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Trusts - So, where are we, post Commercial Nominees?

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Introduction

The answer is simple. The same as we were pre Commercial Nominees. For years the ATO considered the issue of trust resettlement as a special issue and closed shop by refusing to give any advice on the topic until they were able to themselves, come to a position on the matter.

Then in 1999 the ATO released a set of principles that were to provide guidance in the matter.

Then in the High Court there was the famous Commercial Nominees case. Which the ATO last year distinguished from being applicable, so the 1999 Statement of Principles still stands.

So what have we achieved from the last ten years of uncertainty? Well in my opinion not much. So what I would like to go through this afternoon is what we, as professional advisers must use as a basis for giving our advice in relation to trusts.

So as we look at these issues we need to keep in mind and be careful of the fact that there has been no public ruling on resettlements as there has only been a set of guidelines indicating how the ATO may assess a variation of a trust. As each trust deed, each family has a unique set of circumstances and a different trust set up. So therefore one size does not fit all and each particular case will turn on the particular circumstances of each different trust.

First of all, I would like to go through what we need to achieve to make an amendment to a trust, and then look at the possible resettlement issues that may arise. Then quickly look at when trust relationships might arise from our actions such as constructive trusts, then look at winding up a trust, and finish with a discussion on where trusts are heading in the future.

1. Trust Amendments

The first thing to determine when varying a trust is whether the Deed contains an express power of amendment. These clauses come in many shapes and forms. Some are expansive and some are restrictive, so you will need to check if the power of variation allows the trustee to vary the trust in the desired way.

There are sometimes conditions attached to the power to amend, such as:

1. Obtaining the consent of the Guardian/Appointor (you need to check if this person still exists or is still capable of executing the variation).
2. The amendment is to be in the best interest of the beneficiaries.
3. There can be no variation to affect the beneficiary entitlement of a beneficiary once money has been set aside for that beneficiary (in other words once a beneficiary is absolutely entitled as against the trustee the power of amendment cannot be used to divest that interest).
4. All benefits to the settlor are to be excluded.

An example of this can be seen in the extract below:

7. How do you vary this Family Trust?

The Trustee has the power to add, vary or revoke any term of this trust deed subject to Clause 13. However, such amendments do not benefit the Settlor or affect a beneficiary's beneficial entitlement already set aside.

.....

13. Is the Guardian the person in control?

Every discretion and power given to the Trustee by this Deed or at law is completely under the Trustee's control, unless otherwise stated. However:

1. *the Trustee may consult the Guardian before exercising any power;*
2. *the Trustee cannot without the Guardian's consent:*
 - a. *make a declaration of exclusion or alter the Excluded Class*
 - b. *exercise any power contained in clauses subject to this clause*
 - c. *exercise the power relating to dealing with income, net income or distribution of assets or money*

If there is no Guardian then the Trustee cannot make any declaration of exclusion or affect the “Excluded Class”. The Trustee cannot use its powers so as to affect the expectations of:

3. *any Specified Beneficiary; or*
4. *any person appointed by the Guardian to whom the Trust Fund falls to on Vesting Day.*

However the Trustee has power to make a declaration of exclusion for any General Beneficiary upon their request.

The question might arise “is it possible to first amend the power of amendment to remove an obstacle to the desired amendment?” The answer to this will be set out in the terms of the deed. However, care needs to be taken to ensure that the trustee does not exceed their power. Also the trustee must be careful not to breach its fiduciary duty when exercising its power.

What can you do if there is no express power of amendment? This restricts the ability to amend as no power to amend can be implied, as it is the trustee’s duty to carry out the terms of the trust. However sections 89 and 90 of the *Trustees Act 1962* may provide some assistance in this situation.

Section 89 states:

89. Power to Court to authorize dealings with trust property

(1) Where in the opinion of the Court any sale, lease, mortgage, surrender, release or other disposition, or any purchase, investment, acquisition, retention, expenditure or other transaction is expedient in the management or administration of any property vested in a trustee....[that] cannot be effected by reason of the absence of any power....the Court may by order confer upon the trustee, either generally or in any particular instance, the necessary power for the purpose...

