Taxing private trusts – a moving target

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Abstract: Our revenue authorities have been very active recently issuing judgments, making pronouncements and intensifying enforcement activity, all directed to the way the tax system operates in relation to income made from, and gains arising on transactions with, assets that are held on trust. This article highlights the impacts of some important recent developments affecting private trusts. Many of the problems displayed in the cases arise from two fundamental problems: misconceptions about the nature of a trust, viewing it as a type of entity, rather than an arrangement; and the inherent difficulties in correctly predicting whether the courts will apply or relax the basic doctrine in the particular circumstances of the taxpayer. The article also looks at some issues in relation to funding trusts, correctly allocating the tax liability on income and gains arising from assets held on trust (particularly if foreign beneficiaries or foreign assets are involved), and vesting trust assets.

Introduction

Our revenue authorities have been very active recently issuing judgments, making pronouncements and intensifying enforcement activity, all directed to the way the tax system operates in relation to income made from, and gains arising on transactions with, assets that are held on trust. This article highlights the effects of some of the more important developments affecting trusts that are not managed investment trusts (MITs) or attribution managed investment trusts (AMITs).

Going back to basics

Occasionally, our courts go out of their way to remind readers of some basic principles of law because the correct legal analysis must be the starting point from which the tax analysis can then proceed. Start with the wrong idea of what the law is, and the tax analysis is almost guaranteed to be wrong.

The Full Federal Court decision in *Aussiegolfa Pty Ltd (Trustee) v FCT*[1] is an example. Steward J thought it was worth reminding readers just what the word "trust" means at law:[2]

> "… the term 'trust' refers to the legal relationship created – inter vivos or on death – by a person, the settlor, when assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose."

Elsewhere, he said, a "trust is not an entity … it is a relationship governing the basis on which property is held".

There is nothing new in these passages, but the implications are profound and often misunderstood. If a trust is an *arrangement* between people about what happens to an item of property, that arrangement does not have (and cannot be split into) parts or sub-parts. And if any of the people involved in that arrangement change, or the item of property which is subject to the arrangement changes, or the terms of the arrangement change, there is a real chance that something important just happened. Maybe the existing arrangement expanded or contracted to encompass the new situation; but there is the real possibility that there is a new arrangement, albeit with identical terms.

If one thought of a trust as some form of *entity* akin to a company, people's entitlements would likely be similar and all would be against one entity, changes to the constitution of the entity may well be insignificant, adding more assets to the entity would hold no immediate tax consequences, and so on. But if one thought of a trust as a *relationship*, people's entitlements would be unique, peculiar to them and peculiar to this entity, changing the terms of the relationship could be important, and adding new assets could have consequences. For example, what happens if the trustee acquires a new item of property? The answer is, at least prima facie, "technically … every disposition of property to a trust creates a [new and] separate trust" which means that CGT event E1 could be triggered.

The ramifications of the idea that a trust is *not an entity* are profound.

The question which follows is, how much of this analysis does tax legislation change? Clearly, parliament can overrule any or all of this law, but has it? That question is made harder because the answer has to be found in hints and implications; the statute almost never says explicitly, "by the way, what we are meaning to do here is to overrule that doctrine, but just for this purpose and in this situation".

We have indications that some of these doctrines will not be strictly applied for some types of trusts and in some circumstances if "the statutory purpose does not require the conclusion". So far, the courts have relaxed these ideas for:

- **complying superannuation funds:** in *FCT v Commercial Nominees of Australia Ltd*,[3] the High Court accepted that "the nature of [a complying superannuation fund] is such that changes in the incidents of the trust relationship established at its creation are not only possible, but in some respects probable". It could be expected that "the trustee might change from time to time. The trust property would almost certainly be in a constant state of change … The identity of the persons entitled to benefit under the trust would be likely to change over time … The nature of the benefits … might alter over the years". The court said that "whatever may be the position in relation to the continuity of trusts generally, in applying [former] Pt IX of the Assessment Act, the legal and commercial incidents of superannuation funds … must be taken into account" and those "incidents" carried the implication that the trust arrangement remained unaffected by the change of membership of the fund;

