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The Secretary
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Dear Sir

Tax Laws Amendment (2009 Measures No. 6) Bill 2009

Blake Dawson welcomes the opportunity to make submissions on the Tax Laws Amendment (2009 Measures No. 6) Bill 2009 (**Bill**).

The Bill amends the *Income Tax Assessment Act 1997* (**ITAA 1997**) to repeal the exception to capital gains tax (**CGT**) event E1 and CGT event E2 that is colloquially known as the "trust cloning" exception. Instead, it provides a limited rollover relief for the transfer of assets between fixed trusts with the same beneficiaries and the same interests in each trust.

The Explanatory Memorandum to the Bill identifies a number of policy considerations underpinning the removal of this exception. These include: promoting the equity and integrity of the tax system, ensuring that a change in underlying ownership, not merely legal ownership, is the event that attracts CGT, ensuring that CGT issues are not an impediment to trust restructuring and maintaining flexibility.

We submit that the removal of the trust cloning exemption and the proposed rollover does not necessarily accommodate with these policy objectives. Our specific comments are as follows:

1. The abolition of the CGT trust cloning exemption

In our previous submission to the Treasury (copy **attached**), we outlined our view that the trust cloning process often does not result in a change of underlying or economic ownership. This is relevant to the principle, as stated in the Bill's Explanatory Memorandum, that CGT should tax a change in the underlying ownership of an asset, not a change in legal ownership.

An economic owner has an immediate, unconditional and non-contingent right against the legal owner of a particular asset. When a trust is "cloned" a beneficiary which has an immediate, unconditional and non-continent right to a certain portion of the trust will have the same right in the new trust if the beneficiaries and their interests are

maintained. In other words, the economic ownership of the assets contained in the trust, has not changed.

The trust cloning exception reflected the absence of change in economic ownership; it did not operate to provide rollover relief but instead provided that no CGT event had occurred at all. This was a recognition that, in the absence of a change to the ultimate beneficiaries and terms of the cloned trust, it would inappropriate for a CGT event to take place.

We acknowledge the concerns regarding the potential for the trust cloning exception to be used in such a way as to undermine the integrity and equality of the tax system. However, as noted in many previous submissions, the trust cloning exemption is often employed for legitimate, and commercially *bona fide*, objectives such as succession planning, business separation, risk minimisation, asset splitting and consolidating the holdings of several trusts.

The alternative to trust cloning proposed by the Bill is a rollover which would only apply in limited circumstances and not in many of the actions described above. Furthermore, as was stated in the Explanatory Memorandum of the Bill, the rollover may be obtained in some cases where there is no change in underlying ownership, but not all. This was stated as necessary in light of the policy of maintaining integrity but we submit that the proposed rollover is too narrow in application, preventing the transfer of assets between trusts in circumstances where no change in economic ownership has taken place and without sufficient justification for denial.

In light of this we submit that to ensure that the policy objectives of the amendments are fulfilled a number of changes to the proposed rollover must be implemented to broaden the conditions for obtaining relief.

2. The "fixed" trust requirement

The rollover will only be applicable to "fixed trusts". Non-fixed (ie discretionary) trusts are excluded by the requirement in section 126-230 that CGT event E4 must be capable of happening to all units or interests in each of the trusts. This is a significant change in the tax law; previously, fixed and non-fixed trusts could rely on the trust cloning exemption to move assets between trusts provided the terms and beneficiaries were the same.

We submit that excluding all non-fixed trusts from obtaining rollover relief ignores the circumstances in which the transfer of an asset results in no change in economic ownership. The Explanatory Memorandum states that the reason for this exclusion is that "it is difficult to establish, with any degree of certainty, the real underlying ownership of the assets". However, a number of provisions of the Tax Act include mechanisms that seek to identify the "real" owners of assets held though non-fixed trusts. An example is a trust that is the subject of either a family trust election or the interposed entity election under the trust loss measures in Schedule 2F of the *Income Tax Assessment Act 1936* (**ITAA 1936**).

