

PRACTITIONER ARTICLES

[1456] **Trust cloning: a useful reminder 10 years after it "ended"**

- by *Matthew Burgess, Director, View Legal*

The heyday of trust cloning for all forms of inter vivos discretionary trusts largely ended with the abolition of the CGT "cloning" exemption on 31 October 2008. However as previously reported, trust cloning is again be available for trusts carrying on a business which satisfy the genuine restructure test from 1 July 2016 (see 2016 WTB 12 [350]).

Furthermore, the removal of the exemption around 10 years ago did not extend to trusts that are subject to CGT event E4 (that is, unit trusts).

Unit trusts

This means that the ability to proactively manage wealth that has been built up in 1 trust via a tax free trust cloning arrangement is still possible. Situations where trust cloning for unit trusts can be particularly useful include where there is a desire to:

- separate passive investments or valuable capital assets from the risks associated with carrying on a business;
- separate multiple business activities and quarantine the risks associated with each;
- allow divestment of certain assets by way of unit transfer or subscription, while retaining ownership of other assets;
- help create deductible interest expense on borrowings used to finance the transfer of assets between the original and cloned trusts.

Aside from CGT, it is important to remember that trust cloning can have a number of other revenue related consequences that should be considered, however these are outside the scope of this article.

CGT

The definition of a fixed trust for taxation purposes has been the subject of some debate, however it is generally accepted that a trust does not need to satisfy the definition of a fixed trust before being subject to CGT event E4. This is because s 104-70(1) of the ITAA 1997 states that CGT event E4 happens if:

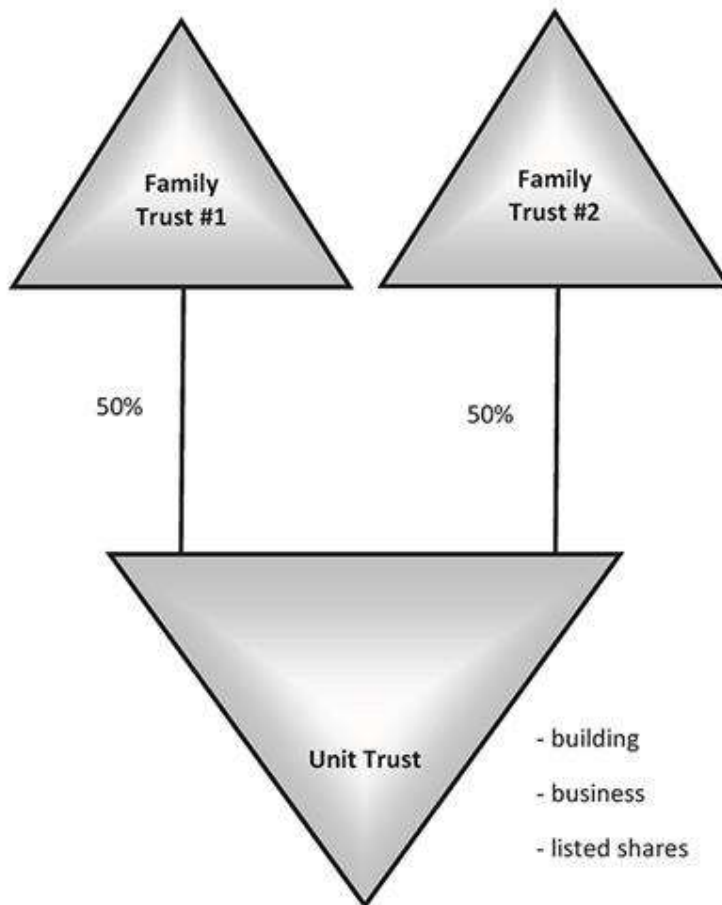
- the trustee of a trust makes a payment to a taxpayer in respect of a unit or interest in the trust (except for CGT event A1, C2, E1, E2, E6 or E7 happening in relation to it); and
- some or all of the payment (the non-assessable part) is not included in the taxpayer's assessable income.

In other words, it is clear that CGT event E4 applies to unit trusts (and therefore in turn fixed trusts), due to the express words in s 104-70(1) "in respect of your unit or interest in the trust".

Notwithstanding the phrase "unit or interest in the trust" in s 104-70, the ATO has confirmed (see private ruling 26597) that the mere label in a trust instrument of an interest as a "unit" is not sufficient for CGT event E4 to apply.

The CGT exemption for cloning is set out under Subdiv 126-G of the ITAA 1997.

Diagrammatically, the structure of a standard arrangement is often represented as follows -



"Standard" unit trusts

The types of clauses in "standard" unit trust deeds that would help support an argument that the trust should be treated as a fixed trust include those that state:

- units of different classes or different rights are not permitted;
- that all income during the life of the trust, together with the net assets of the trust are, on vesting, to be distributed to the unitholders in proportion to their respective unitholdings;
- there is no power to redeem units or transfer units, other than at the market value of the units; and