- **MITs (in some cases):** in *Aussiegolfa*, Steward J said obiter that the "statutory purpose [ie applying the in-house asset rules] does not require the conclusion that each disposition of property to an existing trust constitutes the creation of a new trust … given the complexity of modern managed investment schemes which may receive a continuous flow of subscriptions"; and
- **private trusts, even where the operations have ceased, new corpus has been injected and the members have changed:** in *FCT v Clarke*,[4] the Full Court split over whether capital losses incurred in 1991 to 1993 were still available to be applied against a capital gain made in 2001. The issue was whether a new trust arose from events occurring in 1993: changing the trustee, the existing unitholders selling out, the injection of $1.8m as corpus of the trust and changing the activity of the trustee. One judge took the view that "the trust estate which incurred the relevant losses was gone [because] the affairs of a trust [had] been effectively wound up by disposing of all assets and resolving all outstanding liabilities". But the joint judgment took the view that one looked to find "a continuum of property and membership, which could be identified at any time, even if different from time to time". The judges concluded that the property and the members "changed from time to time, but not their continuum".

But there are also cases where these doctrines are applied on the basis that the statute has not changed the original legal doctrine:

- **managed investment schemes (with differentiated classes of interests):** in *Aussiegolfa*, the Full Court held that the creation and issue by the trustee to the investor of a unique class of units involved the creation of a new arrangement which differed from the existing ones. There was a new trust arrangement because "the terms governing the [arrangement] evinced an intention to create a distinct trust very much separate from any other sub-funds or trusts created by the … Constitution"; and
- **private trusts where assets are segregated:** in *Oswal v FCT*,[5] the court accepted that the trustee's resolution "to appoint for the absolute benefit of the named beneficiaries below, a part of the corpus of the trust [which] shall be held on separate trust and for the absolute benefit of the named beneficiaries in their own individual capacities" accomplished exactly what it said: a new and separate trust arose from the changes to the arrangement, rather than "a separate fund of assets [but still] under the 'umbrella' of the … Trust".

The ATO has ventured into this realm in TD 2018/D3, which is discussed in more detail below, but this is not new territory. In June 1999, the ATO had issued a document, *Creation of a new trust — statement of principles* (which it revised in August 2001), which listed some tentative views about the kinds of "changes potentially leading to a new trust", including:

- 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;
- changes in the nature or features of trust property;
- additions of property which could amount to a new and separate settlement;
- depletion of the trust property;
- a change in the termination date of the trust;
- a change to the trust that is not contemplated by the terms of the original 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.

While that document was subsequently withdrawn in 2012, these are difficult matters. The cases and the draft determination suggest that there is always the potential for danger from:

- the appointment of new trustees;
- changes to the terms of the arrangement, including the addition or variation of administrative powers;
- changes to the identity of the beneficiaries; or
- changing the corpus of the trust estate, whether by sale and reinvestment or adding to the corpus.

But the lesson from *Aussiegolfa* is that, with respect to some events, the extent of the danger declines if the trust deed is drawn in a way which contemplates and facilitates events such as changing the investments, taking in new beneficiaries, or amending the deed from time to time. As Steward J said: "… all of these changes or features are potentially consistent with the presence of a singular continuing relationship of trust. Whether that is so depends, however, upon the particular terms of the Constitution in question."

Before leaving basic doctrines, it is worth mentioning one other ramification: since a trust is an arrangement about what happens to an item of property, there has to be an item of "property" to begin with. This issue cropped up in *FCT v Thomas*.[6] The trustee had attempted to argue that franking credits could be held on trust and be made subject to a different arrangement from the arrangement in relation to the cash dividends. The High Court pointed out the fundamental problem with that position: a franking credit is not an item of "property", nor is it made an item of property by tax law:[7]

> "… the notion that franking credits are discrete items of income that may be dealt with or disposed of as if they were property under the general law … is contrary to the proper understanding of Pt 3.6. Franking credits are a creature of its provisions; their existence and significance depend on those provisions … Div 207 does not treat franking credits as a separate source of income capable of being dealt with, and distributed."