A discretionary trust that makes either a family trust election or an interposed election is confined in its ability to made distributions and conferrals to a particular family group, defined in section 272-90 of Schedule 2F of the ITAA 1936. In summary, any distributions made outside of the family group are exposed to family trust distribution tax. Essentially, "ownership" rights in the form of distributions of income and capital are restricted to a particular nominated family group.

Given the special circumstances surrounding these types of trusts, we submit that the proposed CGT rollover in the Bill should apply to non-fixed trusts that have made a family trust or interposed entity election.

3. The empty trust requirement

Subsection 126-225(1)(b) requires that the receiving trust must be an "empty" trust to qualify for the rollover. An empty trust must not have any CGT assets other than a small amount of cash or debt just prior to the transfer time. We submit that this requirement is unnecessarily onerous, needlessly restricting the rollover to very limited circumstances.

The Explanatory Memorandum states that the empty trust requirement was included to ensure that "the rollover cannot be used to marry gain and loss assets or else 'share' losses in a way that would not otherwise be permitted under the income tax laws". The requirement that the receiving trust be an empty trust therefore appears to be an integrity measure aimed at preventing trusts from offsetting gains against losses. However, section 126-240 operates to effectively cancel any losses in the receiving trust, therefore limiting the circumstance in which losses of the receiving trust can be "shared" (ie offset against) income from assets of the original trust.

If the rationale for the empty trust requirement relates to other loss integrity measures, we submit specific integrity measures would be more appropriate than the empty trust requirement. The empty trust requirement operates to deny rollover relief between trusts without any policy justification. In particular, our concern is that the requirement will mean that the rollover is not available for some trust restructures within existing trust groups (even though the asset transfer does not result in a change in underlying or economic ownership).

4. The same beneficiaries must have the same interests

To qualify for the rollover, subsection 126-225 (1)(c)(i) requires both trusts to have the same direct, not indirect or ultimate, beneficiaries. In light of the principle of CGT consequences only attaching to changes in economic ownership, it is questionable why the tests focus solely on the direct rather than the ultimate beneficiary.

We submit that the rollover relief should be made available as long as the ultimate beneficiaries are the same in respect of both the original trust and the receiving trust. For example, this would allow the application of the rollover to the restructure of large trust groups without the need for complex restructuring.

5. Concluding comments

The recognition that corporate unit trusts and public trading trusts face considerable flexibility in assets transfers highlights the importance that the trust cloning exception represented for other trusts generally. Although the need to separate and transfer assets is not as prominent outside of the corporate unit trust or public trading trust context, trusts are subject to taxing points that would not apply in the company context. These CGT taxing points are an impediment to engaging in legitimate reorganisations of their affairs

If, as we have already outlined, the asset transfers result in no change in underlying or economic ownership, any restrictions on these transfers cannot be justified unless it is crucial to achieving a justifiable and legitimate policy objective. It is for this reason that the rollover must be given the broadest possible application and any barriers to relief must be justified by the prevention of adverse tax consequences and only when a well targeted integrity or anti-avoidance measure would fail to prevent those consequences from occurring.

We would welcome the opportunity to participate in any further consultation or to discuss with you any aspect of our submission.

Yours faithfully

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Dear Sir/Madam

Submission on the Abolition of the Capital Gains Tax Trust Cloning exemption

Blake Dawson welcomes the opportunity to make submissions on the design of the proposal to remove the trust cloning exemption from capital gains tax.

Treasury has identified, as an issue for discussion, that the removal of the trust cloning exemption is consistent with the policy of taxing capital gains where there is a change in economic ownership of an asset.

We do not consider that, in all instances, the process which is colloquially described as "trust cloning" give rise to a change in the economic ownership of an asset. Accordingly, we consider that CGT Events E1 and E2 should continue to provide for a limited exemption from CGT on the basis, firstly, that "trust cloning" does not necessarily result in a change of "economic ownership", and secondly, that the principle does not confirm with the principle that tax should not motivate the structuring of a transaction. In light of this, if the trust cloning exemption is to be abolished, the demerger provisions must be augmented to ensure that persons to whom it is appropriate to allow a CGT roll-over are not unfairly precluded from the relief because of the legal structure through which investments have been made.