Section 90 states:

90. Power of Court to authorize variations of trust

(1) Without limiting any other powers of the Court, it is hereby declared that, where any property is held on trusts arising under any will, settlement or other disposition, or on the intestacy or partial intestacy of any person, or under any order of the Court, the Court may, if it thinks fit....[make] any arrangement ...varying or revoking

all or any of the trusts, or enlarging the powers of the trustees of managing or administering any of the property subject to the trusts.

.... ..

(3) This section does not apply to any trust affecting property settled by any Act, other than the Administration Act 1903.

(4) Any rearrangement approved by the Court under subsection (1) of this section is binding on all persons on whose behalf it was so approved, and thereafter the trusts as so rearranged shall take effect accordingly.

Another possibility of amendment arises if all the beneficiaries are *sui juris* and together they hold the entire beneficial interest, then they may together confer on the trustee the power to deviate from the terms of the trust (or even put an end to the trust). The trustee can also seek to vary the trust with this consent.

If all else fails and an amendment is impossible then there is usually (as many trust deeds permit), the power to vest some or all of the trust fund into another trust, and the new trust has all of the desired terms.

NOTE:

Please don't forget the trustee is always under a fiduciary duty to act in good faith and only use their powers for the purpose for which it was conferred.

So now let's look at the consequences of making an amendment to the trust.

Resettlement issues

2. So what is resettlement?

A resettlement occurs in the situation when changes to a trust are such that, for income tax purposes, one trust estate comes to an end and is replaced by another. The consequences of a trust coming to an end can include:

1. There are Capital Gains Tax (CGT) and Stamp Duty implications if it is deemed that a new Trust has been created. This is because the on resettlement the assets held in the original Trust are said to be transferred into the name of the new Trust. Depending on the

assets held within the Trust this can result in a significant amount of expense.

2. The other issue is that any carried forward tax benefits will be lost when a new Trust is deemed to come into existence. This is because the original Trust is deemed to have ended.

In other situations, although the original trust estate may continue, changes may lead to the creation of new and separate trust estates for tax purposes.

3. So what actually constitutes a Resettlement?

The ATO has prepared a statement of principles as a guide to taxpayers, advisers and ATO decision makers on when the Commissioner will treat trust changes as giving rise to a new trust.

It applies to all trusts other than Superannuation funds, as the decision of the High Court of Australia in *Commissioner of Taxation v. Commercial Nominees of Australia Limited* [2001] HCA 33 effectively rejected the ATO's statement of principles, as it held that there is no resettlement if there is a continuance of the trust (we discuss this case later). This case was held specifically in relation to Superannuation funds, so the ATO has stated that nothing that the High Court said is contrary to the statement of principles and will continue to apply these principles in relation to changes made to the other types of trusts.

BEWARE: The statement of principles are intended for general guidance only, they are not a public ruling. Therefore we can not rely on them chapter and verse. The ATO states that it cannot cover all possibilities or the circumstances of every taxpayer. Therefore we must advise clients cautiously. If circumstances deviate from the ATO examples (set out below), we have to advise our clients that for certainty they must seek a private ruling.

4. The ATO's Resettlement Statement of Principles

General principles

In the ATO's view a new trust arises when there is a fundamental change to the trust relationship. This is very broad statement as it is a change in the essential nature and character of the original trust relationship which creates a new trust.

Below is a list of the changes that the ATO considers when defeminising whether a new trust has been created.

1. any change in beneficial interests in trust property;
2. a new class of beneficial interest (whether introduced or altered);
3. a possible redefinition of the beneficiary class;
4. changes in the terms of the trust or the rights or obligations of the trustee;
5. changes in the nature or features of trust property;
6. additions of property which could amount to a new and separate settlement;
7. depletion of the trust property;
8. a change in the termination date of the trust;
9. a change to the trust that is not contemplated by the terms of the original trust;
10. a change in the essential nature and purpose of the trust; and/or
11. a merger of two or more trusts or a splitting of a trust into two or more trusts.

Depending on their nature and extent, and the combination with other indicia, will determine if these changes may amount to a mere variation of a continuing trust, or alternatively to a fundamental change in the essential nature and character of the trust relationship.

Whether a new trust is created will also depend on other things such as, the terms of the original trust, and on the powers of the trustee, and the original intentions of the settlor as a whole must be considered in determining whether a new trust has been created.

