Tax Office plays secret Santa as the long awaited guidance on trust vesting gets released

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As it seems is tradition, the Tax Office has delivered another substantive release on a long-standing issue in the last month of the calendar year with the publication on 13 December 2017 of Draft Taxation Ruling TR 2017/D10 (see para [1817] of this *Bulletin*).

Subject to being issued as a final ruling, Draft TR 2017/D10 arguably resolves many of the uncertainties surrounding trust vesting.

1.1 Overview

In summary, the key conclusions from the draft ruling are as follows:

- While a trustee may be able to extend an approaching vesting date during the life of the trust to the maximum period available at law (generally 80 years), it is unable to be extended after the trust has vested without a court order.
- Upon the vesting of a discretionary trust, the trustee holds the trust property for the absolute benefit of the takers-in-default named in the trust deed.
- The vesting of a trust will not necessarily, of itself, result in a CGT event. However, this is dependent on the terms of the trust deed and subsequent steps, such as the transfer of assets to the beneficiaries by the trustee, may result in a taxable event.
- While the trustee of a discretionary trust may distribute income between the range of beneficiaries in its discretion during the life of a trust, following vesting, all income is deemed each year to be distributed to the takers-in-default in proportion to their vested interests in the property of the trust.

The Tax Office's conclusions in the ruling appear to be largely uncontroversial, although it is interesting to note ***it has finally explicitly acknowledged that the vesting of a trust will not, by itself, result in any CGT event in many circumstances***.

Arguably the key reason for the relatively uncontroversial nature of the draft ruling stems from a failure to consider many of the fundamental issues the industry has been grappling with for some years.

Indeed, the main position adopted by the Tax Office on a potentially controversial issue is its rejection of the argument that a vesting date may be extended by implication where the vesting day has lapsed and all parties have behaved in a manner which is consistent with the vesting day having been extended.

1.2 Relevant CGT Events

As is generally understood, the relevant CGT events upon the vesting of a trust are A1, E1 and E5, as summarised below. The draft ruling confirms that (subject to the terms of the relevant deed), it is possible none of these events will occur on the vesting of a traditional discretionary trust.

1.3 CGT event A1

Section 104-10 of the ITAA 1997 defines when CGT event A1 occurs and reads:

(1) CGT event A1 happens if you dispose of a CGT asset.

(2) You dispose of a CGT asset if a change of ownership occurs from you to another entity, whether because of some act or event or by operation of law. However, a change of ownership does not occur if you stop being the legal owner of the asset but continue to be its beneficial owner.

In the context of a trust vesting, CGT event A1 will be triggered if the trustee transfers an asset to a beneficiary by way of an in specie distribution in satisfaction of that beneficiary's entitlement.

In other words, it is not the vesting itself which would trigger the CGT event. Rather, it is the subsequent disposal of the asset by the trustee which results in CGT event A1 arising.

1.4 CGT event E5

CGT event E5 is defined in s 104-75 of the ITAA 1997 which reads:

(1) CGT event E5 happens if a beneficiary becomes absolutely entitled to a CGT asset of a trust (except a unit trust or a trust to which Division 128 applies) as against the trustee (disregarding any legal disability the beneficiary is under).

(2) The time of the event is when the beneficiary becomes absolutely entitled to the asset.

At face value, CGT event E5 is the most applicable event arising upon the vesting of a trust, as it could be thought that a beneficiary would become "absolutely entitled" to the trust assets either as a result of a positive determination by the trustee or as a consequence of the default provisions under the trust deed.

However, as discussed in more detail below, the concept of "absolute entitlement" is complex and at times, contentious.

Consequently, it is generally seen (and apparently now accepted by the Tax Office in Draft TR 2017/D10) as unlikely that CGT event E5 will occur automatically upon the vesting of a trust.

1.5 CGT event E7

Section 104-85 of the ITAA 1997 defines when CGT event E7 occurs and reads:

(1) CGT event E7 happens if the trustee of a trust (except a unit trust or a trust to which Division 128 applies) disposes of a CGT asset of the trust to a beneficiary in satisfaction of the beneficiary's interest, or part of it, in the trust capital.

As CGT event E7 only applies where a beneficiary has an interest in the trust capital, it will rarely apply in the context of the vesting of a discretionary trust.

1.6 CGT event E5 and absolute entitlement

As outlined above, CGT event E5 was traditionally regarded as the CGT event most likely to apply upon the vesting of a trust.

However, Tax Office rulings and cases prior to the release of Draft TR 2017/D10 cast significant doubt on the correctness of this position.

Specifically, CGT event E5 applies where a beneficiary becomes "absolutely entitled" to the assets of a trust.

The meaning of the term "absolutely entitled" is subject to significant contention and debate as evidenced by the ongoing failure of the Tax Office to issue a final version of Draft TR 2004/D25 (2004 is not a typo; the draft TR has remainsed unfinalised for well over a decade).

1.7 *Saunders v Vautier*(1841) EWHC Ch 82

The 19th century English decision Saunders v Vautier set the groundwork for the concept of absolute entitlement.

In that judgment, Lord Langdale MR held:

"*I think that principle has been repeatedly acted upon; and where a legacy is directed to accumulate for a certain period, or where the payment is postponed, the legatee, if he has an absolute indefeasible interest in the legacy, is not bound to wait until expiration of that period, but may require payment the moment he is competent to give a valid discharge*."

The judgment has been interpreted as meaning that where a beneficiary who has attained the age of 18 has a vested and indefeasible interest in a trust asset, they can issue a call to the trustee requiring the transfer of the asset to them.