Our reasons are as follows:

1. Economic Ownership

The concept of "economic ownership" is a term that has not been extensively considered. However, legislatively, it is perhaps most prominently adopted in section 40-40 of the *Income Tax Assessment Act 1997* (**ITAA 1997**). This section provides that an entitlement to capital allowances sometimes rests with an "economic owner" and not the legal owner of an asset.

The revised explanatory memorandum to the *New Business Tax System (Capital Allowance) Bill* 2001 states (at paragraph 1.29):

> In some cases, however, an economic owner of an asset is *not* its legal owner. Such an economic owner is a holder of the depreciating asset. Sometimes, also, a legal owner of an asset is not its economic owner. Such a legal owner is not a holder of the depreciating asset. For example, the economic owner of a depreciating asset may lack legal title to that asset merely because it is subject to:
>
> - a legal mortgage;
> - a hire-purchase agreement;
> - a product financing or product sponsor agreement (see Example 1.1);
> - a reservation of title arrangement; or
> - a bare trust.

The explanatory memorandum continues (at paragraph 1.33):

> Where the economic owner does not have actual possession but only a right against the apparent holder to possession, that right must be immediate, unconditional and non-contingent. That is, there must not be any thing to be done before that economic owner has the right to gain actual possession of the asset. For example, a taxpayer may have a call option over a depreciating asset the taxpayer does not hold but until that option is exercised there is no immediate right to possession and the option-holder will not hold that asset.

The economic owner of an asset is somewhat akin to a beneficial owner. However, we acknowledge that the concept is intended to be narrower, in that an economic owner must have an "immediate, unconditional and non-contingent right" as against the legal owner of the particular asset.

Where the relevant asset is subject to a fixed trust of any description (including a unit trust), we submit that, in accordance with the comments at paragraph 1.29 of the explanatory memorandum, each of the beneficiaries (whether the beneficiaries are unit-holders or have fixed entitlement under the trust) are capable of having an immediate, unconditional and non-contingent right to their proportion of the underlying assets of the trust. (Although not directly relevant to the definition of "economic ownership", we note, for practical purposes, the capital allowance provisions are likely to apply differently to assets held in certain trusts.)

If, for example, five beneficiaries under a trust each hold a 20% "immediate, unconditional and non-contingent" interest in a trust that holds a number of assets, each beneficiary would be the economic owner of a 20% interest in each asset. The beneficiaries would nevertheless each be "economic owners" of part of each of the assets (irrespective of whether or not they are the "holders" of the asset for depreciation purposes).

It is trite to say that trusts are not separate legal entities. The ownership interests that each beneficiary has can thus only be defined by the rights that each holds against the trustee of the trust of which they are a beneficiary. In this regard, what is relevant is not the form of the rights, but the substance of those rights.

When a trust is cloned, the rights, although governed by a separate trust deed, are, in essence, replicated. If an immediate, unconditional and non-contingent interest in a share of a certain portion the assets of a trust is held by a beneficiary, and that trust has been cloned, the interest of the beneficiary in the clone trust will also be an immediate, unconditional and non-contingent right to a certain portion of the trust.

If a CGT asset of the first trust is transferred to a clone trust where each of the beneficial owners and their interests are the same, and each of the beneficiaries' rights against the trustee of the trust is identical, we do not see how there has been a change in the

economic ownership of the asset. Each of the beneficiaries is entitled to that to which they were entitled to prior to the transfer of the asset from one trust to a clone trust, that is, an "immediate, unconditional and non-contingent" right to the beneficiaries' share of the asset in question.

Accordingly, we do not consider that the abolition of the trust cloning exemption in paragraphs 104-55(5)(b) and 104-60(5)(b) is consistent with the Treasury's policy of taxing a change in economic ownership of an asset and cannot be justified on this ground.

