creep in the back door.

The Commissioner takes solace in his observation that the policy intent of the forerunner to paragraphs 104-60(5)(b) was to 'provide an exception only in respect of the transfer of an asset as a result of a change of trustee of a single trust'. This view is said to derive out of the Explanatory Memorandum to *Taxation Laws Amendment Act (No 2) 1994*.

To follow this through properly it is necessary to consider the history of paragraph 160M(3)(a) in the 1936 Act. As it was originally introduced it provided:

'Without limiting the generality of subsection (2) a change shall be taken to have occurred in the ownership of an asset by –

(a) a declaration of trust in relation to the asset under which the beneficiary is absolutely entitled to the asset as against the transfer.'

The amended version (including a new subsection (3A)) provided:

'(a) the creation of a trust, by declaration or settlement, over the asset, other than where either:

(i) all of the following sub-subparagraphs apply:

(A) the person who owned the asset immediately before the creation of the trust is the sole beneficiary of the trust;

(B) that person is absolutely entitled to the asset as against the trustee or would, but for a legal disability, be so entitled;

(C) the trust is not a unit trust; or

(ii) all of the following sub-subparagraphs apply:

(A) the trust is created by the transfer of an asset to a trust from another asset;

(B) the beneficiaries of the trusts are identical;

(C) the terms of the trusts, including the interest of each beneficiary in the income and corpus of the trusts, are identical;

(3A) For the purposes of paragraph (3)(a), the transfer of an asset to a trust is taken to be the creation, by settlement, of a trust over the asset.'

The Explanatory Memorandum made the following relevant observations:

'Purpose of amendments

6.2 The amendments make clear the circumstances in which subsections 160M(1A) of the Act will have the effect that a change in the legal ownership of an asset is not to be treated as a change of ownership of an asset for CGT purposes. They will also provide that a declaration of trust over an asset owned by a person or the transfer of an asset to a trust will be a change of ownership of the asset unless the previous owner is absolutely entitled to the asset as against the trustee and the trust is not a unit trust. There will be no change of ownership if there is a mere change of trustee without any change at all in the trust arrangements including the interest of each beneficiary in the trust income and assets [Clause 29].'

It is the last sentence that apparently gives buoyancy to the Commissioner's view that the terms of paragraphs 104-55(5)(b) and 104-60(5)(b) should be interpreted strictly. In this view the amendment to introduce these notions was intended to do no more than allow for an exclusion where there was a mere change of trustee⁶¹. It is acknowledged by the Commissioner that the words travel further than the sentiment expressed in the Explanatory Memorandum. However, it seems to be suggested by the Commissioner that the Parliament did not intend to go further than the objective explained in the last sentence in the passage from the Explanatory Memorandum. It follows on this reasoning as Parliament

⁶¹ This is also expressed in paragraph 197 of TR 2006/4.

has overshoot the mark the Commissioner must be vigilant in reining in what appears to be otherwise a sensible measure.

The thinking of the Australian Taxation Office appears to be that the intention of Parliament was to introduce a very limited exclusion to what would otherwise be a taxable event. This thinking is encapsulated in the following observation from the Ruling (at paragraph 97):

'... it ensures that a transfer of assets between two trusts that have the same beneficiaries and terms is treated in the same way as a change of trustee of a single trust: indeed, these two scenarios could be regarded as mere variations of each other. It complements paragraph 104-10(2)(b) of the ITAA 1987 which says there is no change of ownership merely because of a change of trustee.'

The statement in the Explanatory Memorandum harbours some very imprecise views of the nature of a trust. The new trust is not and cannot be the same trust 'arrangements' because otherwise it would be the same trust but a different (and new) one. A trust is a relationship between trustee (or the trustee's successor) and the beneficiaries (or class of beneficiaries) in relation to particular trust property. Where there is a sufficient change in the relationship between trustee and beneficiaries in relation to the trust property there will be a new Trust (a resettlement) and fertile ground for CGT event E1 to operate. Where there is a change of trustee within the terms of the trust arrangement but no change of trustee within the terms (or of the beneficiary) there is nothing to trigger CGT event E1 (or E2). The exception to CGT event A1 is necessary because subsection 960-100(2) of the 1997 Act provides that:

'The trustee of a trust ... is taken to be an entity consisting of the person who is the trustee, or the persons who are the trustees, at any given time.'