A franking credit is simply an entry in a calculation, like the amount attributed from a controlled foreign country (CFC) or the deemed market value proceeds from a transaction. There is a real item of property (the cash dividend, the shares in the CFC, the actual proceeds of sale) but the rest is not, and consequently, cannot be held on trust. This may have implications for trust deeds which define the "income" of the trust to be the same as the "net income" of the trust as defined under tax law and without modification; the net income includes numbers that are not property and so cannot be the subject of a trust.

Funding the trust's activities

Another recent development concerns the funding of private trusts. TD 2018/9 addresses the position of an object of a discretionary trust who borrows funds at interest, and on-lends the funds to the trustee interest-free. The determination takes the view that the object "is usually not entitled to a deduction for any interest expenditure".

If this transaction were occurring between a shareholder and a company, the judgment in *FCT v Total Holdings (Australia) Pty Ltd*[8] suggests that the interest expense can be deductible (notwithstanding that the shareholder will not be earning any interest income from its loan to the company) if there is a realistic expectation the shareholder will be earning dividend income.

While the prima facie position in the determination is that the interest expense is not deductible, the determination says that some part of the interest expense would be deductible if "the beneficiary is presently entitled to income of the trust estate *at the time the expense is incurred*", but then goes on to say that this circumstance cannot be brought about by making an early and irrevocable resolution to appoint this year's trust income to this object. That is because, in the ATO's view, "an irrevocable resolution made by a trustee of a discretionary trust to exercise a power of appointment of income in favour of a beneficiary does not confer present entitlement to income of the trust estate on that beneficiary until such time as the *income is received* by the trustee and is legally *available for distribution*". The second event probably cannot happen until the end of the year if the trust has expenses.

Allocating the tax liability on income and gains arising from assets held on trust

Streaming

One of the more significant debates in recent years has been whether tax law allows the trustee to stream various classes of income to different groups of beneficiaries (assuming the trust deed is drafted to allow this to happen). The ATO blessed this practice in TR 92/13 for franked dividends and PS LA 2005/1 for capital gains. However, in 2010, the ATO changed its position based on its understanding of the High Court decision in *FCT v Bamford*,[9] stating that "the amount included in a beneficiary's assessable income under section 97 consists of an un-dissected or un-allocated proportionate share of the entirety of the [tax] net income".[10] This prompted the then Assistant Treasurer to issue a press release in December 2010 announcing a consultation process to have the trust rules "updated" and moved into the 1997 Act, followed by a further press release in March 2011 saying that the new rules would "enable the streaming of capital gains and franked distributions".

So-called "interim measures" to allow the streaming of franked dividends and capital gains were enacted in 2011, but the promise of an entirely "updated" set of rules drafted in the 1997 Act style never eventuated and probably never will (even though the 2010 announcement was not one of the "announced but unenacted measures" formally terminated by Treasurer Hockey in 2013 after the election of the Abbott Government). The wash-up is thus: the ATO still insists that streaming is not possible except for the two cases where the statute sets up the mechanism to allow this to happen.

This makes the High Court's judgment in *Thomas* especially interesting. The High Court said:[11]

> "So long as a trust deed confers power on a trustee to apply classes of income of the trust estate to particular beneficiaries to the exclusion of other beneficiaries (or differentially among beneficiaries), Div 207 recognises that a trustee may stream the franked distribution (or any part of it) to one beneficiary and the other income to another beneficiary."

The passage appears to be an unequivocal endorsement of streaming and the court does not appear at all concerned that it might be saying something inconsistent with *Bamford*. The events in the case occurred in 2006 to 2008 and so before the 2011 interim amendments to Div 207, which may also be relevant to the analysis. Clearly, we have not heard the last word on streaming.

Reimbursement agreements

It is understood that the ATO is working on a taxation ruling setting out its views on how s 100A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) operates. The guidance is expected to be issued by December of this year. When s 100A is triggered, the beneficiary who would have been presently entitled to the income is treated as not entitled, which means the amount is taxed to the trustee at the top personal marginal rate (taker-in-default clauses have been held not to operate to prevent this outcome).

