Chapter 2

Schedule 1 – Removal of capital gains tax trust cloning exception and provision of limited fixed trust roll-over

Introduction

2.1 This chapter explains the changes proposed in Schedule 1, outlining their operation and impacts.

Schedule 1 – Trust cloning and roll over relief

2.2 The amendments of Schedule 1 apply to capital gains tax (CGT) events happening on or after 1 November 2008.[1]

2.3 An entity can only make a capital gain or loss if a CGT event takes place in the income year. A CGT event generally occurs where certain classes of assets (CGT assets) are sold, transferred or otherwise 'disposed'.

2.4 There are many special rules and exceptions which operate to modify the CGT law. To assist with the application of this area of taxation law, section 104-5 of the *Income Tax Assessment Act 1997* (ITAA 1997) provides an exhaustive list of those circumstances where a CGT event occurs and outlines what the CGT implications in the circumstances will be.

2.5 Schedule 1 of this bill deals specifically with the abolition of the exception known as 'trust cloning'[2] which affects the operations of CGT events E1 (the situation of a trust being created over a CGT asset) and E2 (a CGT asset being transferred to a trust).

2.6 Under the current legislative framework, where a trust is created over a CGT asset or a CGT asset is transferred to a trust, CGT events E1 and/or E2 are triggered to ensure that the loss or gain arising from the transaction will be taxed appropriately. This rule however is modified by the operation of the 'trust cloning' exception.

2.7 The trust cloning exception, currently contained in subsections 104-55(5) and 104-60(5) of the ITAA 1997, operates to deem that CGT events E1 and/or E2 do not occur, if, in the situation of a trust being created over a CGT asset (E1) the taxpayer is the sole beneficiary of the trust, is absolutely entitled to the asset and the trust is not a

---

1 Explanatory Memorandum, Tax Laws Amendment (2009 Measures No. 6) Bill 2009, para 1.107, p. 37.

2 These provisions are referred to as the 'trust cloning' exceptions as there is no change in the beneficiaries and there is no difference in the terms of the trusts.

unit trust[3]; or in the case of a CGT asset being transferred to a trust (E2), the asset is transferred from another trust and the beneficiaries and terms of both trusts are the same.[4]

2.8 Schedule 1 of this bill will repeal these subsections thereby removing the concessional treatment and tightening its operation. This change is designed to align the taxation of trust restructures with the policy principle of taxing capital gains where there is a change in ownership of an asset.[5]

2.9 In some circumstances CGT 'roll-over relief' will be provided where although there is a change in legal ownership there is no change in the underlying ownership.[6] This relief will be provided through the introduction of subdivision 126-G.[7] Subdivision 126-G will have the effect of deferring the making of any capital gain or loss associated with events E1 and/or E2.

2.10 An exception will be introduced to ensure that CGT events E1 and/or E2 do not arise where there is a change in the person holding the office of trustee given that the trust remains the same entity regardless of any such change.[8]

Eligibility

2.11 To be eligible to access roll-over relief, both trusts must have the same beneficiaries with the same entitlements and terms. The terms of the trusts must also be similar and although they are not required to be exactly the same, they must not contain terms or discretionary powers that would cause different results for the beneficiaries.[9] At the same time the receiving trust is required to be a newly created trust or a trust without any CGT assets other than a small amount of cash or debt – ie an 'empty trust'.[10]

2.12 Roll-over relief will generally be applied on an asset-by-asset basis although relief can be sought for the transfer of multiple assets transferred as part of an arrangement.[11]

---

3 Subsection 104-55(5) of the ITAA 1997.

4 Subsection 104-60(5) of the ITAA 1997.

5 Explanatory Memorandum, p. 11.

6 Explanatory Memorandum, p. 12.

7 New subdivision 126-G will be titled 'Transfers of assets between certain trusts'. (Division 126 of which subdivision 126-G will be a part, is titled 'Same asset roll-overs'.)