For the purposes of subsection 104-10(2) the trustee of the trust is one entity and a different person acting as trustee under the same trust terms and conditions (and taking on that office pursuant to those terms and conditions) will be a different entity. If the first trustee transfers the trust property to the second trustee there will be a change of legal ownership from one entity to another entity. For this reason paragraph 104-10(2)(b) is necessary to prevent the operation of CGT event A1.

CGT event E1 happens when there is a different trust relationship between the trustee (who may or may not be the same person) and the trust property. There must be a sufficient change in the terms of the trust so that the relationship is a different one. If there is a different trust relationship there is a different trust and in consequence a different entity for the purposes of subsection 960-100(2). It must be questioned why CGT event A1 does not operate.

Or, putting it another way, why was it necessary to have CGT event E1. The answer is not immediately obvious without recourse to the ranking of CGT events rule contained in section 102-25 of the Act.

It is explained in the Trust Cloning document that *'it was not designed to provide an exception or a rollover in respect of the transfer between two separately existing trusts'*.

The fact that this is exactly what the words of paragraph 104-60(5)(b) say and provide for:

'CGT event E2 does not happen if:

...

(b) you transferred the asset from another trust and the beneficiaries and terms of both trusts are the same.'

It probably cannot get much clearer than that (albeit it is difficult to know why the word 'to' was not used in place of the word 'from').

The Explanatory Memorandum in paragraph 6.14 had this to say:

'A further exception applies where there is a settlement of an asset to a trustee to hold on terms of an existing trust where the only change that occurs is a change of trustee. The effect of this exception is that where property is transferred from one trustee to another to be held under the same trust arrangements without any change at all in the trust arrangements including the interest of each

beneficiary in the trust income and assets, there will be no change of ownership for CGT purposes'
[Clause 30 — new subparagraph 160M(3)(a)(ii)].

This passage seems to be totally confused. It does concentrate on a mere change of trustees '*under the same trust arrangement*'. However, it uses the language of a single trust only. It would more suitably provide the background explanation for paragraph 104-10(2)(b) of the 1997 Act. A change of ownership which would otherwise trigger CGT event E1 does not occur '*merely because of a change of trustee*'.

This brings us to the point that there is no longer any need for the Commissioner's interpretation of the objective sought to be achieved by paragraphs 104-55(5)(b) and 104-60(5)(b) because that work is now done by paragraph 104-10(2)(b).

It is now time to return to the Commissioner's second conundrum in the Trust Cloning document. The Commissioner will, it seems, press the Court that a transfer between trusts which have the same terms and beneficiaries apart from themselves will not attract the exclusion in paragraph 104-60(5)(b). The exclusion is unavailable because a trust cannot be a beneficiary of itself. It would not surprise the writer if a Court concluded that this is such an absurd result that it cannot have been intended and that the legislation must be read to exclude the self-referencing requirement.

What if the Commissioner is right? Can it be dealt with? Is it as simple as the following?

In trust deed 2 these definitions are to be found:

- '**beneficiary**' has the same meaning as in trust deed 1;
- '**default beneficiary**' has the same meaning as in trust deed 1; and
- '*for avoidance of doubt no person may benefit under the terms of this trust unless that person is a beneficiary under the terms of trust deed 1 and it is intended that the beneficiaries of this trust shall be the same as the beneficiaries of trust deed 1 so that the trusts may satisfy the requirements of paragraph 104-60(5)(b) of the Income Tax Assessment Act 1997.*'

Will this approach succeed? As trust 1 cannot be a beneficiary of itself trust 1 cannot be a beneficiary of trust 2. Trust 2 cannot be a beneficiary of itself but can trust 2 be a beneficiary of trust 1? If trust 2 were to be a beneficiary of trust 1 then it would be necessary for trust 2 to be a beneficiary of itself. However, it cannot be a beneficiary of itself and in consequence it cannot be a beneficiary of trust 1.

The referencing back to the scope of the objects clause of trust 1 would appear to work.

Of course, where this paper has referred to trusts being a beneficiary of a trust it really means to refer to the trustee being the beneficiary in its capacity as trustee of a particular trust.