The explanatory memorandum to the 1979 Bill which enacted this provision said it was directed against "trust-stripping schemes which attempt to pass income derived by trusts on to beneficiaries in a tax-free form". Just what that means has not been well developed in the cases; there are only a handful of cases and they do not produce a clear, complete and consistent picture. It is anticipated that the ATO document will be directed to giving more examples of situations where s 100A is enlivened. But given the number of private trusts in Australia, any document which challenges orthodox views about how extensive the reach of s 100A is would likely prove very controversial.

Non-resident beneficiaries of resident trusts

In December 2016, the ATO released a discussion paper on capital gains and non-resident beneficiaries.[12] It is understood that this issue is still being worked on inside the ATO.

The situations on which the discussion paper focuses are not complicated:

- a resident trustee makes a capital gain on an Australian asset (but one which is not taxable Australian property) and a foreign beneficiary is entitled to the gain. The proper tax treatment is not difficult: Australia should not claim tax on the basis that, had the investor owned and sold the asset itself, no Australian tax would have been payable. The country where the investor resides might claim tax, but Australia should not; and
- a resident trustee makes a capital gain on a foreign asset (which is even more obviously *not* taxable Australian property) and a foreign beneficiary is entitled to the gain. Again, the proper tax treatment is not difficult: Australia should not claim tax. The country where the asset is located might claim tax and the country where the investor resides might also claim tax but Australia should be irrelevant in the structure.

While the correct treatment of both situations seems tolerably clear from a policy perspective, the ATO has formed the view that, as a result of the amendments in 2011 inserting the interim streaming measures, the legislation no longer produces that result. The authors understand that the ATO is apparently taking this point in some cases that are currently working their way through the judicial process. Hopefully, the matter can be sensibly resolved, either through the courts adopting a different interpretation of the provisions, or through a quick and retrospective legislative amendment if necessary. Australia has already devoted a lot of legislative effort in 2010 and 2011 to ensuring that the obvious results occur for certain classes of non-resident investors (in the investment manager rules, tranches 1, 2 and 3); it may be that further work is needed to get the same results for other types of foreign beneficiaries.

Resident beneficiaries of foreign trusts

The ATO has also taken a position regarding distributions representing capital gains to resident beneficiaries from non-resident trusts in two taxation determinations released in 2017. Again, from a policy perspective, the proper tax treatment of this situation should not be difficult: the Australian resident beneficiary should be taxed; it should be taxed on the basis that it is making a capital gain; the gain should be eligible for discount in the hands of individuals and complying superannuation funds; it does not matter that the amount is earned by the trustee of a foreign trust; it does not matter if the asset is an Australian asset or a foreign asset; the only difficult question is when to tax the gain: when it is made, or only if and when it is distributed. Again, the ATO has formed the view that the legislation, as drafted, produces rather different results.

Amendments were made to the Act after the *Nevil Shute* case[13] in 1969 saying that the net income of a trust estate is to be calculated on the assumption that the trustee of a trust is a resident, even if the trustee is a non-resident. Where the trustee is not in fact a resident, prima facie this brings into the Australian tax calculation all the foreign source income of a non-resident trust, and if the deeming were then applied in a CGT context, it would mean that the gains and losses of a foreign trust would enter the Australian tax calculation, even though they might involve assets that were not "taxable Australian property" (TAP). The legislation excludes from the Australian tax calculation a capital gain or capital loss on an asset that is not TAP made by "the trustee of a foreign trust for CGT purposes", but can a trust ever be a "foreign trust" if every trustee is deemed to reside in Australia?

In TD 2017/23, the ATO takes the position that deeming the trustee to be resident does not apply when deciding whether gains and losses made by the trustee are disregarded. Hence, if a foreign trustee sells a foreign asset for a capital gain, the gain does not enter the Australian tax calculation (ie the trust's net income) and none of the complicated consequential provisions about handling the CGT discount are enlivened either. This is the good news.

> "... from a policy perspective, the tax treatment is not difficult; the ATO says the legislation produces rather different results."