8 Explanatory Memorandum, paras 1.18 – 1.19, p. 14.

9 Explanatory Memorandum, para 1.31, p.17, para 1.27 p. 16 and p. 12.

10 Explanatory Memorandum, pp 12, 16.

11 Explanatory Memorandum, paras 1.66 – 1.68, p. 26.

Exceptions to roll-over relief

2.13 The CGT roll-over relief being introduced by subdivision 126-G will not be available in all situations of asset transfer. Roll-over relief will not be available where:

(a) the receiving trust is a foreign trust for CGT purposes and the asset transferred is not taxable Australian property;[12]

(b) the trusts involved are taxed like companies or were at any time during the year that the transfer took place, either a corporate unit trust or a public trading trust;[13] and

(c) in instances where both trusts have not made the same elections ('mirror choices') and the absence[14] of a 'mirror choice' in the other trust will have an ongoing and material impact on the entity's net or taxable income.[15]

Consequences of roll-over relief

Trustees

2.14 In situations where both the trustee of the transferring trust and the trustee of the receiving trust elect roll-over relief, any capital gain or loss made by the transferring trustee in respect of the transferred asset is disregarded.[16] As a result of electing roll-over relief the cost base and reduced cost base of the asset will take the value that it held while in the hands of the transferring trustee just before the transfer time.[17]

2.15 The time of acquisition will also be affected and in all circumstances, except those involving pre-CGT assets, the receiving trust will be taken to acquire the asset at the time the asset is transferred or the trust over the asset is created.[18]

2.16 In those circumstances where the transferred asset was acquired prior to the introduction of the CGT regime (pre 20 September 1985), the transferred asset will be taken to have been acquired by the receiving trust prior to 20 September 1985.[19]

---

12 Explanatory Memorandum, para 1.51, p. 22.

13 Explanatory Memorandum, para 1.52, p. 23.

14 Generally, the 'mirror choice' is required to be in force just after the transfer time - Explanatory Memorandum, para 1.56, p. 24.

15 Explanatory Memorandum, paras 1.53 – 1.55, p. 23.

16 Explanatory Memorandum, para 1.74, p. 28.

17 Explanatory Memorandum, para 1.75, p. 28.

18 Explanatory Memorandum, para 1.77, p. 28.

19 Explanatory Memorandum, para 1.76, p. 28.

2.17 As a result of electing roll-over relief, the receiving trust will be required to forfeit any net capital losses attributable to prior years which they have carried forward.[20]

Beneficiaries

2.18 Like the trustees of the transferring and receiving trusts, after roll-over is elected, the beneficiaries are also required to adjust the cost base and reduced cost base of their interests in each trust on an interest-by-interest basis.[21]

2.19 The date of acquisition of their interests in the receiving trust is deemed to be the transfer time. Again, the only exception is where the interests that are transferred were acquired by the transferring fund prior to 20 September 1985. In this case the beneficiaries will also be deemed to have received their interests prior to 20 September 1985.[22]

2.20 The bill also provides special rules in situations where CGT discounts are required to be calculated.[23]

Requirement to give information

2.21 New subdivision 126-G introduces a notification requirement that will require the trustee of the transferring trust to send written notice containing certain information to each of the beneficiaries following the transfer of the interests.[24] In those instances where there are two or more trustees, each trustee is liable to provide written notice to the beneficiaries although the obligation can be satisfied by any one of the trustees.[25]

2.22 Proposed subsection 126-260(2) specifies that written notice must set out:

- the transfer time;
- the market value of each of the beneficiaries' membership interests in the transferring trust both just before and just after the transfer time; and
- information to enable the beneficiaries to work out which interests in the receiving trust correspond to their interests in the transferring trust.[26]

---

20 Explanatory Memorandum, paras 1.78 – 1.80, p. 29.

21 Explanatory Memorandum, para 1.86. p. 30.

22 Explanatory Memorandum, paras 1.95 – 1.96, pp 33 – 34.

23 To calculate any CGT discount, the ownership period of the beneficiary's membership interests in the receiving trust will include the period of ownership of the member's interests in the transferring trust. Explanatory Memorandum, para 1.97, p. 34.

24 Explanatory Memorandum, para 1.101, p. 36.

25 Explanatory Memorandum, para 1.104, p. 37.

26 Explanatory Memorandum, para 1.102, p. 36.

2.23 The bill provides that where the requirement to give notice is not met the trustee commits an offence.

2.24 Failure to give notice will not relieve the beneficiaries of their obligation to make the necessary adjustments to the cost base and reduced cost base of their interests.[27]

Transitional provisions

2.25 Given the retrospectivity of Schedule 1, the bill proposes the introduction of transitional provisions to ensure that trustees will have adequate time to make the mirror choices required by subsection 126-235(3) and provide the beneficiaries with written notification pursuant to section 126-260.[28] A period of six months from Royal Assent for this transitional period is proposed.

