

## Tax Alert May 2011

### Amending trust deeds - is it really worth it!

Recent case law has again brought into focus the consequences of amending trust deeds, and it's not just a tax problem, but could also involve stamp duty.

Most practitioners that have clients with trust deeds rarely think twice about amending a deed because of a client's instruction. In many cases, the practitioner may also recommend a change. However, very few practitioners seem to be aware of the catastrophic consequences that can befall a client, even on the most innocuous change!

The recent decision in *FCT v Clark* clearly illustrates the ease with which the ATO can take the view that changes to trusts, such as amending deeds, creates a new trust.

The life-cycle of a typical trust estate comprises its establishment and must include its vesting or termination date, which is usually no longer than 80 years. During the course of its life, the deed establishing the trust estate may be varied or amended.

However, the effect of any change must be analysed in the overall framework of the trust relationship to ensure that the character of the trust remains true to its original form. Otherwise, it will have been resettled, or in other words, be a new trust in place of the old one, or at least not be the same continuing trust.

In very general terms, a trust can be seen as the result of a contract when a settlor and a trustee come together to promise that they will both benefit a third party. The only difference is that the settlor gives away property to a trustee who promises to hold it according to the settlor's wishes. It is the settlor that sets out the terms of the contract, and the trustee accepts those terms.

The contract, if varied or amended, can result in something that was different to what the contracting parties initially intended. Analogously, the same effect can occur if the essential character of a trust changes. It is the settlor's contract. If the trustee subsequently changes it, it may well result in something different to what the settlor originally intended.

### The Full Federal Court's decision in Clark

One of the issues before the Court was whether there was continuity of the Trust from the time it incurred capital losses until the time they were deducted against a net capital gain.

On 2 July 1984, the Carringbush Unit Trust (**CUT**) was established. Carringbush Pty Ltd was the first trustee. There were 10 initial units that were issued at \$1 each with a provision for the issue of further units.

In 1988, CUT acquired shares valued at \$2,492,654 in a publicly listed company which subsequently went into liquidation in 1989, rendering them worthless. They were sold to a related entity for \$1, resulting in a capital loss. There were also two other capital losses that were incurred.

Prior to June 1993, the controller of CUT, Mr Denoon, and Mr Clark agreed to enter into joint venture arrangements utilising CUT on the basis that any capital gain on any disposal of a property development could be offset by its capital losses brought forward.

Accordingly, the following material restructuring transactions occurred:

- A new trustee was appointed, subsequent to the retirement of CUT's trustee;
- five of the units held by the Denoon interests were transferred to the Clarks;
- The Clark interests injected \$1.8m into the Trust to meet its immediate projected needs, with Denoon contributing an equal amount if it was required to;
- If Denoon failed to make such contribution, the Clarks could acquire the remaining Clark units for \$1 per unit;
- The new trustee had the benefit of releases of debts owed to or by companies and trusts within the Denoon Group; and
- Carringbush Pty Ltd waiving any right of indemnity out of Trust assets.

CUT's balance sheet before the restructuring transactions showed a material deficiency of trust assets, and subsequently showed a settlement sum of \$10 represented by cash at bank as at 30 June 1993. The relevant capital gains arose in 2001, and the new trustee offset the capital loss carried forward.

The Full Court decided by majority (with Dowsett J. dissenting) that the effect of the restructuring transactions was not sufficient to cause it to become a new trust estate, following an earlier High Court decision in *Commercial Nominees*.

The Commissioner of Taxation has sought special leave to appeal this decision to the High Court. As of this date, the Court has yet to set down a date for hearing.

## Resettlement principles generally

*Clark* brings into focus the types of changes that can cause a trust to change. Being a very complicated area of law, the following principles have been used by the courts in considering if a trust has been resettled:

- A new trust comes into existence if the charter of future rights and obligations imposed upon the trustee has changed and the trustee accepts those changes;
- A trust is changed if there is a change in the underlying beneficial interests in trust property; and
- A trust is changed if the whole substratum of the trust fails and a new trust emerges in its place.

## Taxation issues

The ATO issued its publication entitled *Creation of a new trust - Statement of Principles August 2001*, which is available on the ATO website and explains its views on trust resettlements, and how such resettlements occur.

The ATO says that if changes are such that a new trust relationship arises, there must also be a new trust estate for income tax purposes. If the trustee remains the same, it would dispose of the trust property in its capacity as trustee of one trust estate and reacquire it as trustee of another. The disposal would trigger consequences under the capital gains and other provisions of the tax legislation, and a CGT event would occur.

Because of the lack of continuity of the same estate, any other attributes held would cease to exist. For example, previously incurred losses, whether such losses were on capital account or revenue account, would be lost and unable to be claimed.

Changes potentially leading to a new trust can arise by several means, including variations under a power in the deed and a variation by agreement among the beneficiaries. Listed below are some of the changes which raise the question of whether a new trust has been created:

- Any change in beneficial interests in trust property;
- A new class of beneficial interest (whether introduced or altered);
- A possible redefinition of the beneficiary class;
- Changes in the terms of the trust or the rights or obligations of the trustee;
- A change in the termination date of the trust;
- A change in the essential nature and purpose of the trust; or
- A merger of two or more trusts or a splitting of a trust into two or more trusts.

## Practical issues

In the absence of any other circumstances, the removal of a beneficiary is generally not sufficient to trigger a resettlement, but the addition of a beneficiary can possibly give rise to a resettlement because it places a new fiduciary duty upon the trustee in respect of trust property that affects the trustee's right of ownership vis-à-vis itself and the beneficiaries.

If a trust estate that is established between the settlor and the trustee is for a period less than the statutory maximum of 80 years, and that date is subsequently extended, it is an event that wasn't contemplated by the settlor and invariably gives rise to a resettlement.

A change of trustee does not in itself result in the termination of a trust, as such amendments are usually of an administrative nature.

If there is also a change in the person acting as guardian or appointor, or changes which merely affect administrative and housekeeping procedures without substantially altering the right to the beneficiaries in respect of the trust property, then provided those changes are limited only to those particular areas, there should not be a resettlement.

## Conclusion

In an age where trust deeds are now being necessarily reviewed in light of the proposed legislation dealing with the taxation of trust income, we are seeing examples of deeds where there have been wholesale changes to the terms of the deed that have clearly resettled the trust estate.

The areas of tax risk in a trust resettlement are not confined to just income tax but also indirect tax or stamp duty. When faced with the variation of a trust deed of a trust holding any property, a prudent practitioner will first take advice before recommending any change.

If you or your clients are contemplating a change to any deed, seek specialist advice first. The taxation practitioners at Thomsons Lawyers are always available to help.

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