The ATO then says that, if the net gain is distributed to a resident beneficiary, it is assessable to the beneficiary at that time. This is the logical conclusion from the first point. Concluding that the gain on a non-TAP asset does not form part of the net income of the foreign trust means the relevant taxing point *cannot* be the point at which the Australian resident beneficiary becomes presently entitled to a share of the net income of the foreign trust — the gain will not have been included when working out that amount. Hence, the relevant taxing point, so far as Australia is concerned, is when the amount is paid to or for an Australian resident beneficiary (assuming the amount has not already been attributed to someone under the transferor trust rules).

But the bad news is in TD 2017/24: the ATO insists an amount so distributed now represents some type of amorphous income which lost its original character; it is no longer a capital gain in the hands of the beneficiary. This means that, for a beneficiary which is an individual or complying superannuation fund, the beneficiary cannot claim a CGT discount in respect of the amount, nor can the beneficiary apply any current year or carry forward capital losses against the amount.

It is hard to see a sound basis for this position. As noted above, a trust is simply a legal relationship about what happens to the income and gains from items of property, and there is nothing in trust law which has the effect the ATO claims when the trustee performs its duties under that relationship. So, any change to the character of the amount collected by the trustee (when it turns up in the hands of the beneficiary) would have to happen because of an effect brought about by the statute. The relevant provision just says the assessable income of a beneficiary includes "an amount, being property of a trust estate [that] is paid to, or applied for the benefit of, a beneficiary" which falls a long way short of saying "and it is included in assessable income on the basis that it is no longer a capital amount".

TD 2017/24 asserts that the amount made assessable "does not have the character of a capital gain for Australian tax purposes" and gives an odd explanation why this is so: "If the position were otherwise, section 99B would effectively enable corporate beneficiaries to benefit from the CGT discount, contrary to the intention of [the CGT discount provisions]". This is perplexing. The amount being assessed is the "amount … paid to … a beneficiary" but the determination assumes that a company would suddenly become entitled to a CGT discount on receiving the cheque. The argument put forward is that provisions which remove from tax payments from the corpus of the trust estate and payments that would not be assessable income of that taxpayer would be enlivened for some of the cash payment. It is hard to see that either provision would be relevant and the ATO's concern seems overstated. So, the overall result is confusing: an odd outcome arises and the ATO argues the outcome follows because of an analysis that is even more puzzling.

Circular trust distributions

In the 2018-19 Budget, the government announced that it would "extend to family trusts a specific anti-avoidance rule that applies to other closely held trusts that engage in circular trust distributions". The measure would apply from 1 July 2019 and was estimated to have a gain to revenue of $20m over the following four years. Treasury has now released a draft of the legislation[14] needed to give effect to the announcement.

An example of the problem being addressed would be as follows:

- Trust 1: the trustee of Trust 1 makes the trustee of Trust 2 presently entitled to a share of the net income of Trust 1; and
- Trust 2: the trustee of Trust 2 makes the trustee of Trust 1 presently entitled to a share of the net income of Trust 2.

The chains of trusts can be much more convoluted but the essence of the structure is that the entitlements go around in a never-ending circle.

This is not a new practice, and we already have rules against it, inserted into the ITAA36 in 1999 and then expanded in 2007. These provisions apply to the trustee of a closely held trust if it has a beneficiary which is also a trustee. The trustee of the first trust must collect and then send to the ATO certain details about the trustee beneficiary, and, if the trustee fails to do so (or the statement is incorrect), the trustee becomes liable (and its directors become liable if the trustee is a company) to pay "trustee beneficiary non-disclosure tax" on that share of the (untaxed) net income of the trust estate. The tax is imposed at the top personal marginal rate plus Medicare levy.

However, sending in the correct information is not the end of the story. If an amount is included in the assessable income of a trustee beneficiary under a circular distribution, then, notwithstanding that a correct information return was lodged, a second tax can be triggered. The drafting says a circular distribution arises where "the trustee of the closely held trust becomes presently entitled to an amount that is reasonably attributable to" an amount which is "included in the assessable income of a trustee beneficiary of the closely-held trust". And again, the second tax can be collected from the trustee or its directors if a company.