5. Application of principles in some specific scenarios

5.1. ADDITION OR REMOVAL OF BENEFICIARIES

Any alteration to a beneficiary should be done with extreme caution. This is the easiest trigger for a resettlement. A trust beneficiary is an essential element of the trust obligation and relationship. Therefore, changes amounting to a redefinition of the membership class or classes would terminate the original trust. However, changes in the membership within a continuing class are consistent with a continuing trust. The ATO has provided some example to assist in this characterisation.

Example 5.1.1

A discretionary trust has as its beneficiaries 'the children and grandchildren of X'. One of the children dies and two new grandchildren are born.

These changes do not terminate the trust. They represent changes in the membership of a continuing beneficiary class.

Example 5.1.2

Another discretionary trust has as beneficiaries 'the children of Y', and anyone else named in the deed as a beneficiary at a particular time. The trustee has a power to nominate beneficiaries, but only if they are parents or grandchildren of Y or their spouses. The trustee nominates Y's mother as a beneficiary.

In this case, the beneficiary group could be characterised as the children of Y and those members of the wider group nominated from time to time. Under this approach there is a mere change of membership and no new trust.

Generally, the ATO will accept that there has been only a change in the membership of a continuing class when:

1. an already existing power to nominate new beneficiaries is only exercisable under the terms of the trust in favour of a clearly defined group which it could be reasonably inferred that the trust was intended to benefit; and
2. it can be shown from the deed and surrounding circumstances that the actual objective purpose or theme of the trust was to benefit that wider group.

Example 5.1.3

A family discretionary trust has as its beneficiaries members of the X family. The trustee has a power in the deed to nominate new beneficiaries. It may not be exercised in favour of certain persons such as the settlor, but can vary the trust to benefit people other than members of the family group and their associates. The power is exercised to nominate members of the Y family as beneficiaries.

In this situation the ATO would conclude that the power of nomination has been exercised to redefine the group of beneficiaries, and thus, to create a new trust.

Example 5.1.4

An investment unit trust regularly redeems from, and issues to, investors, units of the same class, or a number of existing classes, on arms' length terms.

The beneficiary class could generally be defined as those who from time to time hold the units under the terms of the trust. This class has an intrinsically changing membership and the issues and redemptions are consistent with a continuing trust.

Example 5.1.5

A piece of real estate is owned by the trustee of an investment unit trust. X owns all the units and all the shares in the corporate trustee. Both the shares and units are transferred to B. The transfer of units could be direct, or by way of redemption and reissue.

In the ATO's view the transfer of units, in itself, is consistent with a continuing trust for the reasons given in Example 5.1.4 above. In respect of the shares, a change in control of the trustee in these circumstances would be a normal incident in the continuing operation of a trust estate of this type.

If we compare this situation with the change in the family discretionary trust in Example 5.1.3. The purpose and essential nature of that trust was to benefit the members of the X family, a new purpose arose on the change of the beneficiaries. However, the unit trust in Example 5.1.5 is for the benefit of those who have subscribed for units and their assignees, and there has been no change in that purpose.

Please note that the above comments only apply where the changes in question are not accompanied by any other indication of a new trust.

Example 5.1.6

An investment unit trust is varied to create and issue a new class of units.

Such variations may not only create a new beneficiary group (the holders of the new class) but also may lead to an express or effective change in the rights attaching to the pre-existing class or classes, for instance through introducing a competing claim on the proceeds of the trust fund. The overall result may be a redefinition of the trustee's obligations to the beneficiaries and hence the trust relationship, resulting in the creation of a new trust.

Resettlement has further reaching implications for unit trusts. Not only is there adverse tax implications for the trustee but adverse implications for the unit holder as well (as they are deemed to have disposed of the old one and purchased the new unit).

5.2. EXTENDING THE TERM (DURATION) OF THE TRUST

The termination date within a family trust can be extended provided that:

1. the trust deed gives an express power to do so;
2. time was not a fundamental feature of the trust; and
3. other accompanying circumstances do not indicate a fundamental change to the trust

4. the extension does not extend the life of the trust to longer than 80 years minus one day perpetuity period.

Where the original trust deed envisaged that the trust was to operate to provide benefits to the beneficiaries from the trust property for a particular amount of time then extending the termination date will most likely be view by the ATO as creating a new trust. This will be even more likely where there are associated changes in investments or other trust activities.