It should also be noted that the exclusions required to avoid the adverse application of subsection 54(3) of the *Duties Act 1997* (NSW) relate to trustees in their own right and not in their capacities as trustees of trusts. Accordingly, the care and consideration suggested in the earlier example is still required. The referencing back to the trustee of the original trust does not overcome that problem.

7.5 The Davies Paper

Glenn Davies, Senior Tax Counsel at the ATO presented a paper at a Seminar held by the Taxation Institute in Melbourne on 29 April 2008 entitled '*Some CGT aspects of trust cloning — an ATO perspective*'⁶².

Glenn makes some very telling points about the lack of structure surrounding the exceptions to CGT event E1 and E2 when they operate by transfer between trusts. Unlike the rollover rules found elsewhere in the tax legislation there are no provisions, which maintain cost bases, retain pre-CGT status or treat the asset as having been acquired for discount purposes at the time acquired by the first trustee⁶³.

⁶² see also the ATO's Tax Agent Portal email bulletin Issue P7/08, 7 May 2008.

⁶³ see pages 6-7 of the paper.

The paper goes on to set out detailed but not exhaustive examples of instances where copy typing the trust deed will not ensure that the terms and objects of the two trusts will be the same. These further examples show how very difficult it is to get the replication right. Some of the examples are:

- **notional settlors** – where a person has contributed to the trust by way of settlement after establishment of the trust that individual will often be excluded from the objects clause (as a settlor). That person would need to be excluded from the replication trust. It is mentioned in the paper that the original trust may itself be a notional settlor of the new trust by virtue of the transfer of assets to the new trust at under value;
- **different trustees** – where there is a clause preventing the trustee from benefiting under the trust then that trustee must be excluded from the objects clause of the replication trust;
- **a discretion to appoint beneficiaries** – where the trustee of the original trust has a discretionary power to appoint additional beneficiaries and the beneficiaries of the replication trust are any beneficiaries of the original trust. It is said that the trustee of the original trust has a power that the trustee of the new trust does not and thus the terms are not the same.

In relation to the self-referencing proposition set out at pages 20 and 21 of this paper Mr Davies had this to say:

'Another possible approach involves the deed for the new trust providing that the term 'beneficiary' has the same meaning as in the deed for the original trust. The deed for the new trust also makes it clear that no person can benefit under its terms unless that person is a beneficiary under the terms of the original trust; and the deed says it is intended that beneficiaries of the new trust shall be the same as the beneficiaries of the original trust so that the trust may satisfy the requirements of paragraph 104-60(5)(b) of the Income Tax Assessment Act 1997.

This seems to us to ensure the original trust is not a beneficiary of the new trust (because the original trust cannot be a beneficiary of itself and therefore cannot be a beneficiary of the new trust).

However, it is not clear to us how this approach actually prevents the new trust being a beneficiary of the original trust. We understand the argument to be that it ensures the new trust cannot be a beneficiary of the original trust unless it was a beneficiary of itself which it cannot be. But it is not clear to us, unless some sort of disclaimer is inferred, that any term in the deed for the new trust can limit the beneficiaries of the original trust (notwithstanding the general intent as expressed in the deed for the new trust is that the beneficiaries of both trusts be the same). However, the issue is an interesting one and we are continuing to examine it.'

8 CLONING – TRACING ASSETS

When there is a transfer of assets from trust 1 to trust 2 it may be for no consideration or for full market value consideration. In either event, if the exception to CGT event E1 applies then the capital gain otherwise arising will be disregarded.

It should be noted, of course, that if the assets transferred are depreciable plant or trading stock the CGT exception will not prevent tax effects.

If the transfer is for market value there is no basis for claw back of the asset or value because of the operation of the trustee's lien over the assets to secure its indemnity nor, if the trustee is an individual, will the trustee in bankruptcy be able to recover back the asset under section 120 of the *Bankruptcy Act*.

However, section 121 would allow the trustee in bankruptcy to recover the asset transferred if the main purpose in entering into the transaction was to ensure that the asset did not become available to the trustee's creditors. The trustee in bankruptcy would need to pay to the transferee (here trust 2) the value

of any consideration given for the asset⁶⁴. This could be critical if a growth asset has been transferred to trust 2. The trustee in bankruptcy would benefit from that growth⁶⁵.

If trustee 2 has not provided market value to the trustee 1 (where an individual) for the asset transferred, the trustee in bankruptcy of trustee 1 may recover back the undervalue utilising section 120 of the *Bankruptcy Act*. Section 121 also operates in the way described in the last paragraph.