The exiting provisions can trigger either tax in respect of the income of a "closely held trust," which is currently defined in the legislation in a way that excludes both a "family trust" and a trust which has made an interposed entity election under the trust loss rules.

The draft legislation released by Treasury now exposes the trustee of a family trust and a trust which has made an interposed entity election (and its directors if the trustee is a company) to the second trustee beneficiary non-disclosure tax — the one payable in respect of circular trust distributions.

Interestingly, the draft legislation does not expose the trustee of a family trust to the first tax (the one payable where the trustee of the closely held trust does not collect and remit details of the trustee beneficiary) "because it is considered that such reporting would impose unnecessary compliance costs on family trusts".

Reorganising the trust arrangement – trust splitting

Another area that has seen some recent ATO activity is attempts to reorganise the structure of a trust through so-called "trust splitting". This seems to be the modern version of "trust cloning", a restructuring practice which was fashionable in the early part of this century, supported by the ATO in TR 2006/4. That practice continued until it was countered by legislative amendments enacted in 2010 which took effect from 2008. And it has echoes of the sub-trust restructuring seen in *Oswal*. In that case, the Federal Court treated the attempt to isolate a group of trust assets as amounting to a new trust arrangement in relation to those assets.

The ATO has ventured into "trust splitting" in TD 2018/D3. It refers to practices which are apparently current that attempt to "split" a trust into multiple "parts" — one trustee will now hold part of the corpus and deal with it one way; another trustee will hold the balance of the corpus and will (likely) deal with it another way. The assumption seems to be that this is "splitting" an "entity" but does not lead to a new trust (so CGT event E1 can be ignored).

If one starts from the notion that a trust is a *thing*, then it seems plausible to say the thing can be "split" into parts, with different trustees for each part, and nothing of any tax consequence happens at that point. But, if one starts from the legal position that a trust is an *arrangement* between people about property, it is hard to disagree with the ATO's view that these events lead to the "creation of a trust by declaration or settlement as the trustee has new personal obligations and new rights have been annexed to property".

Termination by vesting

The next issue involves the difficult topic of how to handle trusts which terminate by vesting. TR 2018/6 addresses the consequences of a trust vesting. Much of the ruling is preoccupied with the problem of a trust that vests while no-one is watching.

It must have been a very standard clause in a precedent somewhere, but there seems to be a common problem with vesting clauses which say, "the trust vests on the vesting day", with the "vesting day" defined to mean:

> "… the first to occur of the following dates namely —
>
> (i) The day specified in the Schedule as the Vesting Day [the Schedule nominates the '21st anniversary of the date of the trust deed'].
>
> (ii) The date being twenty-one (21) years after the death of the last survivor of the descendants now living of his Late Majesty King George VI.
>
> (iii) The date fixed by the Trustee as the Vesting Day."

The deed will then say what follows from vesting: typically, that the income and corpus of the trust is now held on trust for certain beneficiaries absolutely, in equal shares as tenants in common if more than one. In other words, all of the trustee's discretionary powers with respect to retaining income and capital may have ceased to operate; the trustee may no longer have power to classify amounts as income or not; the trustee may have no power to appoint the income just to some of the beneficiaries; the trustee may have no power to change the investments; and so on.

The drafting of this vesting clause tries to sit on three stools at once: para (ii) is intended to give the trust as long a life as possible, while para (iii) is meant to give the trustee the power to terminate the trust earlier if that suits everyone better, but then para (i) gives the trust a precisely defined term. The problem arises when all concerned think the trust has an (almost) indefinite life focusing on para (ii), and everyone knows the trustee has done nothing to enliven para (iii), but the trust actually vests under para (i) while no-one is watching. No-one notices for the next five years and the trust is still being administered as if it had not vested. And then, when people do discover the problem, they might try to rewrite history: they rely on another provision in the deed which allows amendments to the deed, including the vesting date clause, and then purport to change that clause, and with retrospective effect!