Example 5.2.1

A trustee holds Blackacre under a trust set up for a ten year term. The beneficiaries of the trust are entitled to the rents of Blackacre over that period. On consideration of the overall circumstances it is clear that it was those ten years' rents, and not just the rents in general or Blackacre itself, that the trust was established to deal with.

Example 5.2.2

A trust is set up specifically as a vehicle for a particular project or to hold an asset of intrinsically limited duration.

If the trusts referred to in Examples 5.2.1 and 5.2.2 were extended, particularly if there were other changes such as the introduction of new investments or activities, it is likely that a new trust would be formed in respect of the new subject matter.

5.3. CHANGES IN TRUST PROPERTY

Most trust deeds allow for changes and additions the trust property from time to time by way of changing investments and generally in these cases there will be no issue of resettlement if the trust property is altered.

However there are situations where the particular trust property is an integral part of the nature of the trust. The trust may have been expressly set up for the original trust property and in this instance it is likely the ATO will view a replacement of this or the addition of new and different property as the creation of a new Trust.

The other situation where the ATO may determine that a new trust is created is where a dormant trust is 'revived' by the injection of new property. However this

will not usually be the case unless other changes to the trust occur. For example if a dormant Family Trust is 'revived' with an injection of property and the trust remains true to its original purpose then it seems the ATO will not find the trust resettled.

An important point to note however, is that there can be no trust without trust property, so exhaustion of the trust fund will bring a trust to an end.

5.4. CHANGES OF TRUSTEE

Changes made to the trustee do not by themselves result in a resettlement. However if, in addition to a change in the Trustee, other fundamental changes to the trust have been made that alter the nature and character of the Trust relationship then the ATO will deem that a new trust has been created.

5.5. CHANGES TO THE TERMS OF THE TRUST

Only alterations that result in changes to the relationship between the trustee and the beneficiaries in respect to entitlements from trust property will amount to the deeming of a new trust. For example an alteration of a discretionary trust and to fix the beneficiaries' entitlements would be changing the nature and character of the original Trust relationship, thus creating a new trust.

Changes to the trust deed which are merely procedural are unlikely to affect this relationship and are unlikely to have the effect of creating a new trust.

However it is sometimes very difficult to determine whether a change is merely procedural or whether it is one which is fundamental enough to affect the trust relationship. The following examples may assist in this distinction.

Conversion of a trust to a unit trust

Example 5.5.1

The deed of a fixed trust is converted to substitute interests in the trust property for units and to allow the trustee to issue and redeem units.

In the ATO's view, the conversion of a non-unitised fixed trust to a unit trust may involve a fundamental change in the trust relationship. It is likely that the ATO will

hold that this change indicates a new trust purpose. The ATO would generally regard such a conversion as the creation of a new trust.

Conversion of a fixed trust to a 'hybrid' discretionary trust

Example 5.5.2

The deed of a fixed trust (unitised or otherwise) is amended to give the trustee a discretionary power of appointment over the income of the trust.

Although the new discretionary beneficiaries may not have a proprietary interest in the trust fund, the rights of the holders of previously fixed interests are radically changed. In this situation the essential nature and character of the trust relationship changes and a new trust estate comes into being.

Can I give my Trustees the power to accumulate?

If the trustees of a family trust are given the power to accumulate income whereas previously they had an obligation to distribute then this may not be seen as creating a new trust providing the beneficiaries' rights have not changed. If the class of beneficiaries entitled to any distributions remains the same then there will be no new trust in the view of the ATO.

However if the power to accumulate is conferred and the class of beneficiaries is widened then the ATO may well deem that a new Trust has been created.

Conferring a power to accumulate income

Example 5.5.3

A trustee is given the discretion to accumulate income to which beneficiaries previously would have been presently entitled.

The new discretion involves a material change in beneficiaries' rights. However, in the ATO's view this change will not usually be sufficient in itself to alter the essential nature and character of the trust relationship, and therefore does not result in a new trust.

The ATO will accept that creating a power to accumulate is in itself consistent with a continuing trust where the retained income will accumulate solely for the

benefit of those same beneficiaries who would have been presently entitled before the change.

Example 5.5.4

The beneficiaries of a unit trust are presently entitled to each year's income in proportion to their unit holdings. The deed is varied to give the trustee the discretion to accumulate some, or all, of the income. The beneficiaries' beneficial interests in the accumulated income are unaltered, and they are entitled to share in any distribution of income in proportion to their unit holdings.

