

**10 August 2018**

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By email: Peter.hawkins@ato.gov.au

Dear Mr Hawkins

**Draft Taxation Determination TD 2018/D3**

**Income tax: will a trust split arrangement of the type described in this draft Determination cause a new trust to be settled over some but not all assets of the original trust with the result that CGT event E1 in subsection 104-55(1) of the Income Tax Assessment Act 1997 happens?**

The Taxation Committee of the Business Law Section of the Law Council of Australia (**Committee**) welcomes the opportunity to make a submission in relation to *Draft Taxation Determination TD 2018/D3 (Draft TD)*.

**Summary**

1. We are concerned that the Draft TD is internally inconsistent and does not reflect the law.
2. The Draft TD sets out a description of a trust split arrangement which includes elements not necessarily typical of such arrangements.
3. It then reaches conclusions about that arrangement in reliance on an expected outcome of a challenge by an aggrieved beneficiary. That outcome, and the conclusion drawn from it, are not only unsupported by any reasoning, but are contradicted by:
  - the very terms of the arrangement as set out in the sixth dot point of paragraph 2 and the ninth dot point of paragraph 10; and
  - an authority relied on in the Draft TD at paragraph 31.
4. The reasoning in the Draft TD could be applied more widely as it can be applied to any appointment of a new trustee who may exercise discretions in a different manner to the previous trustee. It is unclear what arrangements would be covered by the Draft TD if the trust split arrangements are not on all fours with the description in the Draft TD.

5. If subsequent to the trust split arrangement, actions were taken to establish a new charter of rights over Capital Gains Tax (**CGT**) assets held by either the original trustee or the separate trustee, we agree that then, but only then, that it is possible that CGT event E1 happens in respect of those assets.

## Discussion

6. Before moving to the substance of the Draft TD, it may be useful to restate some fundamental characteristics of trusts:
  - (a) a trust is not an entity, a trust can be described, as in the draft:
    - (i) as a relationship; or
    - (ii) an obligation.
  - (b) a trust continues despite any changes to:
    - (i) the trustee;
    - (ii) the trust property;
    - (iii) the beneficiaries arising out of the terms of the trust; or
    - (iv) the terms of the trust when amended in accordance with those terms, so long as the amendments fall short of creating a new charter of rights.
7. The term “trust split”, is a misleading misnomer, a trust is not an entity that can be split. What happens is some trust assets are held by a separate trustee on the same trusts as were established by the original trust deed, effectively the trust property is divided but remains subject to the same trusts.
8. Usually under a standard discretionary trust there will be:
  - (a) a class of mere objects who have no legal or equitable interest in the property of the trust unless and until the trustee exercises a discretion in their favour. They do have rights of due consideration and due administration, but these are not rights in respect of the property of the trust; and
  - (b) a class of “true” beneficiaries, often called takers in default, who have vested but contingent interests in the property of the trust, which may be defeated by the terms of the trust, e.g. failure to survive to the vesting date, or the exercise of the trustee’s discretion.
9. The mechanics of a trust split are accurately described in paragraph 2, although in many cases separate Appointors are not appointed nor are the rights of indemnity always released over the transferred assets.
10. The discussion in paragraphs 14 to 25 may be accepted as accurate.
11. The critical part of the reasoning in the Draft TD commences at paragraph 26 of the Explanation. The second sentence contains an assumption that is not necessarily correct; in many trust splits the intent is that there is to be no change in those who can benefit, the only change is in the identity of the person appointed as a separate

trustee of part of the trust property who has power to exercise discretions as to who will benefit.

12. It is perfectly correct that the original trustee will have no fiduciary obligations in respect of the assets transferred to the separate trustee, that happens whenever assets are transferred by the trustee whether on vesting or on exercise of an overriding power.
13. It is also perfectly correct that the separate trustee will have no fiduciary obligations in respect of the assets retained by the original trustee.
14. There can be no fiduciary obligations for a trustee over assets in which it has no interest, that simply follows from the nature of a trust.
15. The crucial issue is that both the original trustee and the separate trustee will have precisely the same fiduciary obligations in respect of the trust property they respectively hold.
16. The references to rights of indemnity are not relevant. Those rights are personal to a trustee arising from the personal liability of that trustee. A trustee cannot have personal liability for the acts of another or arising from property held by another. It follows there is no right of indemnity in that case. If the original trustee waives its rights of indemnity over assets transferred to the separate trustee that is a personal matter.
17. Paragraph 27 then draws a conclusion that there are two distinct trust funds. That is obviously so. It is also irrelevant. Conflating a trust fund, or more accurately for tax purposes a trust estate, with a trust borders on treating a trust as an entity by the implicit conclusion that the existence of two trust funds must mean a new trust has been created.
18. CGT event E1 happens when a new trust is created over a CGT asset by declaration or settlement. The test is the creation of a new trust not the existence of more than one trust fund.
19. Once it is recognised there can be one trust, that is the same relationship or obligations in respect of two funds, the practical difficulties referred to in paragraph 28 fall away. Section 97 of ITAA 1936 does not refer to trust funds, it refers to trust estates. While the term is undefined, as set out in the passage from Commercial Nominees cited at paragraph 20, it directs attention to the assets held by a trustee and provides for the taxation consequences for a beneficiary entitled to the income of a trust estate, that is arising from those assets.
20. Paragraph 29 continues the reference to actions concerning the separate trust funds and concludes there is no longer a single trust fund. Again, that is correct, but irrelevant and the supposed practical difficulties do not exist.
21. Paragraph 30 states that a useful check on the analysis set out above in the draft can be obtained by considering a potential challenge by an aggrieved beneficiary after the appointment of a separate trustee.
22. Paragraph 31 states that the classes of beneficiaries remain constant “as a matter of form”; it is not a matter of form, it is the legal and equitable effect of the terms of the trust.