More significantly, where the asset transferred is one over which trustee 1 has a lien to secure its indemnity the trustee in bankruptcy of trustee 1 may recover back the value of the asset (at least when the trustee is incapable of giving away its entitlement to indemnity (as is the case in South Australia and may be the case in New South Wales)). The principles considered on pp.7-9 of this paper apply with equal effect in relation to a cloning.

If the trustee is a corporate trust the same issues arise as discussed on page 9 above in relation to a split.

8.1 Trustee's Duties

The actions of trustee 1 are more likely to come under question when it transfers assets to trustee 2 for no consideration. The question which arises here is whether the trustee purported to appoint capital of the trust in furtherance of a power bestowed on it by the deed or acted outside the terms of the deed and transferred property at an undervalue or for no consideration.

In the first instance where trust 1 appoints capital to trust 2 it would be very difficult (near impossible) to assert breach of duty. Where there is a transfer of the assets without relying on the discretionary powers of the trustee there may be more concern. However, bearing in mind that the beneficiaries are exactly the same it would appear unlikely that there would be a successful action by a beneficiary (even a residuary beneficiary).

8.2 Statute of Frauds

A reminder only to consider the relevant version of the Statute of Frauds in your State or Territory.

In Victoria section 53 of the *Property Law Act 1958* (Vic) requires a other disposition of land to be in writing and section 52 will void a conveyance of land or interest in land unless by deed. In addition, a declaration of trust '*respecting any land or any interest therein*' or '*a disposition of an equitable interest or trust*' not necessarily in respect of land must be in writing (section 53). Section 201 of the *Civil Law (Property) Act 2006* (ACT) and sections 23 and 54A of the *Conveyancing Act 1919* (NSW) provides similarly in respect of land and interests in trusts in the Australian Capital Territory and New South Wales. In Queensland the disposition of land must be in writing (section 59 *Property Law Act 1974* (Qld)).

If the transfers to trust 2 are of land or interests in a trust then they must be reduced into writing (or a deed).

8.3 Stamp Duty

The very great difficulty in addressing this topic is a result of each of the eight jurisdiction having different approaches. However, they can be broadly broken down into three groups:

- Transactional jurisdictions which do not require an instrument – the Australian Capital Territory, New South Wales, Victoria and Tasmania;
- Instrument jurisdictions – South Australia, Western Australia and the Northern Territory;
- Queensland

This paper will only deal with stamp duty in the transactional jurisdictions.

⁶⁴ subsection 121(5) *Bankruptcy Act 1966* (Cth).

⁶⁵ a transfer to an entity caught by Division 4A of the *Bankruptcy Act* would be even worse because the transferee must prove in the bankrupt estate for recovery of any value paid: section 139H *Bankruptcy Act*. However, this provision is unlikely to apply to a transfer under a cloning because not only must the transferor control the recipient trust but must also provide personal services to the transferee at an undervalue.

In the transactional jurisdictions it does not matter whether there is a written instrument or not.⁶⁶ The legislations impose duty on dutiable transactions in respect of dutiable property. Dutiable transactions include:

- A transfer of dutiable property;⁶⁷ and
- A declaration of trust over dutiable property.⁶⁸

A declaration of trust is defined in practically the same way throughout these jurisdictions:

*'declaration of trust means any declaration (other than by will or testamentary instrument) that any identified property vested or to be vested in the person making the declaration is or is to be held in trust for the person or persons, or the purpose or purposes, mentioned in the declaration although the beneficial owner of the property, or the person entitled to appoint the property, may not have joined in or assented to the declaration.'*⁶⁹

It appears from the cases that a trust can be created in one of two ways, transfer or declaration.⁷⁰ Consequently it can be expected that creation of a trust in these jurisdictions even by deftly arranging for confirmation that could satisfy the requirement that there be writing in respect of land will be subject to duty. Even where parol evidence will suffice the transaction is likely still to be caught.

If the trust deed were to provide the trustee with a power to set aside for all of the objects of the original trust assets of the trust on a separate trust which is governed by the same terms, conditions and powers as those contained in the original trust instrument, it must be questioned whether anything at all has happened when the trustee takes action under this power. Arguably there is no separate trust.