Here, the accumulation power can be seen as enabling the trustee to decide from time to time whether the interests of the beneficiaries are best served by retaining or distributing income. As the income can only be accumulated for those that would have been presently entitled there is no new trust created. The ATO accepts that conferring the power, in itself, alters the management of the trust's undertaking rather than the essential nature of the trust relationship itself.

Example 5.5.5

A discretionary trust deed ensures that beneficiaries are presently entitled to all income. It is varied to confer on the trustee a power to accumulate.

Provided that accumulations can only be appointed among the same class of beneficiaries as would otherwise have been presently entitled, the ATO view this situation in the same way as Example 5.5.4. In the absence of other factors, the variation goes to the management of the trust's undertaking rather than the essential nature of the trust relationship.

Example 5.5.6

A unit trust has X units with present entitlement to all income and Y units with rights to capital. The trustee is given a new discretion to accumulate income and add it to capital.

In contrast to the previous examples, here the effect of the change is to redefine the nature of the equitable interests in the trust. There is a fundamental change in the essential nature and character of the trust relationship, and this creates a new trust.

Can I change the definition of trust income?

This type of change also has the potential to alter the substantive rights of the beneficiaries, so caution is need once again. However the ATO states that in the absence of other factors this will not in itself give rise to a new trust where:

1. the purpose of the redefinition is to clarify rather than redefine entitlements; or
2. there is a redefinition of entitlements but it is one that changes the respective entitlements between a single beneficiary or class of beneficiaries not between beneficiaries or classes of beneficiaries.

This is because generally a change to the definition of income does not affect the essential nature and character of the original trust relationship.

Example 5.5.7

The property of a unit trust consists of an annuity with a substantial purchase price. The deed is amended to define 'income' as net income for the purposes of section 95 of the Income Tax Assessment Act 1936. There was no previous definition.

If the trust resembled Example 5.5.4, where income and capital rights accrue to the same units, the ATO would accept in the absence of other factors that there was no fundamental change in the trust relationship and no new trust estate. The change affects distribution of funds rather than the essential character of beneficiaries' interests. However, if the trust resembled Example 5.5.6 the change would significantly alter entitlements between the two classes of units and be a strong indicator of a new trust relationship.

Given the uncertainty of the law and lack of clear judicial and ATO guidance in the past, the ATO will give less weight to changes or insertions of income definitions as indication of a new trust when considering alterations made before the release of this statement.

Reference: the above Examples and Explanations were taken from the ATO's Creation of a New Trust -Statement of Principles (August 2001) www.ato.gov.au

5.6. Date of effect

When did these guidelines take effect?

These principles were originally released on 9 June 1999 and were revised in light of the High Court decision in *Commissioner of Taxation v. Commercial Nominees of Australia Limited*. The ATO believes there has not been any change to the underlying principles and as a result these principles are still in effect.

These principles will be applied to arrangements implemented both before and after the date of their release. However, the ATO has indicated that it will be lenient on any change prior due to the "uncertainty of the relevant law, the diversity of opinions held by experts, the past absence of ATO guidance and the serious consequences arising from the perhaps inadvertent termination of a trust estate".

For these reasons, the ATO will generally only treat arrangements already implemented as having resulted in a new trust estate where, in terms of the preceding principles, there is a very strong indication that the trust relationship has been fundamentally changed.

6. When do Constructive trusts exist?

Trusts are usually created by express intention via a trust deed, however, a trust can be created without any specific intention or knowledge of the parties concerned. In this scenario the trust created is called a resulting or constructive trust. In the case *Zobory v FC of T* (1995) 30 ATR 412 Deane J. refers to a passage that states:

"Where the title to property is acquired by one person under such circumstances that he is under a duty to surrender it, a constructive trust immediately arises"

So why should we be interested in this type of trust? The answer is “it is important to understand when we are in fact trustees, and as a result, the way we must conduct ourselves accordingly”.

The classic example arises - do we hold the money as a debtor or a trustee? The way we hold the money is certainly going to change the way we act. If in fact there is a constructive trust created, some of the issues that arise are:

1. what are the terms of the trust and what obligations does the trustee have?
2. What are the beneficiaries subsequent entitlements to the income etc
3. Is there a requirement for the trustee to lodge an income tax return?

To extend our example, how are unpaid trusts distributions held? Are they held in a separate trust? Or is it just a loan? Clearly there are different obligations depending on the different classifications.