Views on Schedule 1

2.26 As explained in paragraph 2.9, the proposed changes are designed to ensure that the CGT provisions of the income tax law operate in accordance with the principle of taxing capital gains that arise where there is a change in ownership.[29] The changes are being introduced as an integrity measure to ensure that trust cloning is not used inappropriately to avoid taxation.

2.27 After the proposal was first announced on 31 October 2008,[30] the Treasury undertook extensive public consultation during both the policy design and the exposure draft stages.

2.28 The majority of comment received during that period was critical of the changes, opposing them on the basis that there are legitimate reasons for trust cloning and suggesting instead that the government address any uncertainty or integrity concerns with the operation of the existing provisions directly.[31]

2.29 The various concerns that were raised during the consultation process were, in most cases, discounted. However the draft legislation was amended prior to its introduction into the House of Representatives on 25 November 2009 in recognition that there will be some situations where it will be appropriate to provide relief from

---

27 Explanatory Memorandum, paras 1.103 – 1.106, p. 37.

28 Explanatory Memorandum, paras 1.108 – 1.109, pp 37 – 38.

29 The Hon. Chris Bowen MP, Government abolishes trust cloning tax concession, Media release No. 092, 31 October 2008.

30 The Hon. Chris Bowen MP, Government abolishes trust cloning tax concession, Media release No. 092, 31 October 2008.

31 Australian Government, Department of the Treasury, *Abolishing the capital gains tax (CGT) trust cloning exception and providing a roll-over for fixed trusts, Summary of Consultation Process*, December 2009.

CGT where assets are transferred between certain trusts. As a result, the bill now provides for limited roll-over relief through proposed Subdivision 126-G, its effect being to ensure that any CGT consequences that arise as a result of a transfer are deferred.[32]

2.30 Subdivision 126-G will identify those instances where roll-over relief is available and the consequences of electing to access that option.

The current inquiry

2.31 In conducting its inquiry into TLAB 6 the committee received 10 submissions. Of those, only one made mention of the changes proposed by Schedule 1 detailing the concern that they will not achieve the policy intent being sought and suggesting that the operation of the amendments and the application of the proposed roll-over relief will be far too narrow.[33]

2.32 The submission was critical of the criteria that will be introduced and required to be met to enable a trust to qualify for the relief and suggested a number of changes be made to widen access to what will be the new Subdivision 126-G.[34]

Committee view

2.33 The committee notes that the purpose of the amendments is to ensure that CGT considerations do not excessively interfere with decisions concerning trust restructures yet at the same time ensures that the parties involved are taxed appropriately.[35] The committee takes the view that it is appropriate to limit roll-over relief in situations of restructure to ensure restructuring is not principally used as a mechanism for avoiding tax.

2.34 The committee acknowledges that the proposed amendments will tighten the existing legislative provisions resulting in instances where a CGT liability that would not have arisen due to the trust cloning exceptions will be incurred. As the proposed change is an integrity measure it is considered appropriate that the law be modified to

32 The Hon. Chris Bowen MP, Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, Government acts to reduce compliance costs and improve the tax law (Attachment F), Media Release No. 048, 12 May 2009.

33 Blake Dawson, *Submission 3*, 18 December 2009, pp 1 – 2.

34 Blake Dawson, *Submission 3*, 18 December 2009, p. 3.

35 Explanatory Memorandum, p. 15.

tighten access to concessional taxation treatment where its operation has revealed such a need.[36]

Recommendation 1

As the limited roll-over relief to be introduced by Subdivision 126-G is adequately broad, the Committee recommends the Senate pass Schedule 1 without amendment.

36 The need to tighten the trust cloning exception to CGT events E1 and E2 was acknowledged by the accounting industry who, in their submission to Treasury advised that they considered it too wide and needing to be narrowed to protect the CGT base. Source: The Institute of Chartered Accountants in Australia, *Submission to the Treasury on exposure draft – abolishing the capital gains tax trust cloning exception and providing a roll-over relief for fixed trusts,* 6 October 2009, Appendix 1, p. 4.