In TR 2018/6, the ATO tries to address these problems. The ruling says:

- the attempt to reverse the effect of the vesting of the trust does not work once the vesting date has passed: "it is no longer possible for a trustee to change the vesting date";
- but, if the trustee acts in time or a court allows a retrospective amendment, this will not cause a new trust to arise: "CGT event E1 does not happen by amending the vesting date through the valid exercise of a power in a trust deed or on approval of a relevant court". This is a stronger expression of the view in the ATO's 2001 document, *Creation of a new trust — statement of principles*, that changing the termination date might amount to a change sufficient to amount to a new trust, although "the ATO will accept that in most circumstances the mere extension of the term of a trust is consistent with a continuing trust estate";
- as a matter of trust law, the vesting of the trust does not automatically cause the trust to end, nor cause a new trust to arise. Rather, unless the trust has actually been wound up, the trustee is continuing to hold the trust property for certain beneficiaries, the property is being held under the same arrangement as existed prior to the vesting, although some aspects of the arrangement have undoubtedly changed;
- this confirms that CGT event E1 should not occur: "CGT event E1 need not happen merely because a trust has vested";
- however, the vesting of a trust "may result in the takers on vesting becoming absolutely entitled as against the trustee to CGT assets of the trust" and, if that happens, CGT event E5 is triggered;
- but, if that does not happen, CGT event E7 will likely happen on actual distribution of the CGT assets to the beneficiaries.

This seems relatively coherent, but there are some troubling aspects of the ruling.

One issue is the analysis of what happens once the mistake is discovered. An example in TR 2018/6 presents a scenario where the trustee becomes aware that the vesting date has passed and executes a deed purporting to extend the trust's vesting date. The text notes the execution of the deed "is void and ineffective" but then says that a new trust would arise if "it is realised that the deed of extension is ineffective to change the trust's vesting date [and] *all of the takers on vesting agree* that the trust assets should continue to be held on a new trust on the same terms as the original trust". No doubt that is correct, but it is not very realistic. What is more likely to happen is that the parties *do not* realise that the deed of extension is ineffective; everyone just assumes it is, and behaves accordingly; there is no agreement to establish a new trust because everyone assumes the past has been successfully rewritten. Does the more likely scenario amount to creating a new trust? Was it critical to the conclusion in the example that a new trust was created that everyone consciously "agree[s] that the trust assets should … be held on a new trust"?

A second issue is the way the ruling handles the taxation of income earned after the trust has (unexpectedly) vested. The assumption is that the trustee no longer has discretionary powers to appoint trust income, except that the trustee has behaved as if it has, and the trustee and objects have all filed returns on that basis. The ruling says:

- for the year in which the (unexpected) vesting occurred, "the Commissioner will accept an allocation of income of the trust estate into pre-vesting and post-vesting income of the trust estate in the year in which vesting occurs that is done on a fair and reasonable basis having regard to all of the relevant circumstances". The problem, of course, is that no-one has divided the income into "pre-vesting and post-vesting income";
- in the subsequent income years, since the takers on vesting will have fixed entitlements to all the income of the trust estate, none of the net income will fall to be assessed to the trustee;
- but any "payment or other purported distribution of income or capital by a trustee post-vesting that is not consistent with the vested beneficiaries' fixed interests is in breach of trust and void or otherwise not effective". Presumably, that means everyone (including the trustee) needs to file amended returns once the problem is discovered.

Tomorrow's changes

If the opinion polls are to be believed, the ALP will form government by the middle of 2019 and so its announced policies on the treatment of income and assets held on trust is important. The ALP proposes to impose "a standard minimum 30 per cent tax rate for discretionary trust distributions to … people over the age of 18".

The 30% tax on distributions will be a semi-final tax:

- for low income individuals, there will apparently be no reconciliation against the individual's actual tax liability for the year so that the 30% rate always applies to low income earners' discretionary trust income;
- for high income individuals, the ALP briefing note says a "higher rate would apply"; and
- presumably, income to which no beneficiary is presently entitled will still be taxed at the top personal marginal rate.

The policy is limited in two important respects. It applies to:

- income distributions to "individuals", so it seems distributions to so-called "bucket companies" will not be affected; and
- income derived through "discretionary trusts". While the core of this idea will be clear, in many cases, there will undoubtedly be disagreement at the margins about whether a particular trust is within that label.

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