To clarify this issue – if a loan is to exist you would normally expect to find some sort of written agreement, but in a family trust this may be unlikely. So at the end of the day we need to examine what evidence exists and ascertain how the money is held and how we need to conduct ourselves accordingly.

7. Are Residuary Beneficiaries Still Important

Default beneficiaries have come into the lime light once again, as the recent case BRK (Bris) Pty Ltd v Commissioner of Taxation [2001] FCA 164 has put default clauses in many Family Trusts in doubt.

Facts:

In the 80's The Wagner Family Trust (“WFT”) was set up. It had many default beneficiaries and the deed also stated that if any of the specified beneficiaries had interest or shares in any companies or trusts then these can become general beneficiaries. The trustee then the made the following distributions:

30 June 1993 – 100% of WFT income to Hendon Unit Trust

30 June 1994 - \$304,021.72 to the Trustee of the Hendon Unit Trust HUT,

the balance to Bill and Jessica

30 June 1995 - \$220,000 to Hendon Unit Trust

\$100,000 to Northbourne Trust (wasn't an issue in this case)

the balance to Bill and Jessica

It held that the resolutions that made these other companies and trusts general beneficiaries were void *ab initio*. So the distributions were invalid.

The issue was then, if these distributions were invalid then by virtue of the default beneficiaries clause, the income would be deemed to be paid to them.

Analysis of the Deed

This was a poorly drafted deed as confessed by their own counsel.

The clauses of concern were:

4. The Trustee may in its absolute and uncontrolled discretion accumulate any of the income of the Fund and hold the same as an accretion to and part of the capital of the Fund.

5. Until the perpetuity date the Trustee shall hold the Trust Fund upon trust to pay divide or apply the whole or any part of the income of the Trust Fund to or between or for the maintenance education support or benefit of all or any one or more of the beneficiaries in such proportions and in such manner as the Trustee shall in his uncontrolled discretion think fit PROVIDED ALWAYS that the Trustee may at his own discretion at any time or times after the date hereof and before the expiration of the perpetuity date if in his uncontrolled discretion thinks fit pay or apply the whole or any part or parts of the capital of the Fund to or for the benefit of any one or more of the beneficiaries or in writing appoint that the whole or any part or parts of such capital shall be held upon such trusts either revocable or irrevocable for the benefit of the beneficiaries or any of them subject to such powers and discretions exercisable by any person or persons other than the Settlor and generally in such manner as the Trustee shall think fit but so that all interests so created shall vest on or

prior to the perpetuity date PROVIDED FURTHER that if the Trustee shall not exercise any discretion as aforesaid then the Fund in relation to any income year shall be distributed equally between the beneficiaries as tenants in common.

7. In default of, and subject to any exercise of any discretion payment application transfer accumulation or determination pursuant to any other provision of this Deed the Trustee shall at all times divide the Fund equally among the beneficiaries named in the Schedule hereto.

So what do you think? Should these clauses allow the invalid distributions default to the named beneficiaries?

Cooper J held at paragraph 32 that:

The presence of the default proviso in clause 5, in my judgment, indicates that the trustee has a duty to consider the exercise of the discretion to accumulate income under clause 4 and to consider the exercise of the discretion to apply the income in respect of each income yearHowever, the default proviso does not require that the duty be discharged within the income year.

Does the deed require that distributions be made in the income year?

Cooper J stated at paragraph 35 that:

The duties of the trustee as set out above (clause 4,5,7) apply to the discrete income of particular income years. Although they may be satisfied within the relevant income year, there is no obligation under the Trust to do so and there will be no breach of trust or duty provided that the duty is satisfied within a reasonable time after the end of the income year.

So when reviewing your clients trust deeds, as the question- does the trustee have to make the distributions before the end of the year or within a reasonable accounting period? If they can then this is a faulty default clause.

So we might get away with our deed. What did Cooper J think?

Cooper J stated at paragraph 37 that:

It follows, in my judgment, that the circumstances necessary to trigger the default proviso in clause 5 had not arisen in any of the financial years in issue in these proceedings. ...At the end of each of the financial years in issue, there was no beneficiary presently entitled to the income which the applicant had ineffectively attempted to appoint to the Hendon Unit Trust.