23. Paragraph 32 refers to a court ascertaining the purposes for which the discretionary powers have been vested in each trustee by reference only to reasons for or object of the re-organisation.
24. The footnote to paragraph 32 refers to four well known decisions. The first, *Byrnes v Kendle* (2011) 243 CLR at 275 [59] is discussing the intention to create a trust, not the purpose for which the trust is created. Nevertheless, it is a valuable reminder that it is the manifestation of intention that is to be considered and not the subjective intentions.
25. The passage in *Schmidt v Rosewood Trust Ltd* [2003] 2 AC 709, [31] deals with the construction of certain terms of the trust by reference to the surrounding circumstances when it was made; it is not authority for the proposition for which it is cited.
26. The passage cited from *Karger v Paul* [1984] VR 161, 175 refers to matters which the trustee is entitled to take into account, it is not authority that extrinsic evidence may be permitted of the subjective reasons to the re-organisation.
27. Finally, in *Hartigan Nominees Pty Ltd v Rydge* (1992) 29 NSWLR 405 at 429 an explicit distinction is drawn between the wishes of the settlor that may be taken into account by a trustee and the purposes of the trust as appearing from its terms. See also *Thomas on Powers* G Thomas, OUP 2<sup>nd</sup> Ed at 9.03.
28. It is submitted that the four cases establish that a court will have regard to the purposes for which the trust was established as manifested in its terms. This will be important if an allegation of fraud on power is made.
29. *Karger v Paul* and *Hartigan Nominees* give guidance as to matters the trustee is entitled and, in some cases in discharge of its duty of due consideration, is bound to take into account.
30. The conclusions in paragraph 33 do not follow; the purpose for which the trust is established which may be summarised as enabling the trustee for the time being to exercise its discretion as to which beneficiaries are to benefit and to what degree.
31. The fact that after taking into account the matters that the original and separate trustees are entitled or obliged to do, they may come to different decisions does not mean that the powers and discretions have different purposes, the purposes remain the same, the implementation of those purposes is what differs.
32. If a court were to uphold a challenge to the exercise of a trustee's discretion, it would not be because it was inconsistent with the subjective intentions of the parties, it could only be that the powers had been exercised beyond the scope of the trust deed, for example to confer a benefit on a non-beneficiary, or that the trustee had failed in its duty to give due consideration to the beneficiaries, see *Karger v Paul* at 175 as to the duty of real and genuine consideration.
33. Applying the test set out in the passage from *Breckler* cited in footnote 20, it must be doubted whether the challenge could succeed.
34. The fallacy of the reasoning in paragraph 33 and the conclusion in paragraph 34 can be readily demonstrated. If such a new trust had been created then the trustee would have no power to give consideration to Ben or Holly or to make any distribution to

them despite the terms of the trust binding on the trustee. A further, and more bizarre consequence, would be that if the trustee failed to exercise a discretion then any terms of the trust deed conferring benefits on Ben and Holly would be of no effect. How could that be so when, as set out in paragraph 2, the rights obligations and powers of the trustees and beneficiaries remain governed by the one deed?

35. The fallacy may be expressed in another way; it does not logically follow that if the trustees have power to benefit one beneficiary or one class of beneficiaries they do not have power to benefit any other beneficiary or class of beneficiaries. That must be so when the governing document expressly gives the trustee the power to exercise the discretion in favour of any one or more of the beneficiaries.
36. However, if by the subsequent exercise of powers, the assets held by the original trustee or by the separate trustee, become subject to a new charter of rights, then, and only then, will CGT event E1 happen.
37. In addition to the substantive flaws outlined above, we also query the effectiveness of the approach taken in the Draft TD in providing any meaningful precedential Australian Taxation Office view for its personnel for the purposes of PS LA 2003/3.
38. In particular, having regard to the broad range of necessary amendments to family trust deeds and trust structures that can arise out of changed family circumstances, the draft TD's identification of what constitutes a "trust split" and the examples which are given are more likely to cause confusion than provide certainty as to what is the intended application of the law.

If you would like to discuss any of the above, in the first instance please contact Clint Harding on 02 9226 7236 or [charding@abl.com.au](mailto:charding@abl.com.au) .

Yours sincerely



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