If a new trustee were to be appointed to the 'second trust' then, if one subscribes to the new trustee new trust school of thought a new trust springs into existence. Resort might then be had to the relief granted to replacement trustees. It is a desirable result, but, unfortunately, the writer's view is that there is no new trust on appointment of a replacement trustee.

Another approach to the problem is to establish a second but identical trust as to terms and objects by conventional settlement. The trustee of Trust A and Trust B is the same. The power of advancement would be expressed so as to allow the trustee to signal by action eg. by keeping a separate set of accounts that the particular assets are held on the terms of Trust B.

Where a person holds property on trust for another the usual way to evidence that action is to make a declaration that one is doing so. 'Declaration' suggests a statement, whether written or oral. A passive act effected in accordance with the terms of the trust deed is arguably not a declaration (in this case the action signalling that the assets are held on the terms of a different but identical trust).

Unfortunately these arguments are not very convincing. There appears to be only two ways of establishing a trust – settlement or declaration. If neither of these occur there is no separate trust.

Further, the trust must be evidenced in writing if it is in respect of land. Not that that matters – the transactional jurisdictions do not need writing to impose duty.

The writer is pessimistic about stamp duty in these jurisdictions.

⁶⁶ Section 9 *Duties Act 1999* (ACT); section 10 *Duties Act 1997* (NSW); section 9 *Duties Act 2000* (Vic); section 8 *Duties Act 2001* (Tas).

⁶⁷ Paragraph 7(1)(a) *Duties Act 1999* (ACT); paragraph 8(1)(a) *Duties Act 1997* (NSW); paragraph 7(1)(a) *Duties Act 2000* (Vic); paragraph 6(1)(a) *Duties Act 2001* (Tas).

⁶⁸ Subparagraph 7(1)(b)(ii) *Duties Act 1999* (ACT); subparagraph 8(1)(b)(ii) *Duties Act 1997* (NSW); subparagraph 7(1)(b)(i) *Duties Act 2000* (Vic); subparagraph 6(1)(b)(ii) *Duties Act 2001* (Tas).

⁶⁹ Section 6 *Duties Act 1999* (ACT); subsection 8(3) *Duties Act 1997* (NSW); section 7(4) *Duties Act 2000* (Vic); subsection 6(3) *Duties Act 2001* (Tas). The declaration of trust head of dutiable transaction in subparagraph 7(1)(i) of the *Duties Act 2000* (Vic) is slightly different because it requires the specification of the property subject of the trust in the declaration. This is probably saying no more than that the property must be identifiable.

⁷⁰ In *Commissioner of State Revenue v Lam & Kym Pty Ltd* [2004] VSCA 204 (15 November 2004), Mr Merralls for the respondent had argued that the power to appoint property of the trust to be held on the terms of a separate trust was a special power of appointment and its exercise giving rise to a trust relationship was neither a settlement or declaration. The argument was rejected by the Court of Appeal which reiterated that there existed only the two means of creating a trust.

8.4 Family Provision Legislation

It may seem to be from left field and it may also appear to be of limited application but when cloning particular attention needs to be paid to the family provision legislation in the relevant State or Territory. This is an example only of how alert one must be to extraneous effects of transferring assets on cloning.

In New South Wales this is the *Family Provision Act 1982* (NSW). The New South Wales has what would appear to be unique provisions concerning property which has been alienated by the deceased in the 3 year period prior to death – the notional estate⁷¹.

The decision in *Karalee v. Burnbridge*⁷² is instructive as to the breadth of the notional estate provisions. In that case the Court found that the failure of the deceased (Mr Hyland) to cause a founder of a Liechtenstein stiftung to revoke a by-law of the stiftung which effectively vested property in a person other than the claimant was sufficient to trigger a claim.

In the context of cloning, if property is moved from trust 1 to the separate control of trust 2 by a person who later dies, a claimant against the deceased's estate may be successful in recovering back the funds under the *Family Provisions Act*. Every matter of this kind will be different. It is not meant to suggest that there will always be a successful claim. All that is suggested is that when steps are taken to transfer property from trust 1 to trust 2 a weather eye be kept for a potential application of these rules and other left field issues, which could arise.

⁷¹ section 7 and sections 21 to 29 *Family Provision Act 1982* (NSW).

⁷² [1998] NSW SC111.