Therefore there must be a clear trigger that sets off the default clause within the financial year, otherwise there is no beneficiary entitled to the distribution at that time of the default.

What if the deed states that “the trustee must distribute to the default beneficiaries if no distribution has been made by the end of the year”?

Cooper J stated at paragraph 38 that:

Even if, as the applicant contends, the discretion was to be exercised in the income year, as a matter of construction of clause 5, it remained open to the trustee until the last moment of the income year to exercise the discretion.

Default, in these circumstances, would not have occurred until the income year had expired.... The consequence would be that in the subsequent financial year, the default beneficiaries would become entitled to income of the Trust earned in the previous financial year. However, the position would remain that as at the end of the financial year, there was no beneficiary presently entitled to the income.

Result - You are taxed under section 99A at 48.5%

What about Clause 7?

Cooper went on to say paragraph 39 that, “The terms of clause 7 do not assist the applicant. This clause is intended to ensure that the Fund will, in default of, and subject to any prior action of the trustee, vest on the expiry of the perpetuity period in the beneficiaries named in the schedule in equal shares.”

So what do trust deed now to have effective default beneficiaries? how identify a valid default clause?

We need to have:

1. Clear definitions of capital and income accumulations
2. Accumulation restrictions (time before financial year)
3. Clear triggers requirements that default within the financial year
(for example trustees must distribute to the default beneficiary before the end of the financial year.

8. How do you Winding Up a Trust?

So when does the winding up occur?

It must occur upon the Vesting date as set out in the terms of the trust deed. This is subject to the fact the vesting must occur within the perpetuity period (80 years minus one day). It also occurs when there are no more assets in the trust.

Winding up is generally a straight forward procedure. There is no need (as with companies) to inform the appropriate regulatory bodies.

A trust can be wound up by either a trustee minute or by deed. Deed may be more expensive, but proves better protecting the trustee and your interests. The process of winding up is determined by the terms of the trust deed.

The procedure is to:

1. review the trust deed to see if the trust can be wound up.
2. review the latest financial reports to ascertain assets and liabilities
3. seek consent of the Guardian/Appointor
4. determine if beneficiaries wish to receive the assets in specie or cash
5. the trustee should get consent letter from the beneficiaries
6. the trustee holds a meeting to confirm that the trust can be wound up and that all due diligence has been completed.
7. all liabilities are discharged
8. the trustee withholds any tax amounts due (ITAA 36 s.254(1)(d))
9. distributed the assets according to trustee discretion (with Guardian/Appointor consent) or via the default provisions.
10. receipt from beneficiaries
11. complete final financial reports and last tax return

Some examples of winding up clauses are below:

1. Family Trust

Who gets the assets in this trust on the Vesting Day?

(1) From the Vesting Day the Trustee holds the Trust Fund and the Income in trust for such of the Beneficiaries in such proportions as the Trustee states (with the Guardian's consent) before the Vesting Day. However:

- (a) if no Guardian is in office the Trustee has no such power of appointment
- (b) any revocable appointment made with the consent of the Guardian is revocable by the Guardian
- (c) any revocable appointment is revocable only until 5 pm on the day preceding the Vesting Day

(2) If the Trust Fund is not disposed of under the above sub-clauses then the Specified Beneficiaries take as tenants in common in equal shares. If any of the Specified Beneficiaries' are dead then their heirs take as tenants in common what the dead Specified Beneficiary would have taken.

(3) If the Trust Fund is not disposed according to the above sub-clauses then in trust for the nearest relative of the Appointor living at the Vesting Day.

Question?

What happens when winding up the trust and there is no guardian?

2. Unit Trust

What happens when this Trust Ends

Upon the Vesting Date or when practical after the Vesting date (but subject to any variation referred to) the Trustee must:

- i. sell call in and convert the Trust Fund into money; and
- ii. after payment of all debts and the discharge of all liabilities of the Trust Fund distribute the balance (less all costs and disbursements, commissions, brokerage and other fees, taxes, expenses, management, charges, solicitor's costs, valuation fees, claims, demands and other outgoing debts or liabilities incurred or reasonably anticipated by the Trustee in the termination of the Trust) to the Unit Holders in proportion to the number of Units held by them at the Vesting Date. The Trustee may in its discretion at the request of any Unit Holder transfer to that Unit Holder any part of the Trust Fund in specie in full or partial satisfaction of that Unit

Holder's share in the Trust Fund at the Market Value of that part of the Trust Fund at the Vesting Date.