2. Trust cloning and Consistency of Treatment of Transaction Structures

We submit that the changes to the trust cloning provisions create the potential for different investment vehicles to be treated differently under the tax law provisions, such that tax may potentially become the motivator behind a transaction structure. We understand that, to the greatest extent possible, the Government policy is to treat transactions that bring about the same economic substance as having the same taxation consequences, irrespective of form. The removal of this exemption has the potential to operate contrary to this policy.

By way of example, we refer to the demerger provisions contained in Division 125 of the ITAA 1997. These provisions allow companies and trusts to "demerge" the assets of the company or trust to its shareholders or unitholders/interest-holders without triggering a capital gain (due to roll-over relief), subject to certain conditions. (The conditions, broadly, are that it must occur to at least 80% of the interests, that owners in the original entity must own the same proportions of the demerged entity, and that the market values of the interests before and after the demerger must broadly be equivalent.)

Although the rules have a wide application (as they can apply to companies, unit trusts and other fixed interest trusts), they could cause certain trust structures to be preferred over others when, from an economic perspective, the structures are equivalent.

If, for example, two parcels of land were held directly by a trust (either a unit trust or other fixed trust) which had five 20% beneficiaries, it would not be possible to use the demerger provisions to separate the holdings into two separate trusts under the demerger provisions. If, however, the same parcels of land were ultimately held by the same trust as above, but in this example, the trust had two wholly-owned two sub-trusts, and each sub-trust owned one parcel of land, then either sub-trust could be demerged to the five beneficiaries and each parcel of land would be in an entity that could be dealt with separately.

Were the first fixed trust to interpose two sub-trusts between itself and the two parcels of land to replicate the structure of the second trust, in our view, it would not qualify for roll-over relief under Division 124 ITAA 1997, as the trust would be exchanging an underlying asset for interests in a trust, and not interests for either interests or shares.

Intuitively, there appears not to be any policy justification for the disparate treatment under the tax law, as effectively the assets are each 20% owned by each of the five beneficiaries (the trusts being fiscally transparent). The trust cloning provisions avoid the possibility of disparate treatment, by enabling assets to be moved between trusts that have exactly the same ownership structure without triggering a capital gains tax event.

While it is acknowledged that the trust cloning provisions are currently interpreted and applied narrowly by the Australian Tax Office, we, nonetheless, consider that they are necessary in order to remove the need for elaborate transaction structuring to ensure that roll-overs are available in the future. If anything, we would expect that it would be the Government's intention to **reduce** the benefit inherent in elaborate tax structuring, particularly given the lack of transparency and compliance risks associated with such structuring.

Assuming the trust cloning exemption is abolished, the investor who has opted for a straightforward trust structure will be penalised on a restructure of his or her holdings, while the investor with the elaborate trust structure is able to utilise roll-overs and separate out ownership without immediate CGT liability.

To add strength to this conclusion, we reiterate our earlier comments that a transfer of an asset to a clone trust is not a change in economic ownership of an asset. The trust cloning exemption is not a mechanism that lends itself to a tax avoidance purpose, particularly due to its rigid interpretation by the Australian Taxation Office. We do not consider there to be scope for the exemption, as currently applied, to be misused.

If the trust cloning exemptions are to be abolished, Division 125 should be expanded to enable greater flexibility in separating out asset ownership into different entities. In particular, Treasury may consider limited exemptions for exchanging underlying interests in an asset for interests/units/shares in another entity which becomes the holder of that asset.

If the exemption is enhancing the consistency of treatment across the Australian taxation system and is serving a legitimate and justifiable purpose, we do not see any pressing need to abolish the exemption, particularly given that the policy objective pursuant to which it has become slated for abolition is not properly served by its removal from the ITAA 1997.

We would welcome the opportunity to participate in any further consultation or to discuss with you any aspect of our submission.

Yours faithfully,

Blake Dawson