The principles of this case are akin to that of absolute entitlement. Where a beneficiary has a vested and indefeasible interest in a trust asset sufficient for them to require the trustee to transfer the asset to them, they are likely to be absolutely entitled to that asset.

1.8 Draft TR 2004/D25

In summary, Draft TR 2004/D25 takes the position that absolute entitlement over a single asset will only arise where a single beneficiary has all the interests in that asset.

Following that line of argument, the draft ruling concludes that if more than 1 beneficiary has an interest in a particular asset, no beneficiary will be absolutely entitled to that asset.

Applying this to a discretionary trust which generally vests with multiple beneficiaries each being entitled to a percentage of the trust assets, Draft TR 2004/D25 implies that none of those beneficiaries would be absolutely entitled as against the trustee (unless each beneficiary had an entitlement to a discrete asset).

Furthermore, the draft ruling takes the view (at paragraphs 16-19) that:

- a beneficiary can be absolutely entitled to an asset even though they hold their interests in it as trustee for 1 or more others;
- the existence of a mortgage or encumbrance over the asset in favour of a third party does not prevent the beneficiary from being absolutely entitled;
- the existence of a trustee's lien (and ability to sell the assets of the trust) to enforce a right of indemnity against a trust asset will not prevent a beneficiary from being absolutely entitled to the asset; and
- a beneficiary can still be absolutely entitled to an asset for CGT purposes where they are suffering a legal disability (such an infancy or insanity).

The correctness of a number of points contained in the draft ruling are subject to significant conjecture, perhaps none more so than the ramifications of the trustee's right of indemnity out of trust assets.

This point was tested in the decision of *FCT v Oswal* [2012] FCA 1507 ("Oswal"). Interestingly, this decision is not mentioned in Draft TR 2017/D10, despite an opposite conclusion being reached in Example 7 (which concludes that where a trust vests with a sole capital beneficiary, that beneficiary becomes absolutely entitled to the trust assets and CGT event E5 occurs).

1.9 *FCT v Oswal* [2012] FCA 1507

As first reported at 2013 WTB 2 [58], the *Oswal* case involved the trustee of a discretionary trust who decided to make 2 beneficiaries entitled to specific assets of the trust, being shares in a company.

The Tax Office put forward several alternative positions regarding the exercise of the power by the trustee, namely that it triggered 1 of:

- CGT event E1 (creation of a trust);
- CGT event E5 (creation of absolute entitlement); or
- CGT event A1 (disposal).

By contrast, the taxpayer argued that the determination by the trustee did nothing more than establish "a separate fund of assets under the umbrella of the trust" and that the determination did not trigger any of the CGT events listed above.

The Federal Court determined that CGT event E1 (creation of a trust) was triggered by the determination and a subsequent application by the taxpayer for leave to appeal the decision was denied by the Court.

The most significant comments in the judgment however perhaps related to the arguments regarding CGT event E5.

Justice Edmonds (in *Oswal v FCT* [2013] FCA 745) found that CGT event E5 could not arise, because the beneficiaries could not become absolutely entitled to trust assets where the trustee had a lien over the assets in respect of its right to be indemnified for trust liabilities out of trust assets.

Adopting the Court's view in *Oswal*, it seems the beneficiaries of a discretionary trust will rarely (if ever) be absolutely entitled against a trustee when a trust vests, as the trustee will always have a common law right of indemnity out of trust assets, able to be satisfied via an equitable lien.

While draft TR 2017/D10 does not explore any of the above arguments, it does still reach largely the same conclusion. ***It is hoped that before the final ruling is issued, the Tax Office does explain the reasons for concluding that CGT event E5 does not occur on the vesting of a trust and the inconsistency between the Oswal decision and the Example 7 in the draft ruling is addressed***.

1.10 Some of the missing answers

The draft ruling does not attempt to address a range of questions that would seem to be critical to include before the ruling is finalised.

For example:

- In what circumstances will a power of variation be deemed to be too narrow to allow an extension of a vesting date?
- If a power of variation expressly permits retrospective amendments, why will this not allow a vesting date to be extended after it has passed (the draft ruling is blunt in its view that a trust vesting date can never be extended once it has passed)?
- If there are no default beneficiaries, will the trustee of the trust be taxed on all income and capital gains derived (at the top marginal rate, with no CGT discount) pending the assets of the trust being distributed?
- Alternatively, if there are no default beneficiaries, does the Tax Office instead believe that the assets of the trust pass on a resulting trust to the settlor?
- Can a trustee resolve to amend the jurisdiction of the trust to South Australia, and thus have any vesting date essentially abolished?
- If an individual default beneficiary of a vested trust dies before the trustee distributes the assets to them, do those assets pass in accordance with their will, without tax consequence due to Div 128 of the ITAA 1997?
- What approach will the Tax Office have in relation to lost trust deeds, where it is impossible to confirm the date of vesting?

1.11 Conclusion

Draft TR 2017/D10 provides some welcome clarity to the Tax Office's view in relation to trust vesting, although much of the guidance it provides is subject to the qualification that the issue "requires a close consideration of the effect of vesting as specified in the deed" and is subject to language such as "…it may be the case…".

Perhaps however these comments are merely the Tax Office using its language to restate the mantra featured regularly in this *Bulletin*, namely – ***Read the Deed***.

Furthermore, as flagged above, there are a number of fundamental issues that have not been considered at all; a disappointing outcome given how long it has taken for the draft ruling to be released.

Without being deliberately trite, it is hoped that the final version of Draft TR 20017/D10 does not suffer the same delays as Draft TR 2004/D25.