

The Clark decision: possible consequences for CGT event E4?

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Abstract: An article entitled “Fixed trusts and unit trusts: one and the same?”, which was published in the December 2013/January 2014 issue of this journal, considered a number of aspects of fixed trusts and unit trusts. Questions have been raised about comments that CGT event E4 should apply only to fixed trusts and, by implication, not unit trusts. This article explores the various issues, including the potential consequences of the decision of the Full Court of the Federal Court in *FCT v Clark*, and the relevance of ATO pronouncements. The authors conclude that it is arguably possible to vary a trust deed to limit the impact of CGT event E4 where the trust is not a fixed trust. However, where a trust satisfies the definition of a fixed trust, or has a prohibition on variation as outlined, there will be no ability to leverage off the *Clark* decision to minimise the potential application of CGT event E4.

CGT event E4

While a landmark decision in relation to CGT event E1 and the concept of trust resettlements, the decision of *FCT v Clark*¹ (*Clark*) also has potential consequences for CGT event E4.

CGT event E4 happens if:

- (1) the trustee of a trust makes a payment to a taxpayer in respect of a unit or interest in the trust (except for CGT event A1, C2, E1, E2, E6 or E7 happening in relation to it); and
- (2) some or all of the payment (the non-assessable part) is not included in the taxpayer’s assessable income.²

It is clear that CGT event E4 applies to unit trusts and fixed trusts, due to the express words in s 104-70(1) of the *Income Tax Assessment Act 1997* (Cth), “in respect of your unit or interest in the trust”. However, the ATO has provided clarification in TD 2003/28 about the meaning of the words “interest in the trust” in s 104-70(1), stating:³

“The meaning to be given to the words ‘interest in the trust’ depends on the context in which they are used, see for example *Leedale v. Lewis* [1982] 3 All ER 808 and *Gartside v. IRC* [1968] AC 553. In its context in section 104-70, the interest in the trust is one that is coloured by the nature of a unit in a unit trust, that is, the interest in the trust is one that is akin to the interest that a unit holder has in a unit trust. The interest that is contemplated is one in which a taxpayer invests.”

TD 2003/28 confirms that CGT event E4 does not apply where a beneficiary’s interest is that of a mere object in a

discretionary trust, even if the beneficiary has an interest in default of appointment.⁴

In light of the comments in TD 2003/28, there has been some uncertainty as to the application of CGT event E4 to an interest in a “hybrid” trust (for example, a unit trust where beneficiaries have both fixed and discretionary entitlements).⁵

The National Tax Liaison Group Subcommittee minutes from the meeting on 11 June 2003 (NTLG minutes) indicate that CGT event E4 will not apply in the case of a unit trust, even where there are discretionary units (for example, a hybrid trust). This conclusion is based on the ATO’s reasoning in TD 97/15W (the predecessor to TD 2003/28) that CGT event E4 does not apply to a non-assessable payment made by a trustee to a beneficiary of a discretionary trust.

In particular, the NTLG minutes state:

“... a non-assessable amount paid to the owners of discretionary ‘special units’ is not a payment of the type contemplated by section 104-70 of the ITAA 1997. Therefore CGT event E4 will not happen when such payment is made to the owners of special units that only have a discretionary entitlement to capital contributions. A beneficiary with only a discretionary interest in a trust does not own an interest in the trust that is of the nature or character contemplated by section 104-70 of the ITAA 1997.”

The NTLG minutes refer to TD 97/15, which was withdrawn after the NTLG minutes were released and effectively replaced with TD 2003/28. The notice of withdrawal for TD 97/15 confirms that the views of the ATO expressed in TD 2003/28 are the same

as those in TD 97/15 in respect of the mere objects of a trust. Therefore, the withdrawal of TD 97/15 should not alter the effect of the comments in the NTLG minutes.

Notwithstanding the phrase “unit or interest in the trust” in s 104-70, the NTLG minutes and various private rulings issued by the ATO (for example, private ruling 26597) confirm that the mere label in a trust instrument of an interest as a “unit” is not sufficient for CGT event E4 to apply. Instead, the relevant consideration is whether the units or interest create particular entitlements that sufficiently satisfy the provisions in s 104-70.

While the NTLG minutes are obviously not binding on the question of whether CGT event E4 can apply to a unit trust where the unitholders have discretionary entitlements, the comments do assist with the ATO’s likely interpretation of s 104-70, particularly when read in conjunction with the guidance in TD 2003/28.