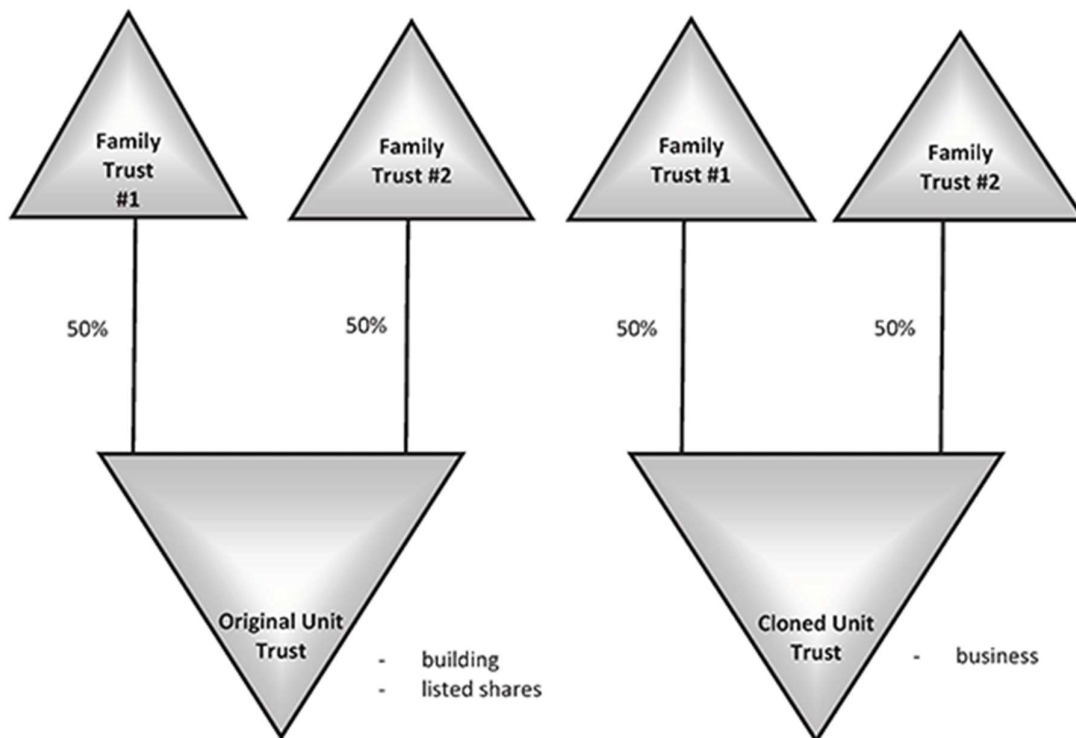
- that the trust deed cannot be amended without at least 75%, and preferably, 100% consent of the unitholders.

CGT rollover relief

In summary, Subdiv 126-G requires the following conditions to be met in order to access the rollover relief:

- the trustee of a trust (the transferring or "original" trust) creates a trust (the "receiving" trust), by declaration or settlement, over 1 or more CGT assets that include the rollover asset or transfers the rollover asset to an existing trust (the receiving trust) and the receiving trust has no CGT assets, other than small amounts of cash or debt;
- just after the transfer time:
 - each of the trusts has the same beneficiaries;
 - the receiving trust has the same classes of membership interests that the transferring trust had just before, and has just after, the transfer time;
 - the sum of the market values of each beneficiary's membership interests of a particular class in both trusts is substantially the same as the sum of the market values, just before the transfer time, of the beneficiary's membership interests of that class in both trusts;
- CGT event E4 is capable of happening to all of the membership interests in each of the trusts.

Diagrammatically, the structure of a standard trust cloning arrangement can be represented as follows -



Cost base position

Where the rollover relief applies, s 126-240 of the ITAA 1997 confirms the cost base of the CGT assets transferred to the receiving trust is their pre-existing tax cost base in the hands of the transferring trust.

Importantly, if a transferring trust acquired any of the assets being transferred prior to 20 September 1985, those assets will continue to be pre-CGT assets in the receiving trust.

Following a transfer of CGT assets to the receiving trust, the CGT cost base of the unitholders' units in the transferring trust are reduced by the market value of the units transferred.

In turn, the CGT cost base of the unitholders' units in the receiving trust will equate to the amount of the reduction in the CGT cost base of the units in the transferring trust and any pre-CGT status is retained (see s 126-245 of the ITAA 1997).

Consideration under transfer documents

Generally the approach adopted to avoid any application of CGT event E4 on the transfer of assets is to ensure the trustee of the transferring trust merely ceases to hold the relevant assets on that trust, and in turn commences to hold them, on the terms of the receiving trust.

This approach, while altering the equitable obligations in relation to the assets, effectively avoids any "payment" to the unitholders of the transferring trust. The ATO has confirmed this outcome in Class Ruling CR 2010/77.

By adopting the approach where the trustee ceases to hold assets on 1 trust and commences to hold them on another trust, from a trust law perspective, the transfer will still likely be treated as a distribution, however appropriate drafting of the implementation documentation can minimise the risk of any issues arising.

Accessing the CGT relief

The choice by the trustee of each of the transferring trust and the receiving trust to access the rollover (see s 126-225(3) of the ITAA 1997) should be made on or before the day each trust lodges its tax return for the year in which the transfer occurs.

The way in which the tax returns are prepared is sufficient evidence of making the choice to obtain the rollover in this regard. Trustees should also be aware of the notices that must be provided to unitholders within 3 months of the end of the income year that the transfer take place (see s 126-260 of the ITAA 1997).

Conclusion

In many respects, the ability to clone a unit trust is a simple, yet powerful, strategy that practically is useful in a large range of circumstances.

There are however some fundamental threshold issues that need to be addressed to ensure the CGT relief can be validly accessed. Furthermore, given the significant number of issues aside from CGT that are potentially relevant, it is critical that a methodical approach is adopted.

Given the prevalence of various forms of unit trusts as an investment structure for many years and the massive amount of wealth that is likely to be subject to intergenerational transfer over the next 20 years, the planning opportunities in relation to fixed trust cloning will in all likelihood become increasingly important.