



WEEKLY TAX BULLETIN

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Lost trust deeds – the adverse revenue consequences are many

- by *Matthew Burgess, Director, View Legal*

The decision in *Mantovani v Vanta Pty Ltd (No 2)* [2021] VSC 771 ("Vanta") was discussed in the article at 2021 WTb 49 [1171].

While not the focus of the case, the related revenue consequences that likely flow from similar situations of lost trust deeds creating a resulting trust in favour of the settlor are significant.

Revenue related issues

Some of the potential revenue related issues that should likely be considered in this regard include the following.

- At the date of the trust deed being deemed to be lost, a capital gains tax (CGT) event will occur; most likely CGT Event E1 as the more specific event (being the creation of a trust over a CGT asset by declaration or settlement, see the discussion of *Kafataris v DCT* [2008] FCA 1454 at 2015 WTb 36 [1362]).
- Income tax being payable on non-capital assets, such as plant and equipment and trading stock.
- Similarly, to the extent any trust property is dutiable, the resulting trust will likely cause a stamp duty impost, being a transaction that is one or more of a transfer, resettlement, trust acquisition or trust disposal.
- Given that generally the settlor of a trust is completely unrelated to the key beneficiaries (eg, an accountant or lawyer), the settlor may decide it appropriate to transfer the assets received due to the resulting trust to the "rightful" controllers, triggering further CGT and income tax (for increases in value in the intervening period) and stamp duty (if the assets are dutiable) costs. In this regard it is worth noting that some lawyers have been known (perhaps given *Vanta*, not in jest) to claim that they aim to be the settlor of as many trusts as possible; as part of a retirement planning strategy (in the hope that some trusts fail and allow the settlor to be entitled to all trust assets due to the resulting trust rules).
- There is also a risk, depending on the exact situation that the revocable trust rules under s 102 of ITAA 1936 will be held to apply, allowing the Commissioner to assess the trustee on the income from the settled property in each relevant year, and at a rate referable to the marginal rate at which the settlor would have paid tax on that income.

- Alternatively, if as in *Vanta*, there is a key beneficiary responsible for establishing the trust and transferring property to the trustee they may be deemed to be entitled, as opposed to the settlor. It should be noted however that in *Vanta* the court confirmed the ultimate outcome of who received the assets on the resulting trust was in fact the same as if the assets had passed to the settlor (as the settlor was deceased and the key beneficiary was the sole beneficiary of his estate). Therefore, there is some risk that at law there is not in fact an ability to have the assets on a resulting trust pass to a "key beneficiary" as opposed to the settlor.
- If the lost trust deed can be shown to have gone further than simply excluding the initial settlor of the trust – and also excluded "notional settlors", being any person who contributes something to the trust for less than market value (eg, any person who makes a gift to the trust), then again the revocable trust taxation regime would be likely to be applied.
- In relation to purported, but invalid, distributions made other than to the settlor during the term of the resulting trust it is also likely that the trustee will be taxed on all such income and capital gains, at the top marginal rate under s 99 or 99A of the ITAA 1936, with no access to the CGT discount regime.
- Any losses the trust had accumulated will be forgone at the date of the resulting trust and cannot be carried forward to offset income in the "new" trust – furthermore, if there is a "retransfer" of assets by the settlor to the key beneficiaries, this will also terminate access to any other losses accumulated in the intervening period.
- Given the Court's clear articulation in *Vanta* of the fact that the obligation on a trustee to act in strict conformance with the terms of a trust deed is "perhaps the most important duty" of a trustee, there is a material risk that revenue authorities will adopt anything but a conciliatory approach in relation to penalties over and above the primary taxes payable during the period from when the trust deed was lost.
- Furthermore, to the extent the trustee engaged advisers at any time after the trust deed was lost, there would appear to be a material risk that aggrieved parties would explore what rights they may have for the (arguably) inadequate professional advice.

Relevant related decision

As an example of the suspected approach of the ATO in a broadly similar factual matrix (in terms of the failure to read a trust deed), the case of *Benaroon Pty Ltd v Larmar & Ors* [2020] QCA 62 ("Larmar") is relevant.

Here, in summary:

- an (assumed thought to be) "standard" discretionary trust deed was created in 1977;
- for over 40 years distributions had been made to the person responsible for requesting the trust be established, Brisbane accountant and property investor EL, his wife at the time of establishment of the trust and a subsequent wife (following divorce from the first wife);
- the trust deed however did not include in the range of potential beneficiaries EL, nor either wife;
- it was accepted that in the absence of rectification of the trust deed to add EL as a beneficiary, any distribution to him (and his former and current spouses) will have been made without authority; and
- the requested rectification was opposed by EL's current wife ("ML"), in relation to whom the ATO took the view, after an audit, that she would be entitled to a tax refund if not a beneficiary of the trust, but would have a tax liability of nearly \$8 million if she was a beneficiary.

In denying the rectification application (and thereby ensuring that many years of trust distributions had failed, with the resulting tax detriments outlined above) the Court confirmed that the case of *Public Trustee v Smith* [2008] NSWSC 397 ("Smith") confirms the key test for rectification, namely:

"... there must be clear and convincing evidence that at the time the trust deed was executed the trustee and the settlor had an actual intention as to the effect which the deed was intended to create which was different from the effect which the instrument did have in a clearly identified way. It must be demonstrated with clarity that the parties had a sufficiently precise intention that the court can determine both the substance and the detail of the precise variation to be made to the wording of the instrument".

Here, the available evidence was uncertain in many respects and could not be described as either clear or convincing. The evidence submitted by the trustee to the court about trust distributions that were made to EL and ML (in breach of the terms of the trust deed) did not help provide clear and convincing proof of the form which the trust deed was intended to take – indeed these distributions only added to uncertainty about what the original intentions were.

Ultimately, the function of a court rectification is to reform a trust instrument so that it accords with the relevant intention, not to redraft it into a form it might have taken – had the parties thought more about it at the time it was executed.

Conclusion

While it was not expressly stated in the *Larmar* decision – nor indeed in *Vanta*, and is admittedly a rather obvious observation with hindsight, the question that must be asked by all trust advisers is: why were distributions being made for decades, apparently without any reference to the definition of beneficiaries under the trust instruments?

Furthermore, a follow up question to consider: how many more trusts are there where advisers are complicit in adopting the same approach of ignoring trust deed provisions?