The recent article “Payment of non-assessable amount to an owner of discretionary units and CGT event E4” provides further examination of the ATO guidance in this regard.⁶

The Clark decision

There have been numerous articles published in *Taxation in Australia* about the *Clark* decision, and this article therefore does not set out an in-depth analysis of the case. However, briefly, in *Clark*, the Full Court of the Federal Court effectively confirmed that there is a very wide ability to amend a trust deed without causing a resettlement, provided the amendment

is within the scope of the variation power under the trust instrument.

The *Clark* case involved a unit trust which had been substantially varied over several years. Some of the variations included the changing of the trustee, the beneficiaries and the trust property. The court rejected the ATO's argument that these amendments had amounted to a resettlement of the trust, stating that a resettlement will not occur where there has been continuity of:

- (1) the terms of the trust deed;
- (2) the trust property; and
- (3) the membership of the trust.

The court also confirmed that where variations are within the scope of a variation power in the relevant trust deed, changes over time to the trust property and beneficiaries should not trigger a resettlement, provided that they can be identified at all times and there has not been a severance which would lead to the termination of the trust.

The ATO has accepted in TD 2012/21 that a valid amendment to a trust not resulting in a termination of the trust will not of itself result in the happening of CGT event E1.

Possible consequences for CGT event E4 following Clark

Following the *Clark* decision, it is arguably possible to vary a trust deed to limit the impact of CGT event E4 in circumstances where the trust in question is not a fixed trust.

In particular, where a unit trust deed contains an adequate variation power, the rights of the unitholders could be varied to create a discretionary entitlement, such that the trust will effectively become a hybrid trust, with both fixed and discretionary entitlements. Applying the principles from the *Clark* decision, this style of variation should not trigger a resettlement of the trust.

In turn, applying the guidance provided in the NTLG minutes and TD 2003/28, CGT event E4 should then not apply in relation to payments made via the discretionary entitlements. That is, where a unitholder's entitlement to a payment is at the discretion of the trustee, CGT event E4 will not be relevant.

As set out in the recent article "Fixed trusts and unit trusts: one and the same",⁷ following the *Colonial* decision,⁸ a trust will be a fixed trust for taxation purposes where beneficiaries (or unitholders) have a vested and indefeasible interest in the trust.

It is generally accepted that a fixed trust will exist if a trust deed has the following provisions:

- (1) the trustee cannot create different rights or different classes of units;
- (2) all units on issue must have the same rights to receive income and capital of the trust;
- (3) all units must be allotted for market value;
- (4) all income and capital of the trust must be distributed in proportion to the unitholdings, ie there is no discretion held by the trustee and in particular there must be no discretionary elements that may mean the trust is a "hybrid" trust;
- (5) partly paid units cannot be issued;
- (6) the trust deed must require all unitholders to agree on the redemption of units and any redemption must be at market value;
- (7) all valuations of the trust fund, and in turn the determination of unit values, must be conducted by a valuer in accordance with "applicable Australian accounting principles";
- (8) the trustee cannot make gifts; and
- (9) the unanimous consent of all unitholders must be required to vary the trust deed. However, there must be a complete prohibition in the variation power ensuring that no amendments can be made in relation to any of the above provisions.

Conclusion

Where a trust satisfies the definition of a fixed trust, or has a prohibition on variation similar to that outlined above, there will be no ability to leverage off the *Clark* decision to minimise the potential application of CGT event E4.

Given the observation in *Colonial* that very few trusts are likely to satisfy the definition of a fixed trust, prudence would dictate considering the impact of the *Clark* decision in the context of any trust to which CGT event E4 may otherwise apply. That said, it is also important to consider all consequences of varying a non-fixed trust deed in a manner that may limit the operation of CGT event E4, for example:

- (1) this type of approach is unlikely to be commercially appropriate where the units are held by arm's length parties;
- (2) the impact of any interest deductions where unitholders have borrowed funds

to acquire the units would need to be considered; and

- (3) the application of Pt IVA of the *Income Tax Assessment Act 1936* (Cth) must always be analysed.

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References

- 1 [2011] FCAFC 5.
- 2 S 104-70(1) of the *Income Tax Assessment Act 1997* (Cth).
- 3 Para 4 of TD 2003/28.
- 4 Para 3 of TD 2003/28.
- 5 D Tan, "Payment of a non-assessable amount to an owner of discretionary units and CGT event E4", (2013) 48(3) *Taxation in Australia* 148; and F Martin, "Does CGT event C2 apply when a beneficiary's interest in a trust ends?" (2013/14) 48(6) *Taxation in Australia* 318.
- 6 D Tan, "Payment of a non-assessable amount to an owner of discretionary units and CGT event E4", (2013) 48(3) *Taxation in Australia* 148.
- 7 T Lucke, M Burgess and L Polkinghorne, (2013/14) 48(6) *Taxation in Australia* 321.
- 8 [2011] FCA 16.