9. The Future - Where to now?

Commercial Nominees Decision

Has the commercial Nominees case given any hope for the future in relation the restriction placed on trusts? The direct answer at this stage is no. but it has provided a strong precedent that may be followed in other test cases.

What is the Commercial Nominees case?

Commercial Nominees (*Commissioner of Taxation v. Commercial Nominees of Australia Ltd* [2001] HCA 33) is a test case involving a superannuation fund established by a deed of trust in which the ATO sought guidance from the Courts as to when changes made to the nature and character of a trust relationship result in the creation of a new trust.

The High Court of Australia handed down its decision on 31 May 2001. The five judges ruled that, for the purposes of the superannuation and tax loss rules in the income tax law, the amendments made to the trust deed did not create a new trust.

What were the facts in the Commercial Nominees case?

The trustee of a superannuation fund sought to claim tax losses from previous years as allowable deductions. The ATO argued that, because of amendments made to the trust deed, there was a fundamental alteration in the trust relationship established by the original deed, such that it destroyed the necessary continuity of the 'taxpayer' for the purposes of the carry forward loss provisions in the income tax law.

The original trust deed contained wide powers of amendment. The amendments made to the trust deed allowed the fund to accept new members from outside the companies for which the fund was originally established. A new trustee was appointed and a professional management company was appointed administrator. There was also a change in the nature of the benefits, from defined benefits to accumulations.

Why did the High Court rule there was no new trust created?

The High Court recognised that the superannuation fund must maintain its continuity in order to be able to claim the tax losses. The Court referred to three main indicia of continuity for the purposes of the superannuation rules in the income tax law:

1. the constitution of the trust under which the fund operates;
2. the trust property; and
3. membership.

The High Court concluded there was no new trust created as the amendments to the trust deed were authorised by the deed, the property of the trust did not alter when the amendments took effect, and the members before the amendments remained members after the amendments. The High Court also took into account that the superannuation industry regulatory authority treated the fund as a single fund both before and after the amendments.

What are the consequences of the Commercial Nominees decision?

The High Court's decision goes against some of the statement of principles released by ATO.

However, The High Court confined its reasons for judgment to superannuation funds. Trustees and tax practitioners should be careful in applying the decision to other superannuation funds or to trusts more generally. The question still remains "do the changes made to a trust affect the continuity of that trust?".

What was the ATO response to this case?

The ATO believes that nothing the High Court has said is contrary to the principles stated in the Statement of Principles (Changes to trusts leading to the creation of a new trust). The ATO adheres to the views expressed in this statement which was released on 9 June 1999. While the ATO has reviewed and

updated the Statement of Principles in light of the High Court's decision, the basic concepts underlying the Statement of Principles have not changed.

Reference: the above Case and Explanations were taken from the ATO's Website: www.ato.gov.au

Entity Tax

What about the shadow of the entity tax that family trusts exist under?

As we all know, this was a Bill that proved too difficult in an election year, and I can't and don't intend to comment on any likely future legislation on this matter, other than the fact, it is reasonable to expect that it will return to us in one form or another.

If upon the implementation of a new entity tax, a tax burden is placed on trusts, we can only hope for some type of transitional provisions that may ease this.

However as advisers it is our duty to inform new trust participants that there is likely to be an introduction in some form of the entity tax.

But without looking at any future possible tax ramifications the question is – “is it likely that trusts are going to be desirable in the future?” Well in my opinion - Yes for they still may be important for non tax reasons such as:

1. assets in a trust do offer some protection in cases of Bankruptcy
2. assets in a trust can be held separately for the duration of 80 years minus one day
3. interests of several families can be joined in one entity
4. there can be discretion for capital and income distributions (not possible in a company, however, this may change)
5. trusts are cheaper and easier to run than companies

6. family trusts are not subject to challenges under the *Inheritance Act*

Conclusion

To conclude quickly, a trust deed will need reviewing and amendment from time to time to keep up with the never ending evolution of the trust fund. Even though there have been major restrictions placed on the types of amendments, there still is the ability to make many necessary amendments so that trust perform effectively, without incurring a tax penalty.

It is in my opinion that at this point in time, trusts still are an advantageous structure that deals effectively with taxation and non taxation matters.