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A Loss of Trust in Loss Trusts

Abstract

There is little doubt that the tax treatment of trust losses is a topical issue at present and, in this article, the author provides a detailed discussion of the issue. The effect on the carryforward of trust losses of changes made after the acquisition of a loss trust is also considered. The paper further examines the loss trust anti-trafficking measures announced in the 1995/1996 Federal Budget. The author concludes that the uncertainty in the application of the existing tax law to the carryforward of trust losses, combined with the introduction of the new Budget measures, pose significant tax risks in acquiring a loss trust.

Keywords

law, tax, trusts

A LOSS OF TRUST IN LOSS TRUSTS



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There is little doubt that the tax treatment of trust losses is a topical issue at present and, in this article, the author provides a detailed discussion of the issue. The effect on the carryforward of trust losses of changes made after the acquisition of a loss trust is also considered. The paper further examines the loss trust anti-trafficking measures announced in the 1995/1996 Federal Budget. The author concludes that the uncertainty in the application of the existing tax law to the carryforward of trust losses, combined with the introduction of the new Budget measures, pose significant tax risks in acquiring a loss trust.

INTRODUCTION

The use of a trust as an investment and business vehicle is commonplace. This is particularly so after the introduction of the capital gains tax provisions into the Income Tax Assessment Act 1936 (Cth) (the Act). In light of the recent recession and the crash in the commercial property market, many trusts which have invested in real estate have incurred substantial losses. These losses have been contributed to by a period of high interest rates, an over supply of rental space, a reduction in rental levels and a drop in property values. It is therefore not surprising that the tax treatment of trust losses is a topical issue at present.

Anecdotal evidence suggests that there has been an increase in trafficking in loss trusts in more recent times. This usually involves the acquisition of the "ownership" structure of the trust which has incurred losses, rather than simply acquiring the trust assets alone. As part of the acquisition, various changes are made in respect of the loss trust to ensure the rights to control the trust and to benefit from

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it pass to the new owner. If the loss trust is a unit trust, these changes could involve some or all of the following:

- (1) A new trustee is appointed or, if the trust has a corporate trustee, control of the trustee company is acquired, for example, by changing the company's shareholders and appointing new directors;
- (2) Existing units are transferred, redeemed or have their rights varied, and additional units may be issued;
- (3) Additional income producing property or a new income source is introduced into the trust;
- (4) A new appointor is nominated; and
- (5) Amendments are made to the trust deed itself.

If the loss trust is a discretionary trust, the changes could involve the same steps except that, in lieu of the changes in (2), new beneficiaries would be added and perhaps there would be deletions from the existing class of beneficiaries, whether they be takers in default or merely objects.

The acquisition of the "ownership" structure of a loss trust rather than the trust assets could be undertaken for tax reasons, namely, to take advantage of past year tax losses available to the trust to shelter future assessable income generated by the trust from income tax. But there could also exist sound commercial reasons for acquiring the trust structure. These might include:

- (1) A saving in stamp duty: the net asset value of a loss trust is likely to be less than the market value of the trust's assets, given that the losses would usually be comprised of financing costs whereby any rent derived by the trust has been exceeded by interest incurred on borrowings;
- (2) The maintenance of rental guarantees under existing leases of a rental property: arguably such guarantees comprise personal covenants to a landlord from the tenants, and as such their benefit may not pass to the new owner of a property if only the assets of a trust are acquired; and
- (3) The maintenance of other important agreements in place: finance, supply and employment agreements are examples of

already existing agreements which would otherwise need to be renegotiated.

The increase in trust loss trafficking in recent times has not gone unnoticed by the Federal Government. In the 1995/1996 Federal Budget, the Government announced the introduction of new measures to restrict the circumstances in which trusts can deduct current year and prior year losses. The new measures applied from 7.30 pm AEST on 9 May 1995 and are specifically designed to prevent trafficking in trust losses. Up to three new tests may be involved, depending upon the type of trust which has incurred the losses. The new tests will be similar to the continuity of beneficial ownership and same business tests which apply to limit the deductibility of company losses. However, a new test - the income injection test - will apply to all loss trusts. Another difference will be that the same business test will only apply to widely held listed public unit trusts and not to other trusts.

The purpose of this article is to examine the way in which trafficking in loss trusts is addressed in the Act. The article first provides an outline of the tax treatment of trusts in general. This is followed by a detailed discussion of the tax treatment of trust losses and the meaning of the expression "trust estate" as it appears in the trust provisions of the Act. The effect of the possible changes after acquisition on the carryforward of trust losses is then considered. Although not yet enacted, the loss trust anti-trafficking measures announced in the 1995/1996 Federal Budget are also examined.

TAX TREATMENT OF TRUSTS

Division 6 of Part III of the Act is titled "Trust Income" and contains provisions dealing with the taxation of trust income. The scheme of the Division is to impose a liability to tax in respect of the "net income of a trust estate" upon either the trustee or a beneficiary of a trust estate, and not both: *Tindal v FCT*.¹ Whether the liability to tax falls upon the trustee or beneficiary depends upon whether there is a beneficiary "presently entitled to a share of the income of the trust estate" and whether the beneficiary is under a legal disability.

Where there is a beneficiary who is presently entitled to a share of the income of the trust estate and who is not under a legal

¹ (1946) 8 ATD 152 at 155 and 156.

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disability, the Division includes in the assessable income of the beneficiary that share of the "net income of the trust estate": s 97. Where the beneficiary is presently entitled to a share of the income of the trust estate and is under a legal disability, the trustee is assessed and liable to tax on that share of the "net income of the trust estate": s 98. Where there is a share of the trust income to which no beneficiary is presently entitled, the trustee is assessed and liable to tax on that share of the "net income of the trust estate": s 99 and s 99A.²

Central to this scheme is the concept of "net income of the trust estate". Section 95(1) defines "net income" in relation to a trust estate to mean:

the total assessable income of the trust estate calculated under this Act as if the trustee were a taxpayer in respect of that income and were a resident, less all allowable deductions, except deductions under Division 16C and except also, in respect of any beneficiary who has no beneficial interest in the corpus of the trust estate or in respect of any life tenant, the deductions allowable under section 79E, 79F, 80, 80AAA or 80AA in respect of such of the losses of previous years as are required to be met out of corpus.

Thus, the "net income" of a trust estate is to be calculated "as if the trustee were a taxpayer" in respect of the assessable income of the trust estate and were an Australian resident. In other words, the trustee is deemed to be a taxpayer for the purposes of calculating assessable income. This deeming of the trustee as a taxpayer in effect creates a notional tax entity, but only for calculation purposes. A tax entity would not otherwise exist given that the definition of a "taxpayer" in s 6(1) requires the existence of a "person", whether natural or artificial. Of course, a trust estate does not constitute such a person as it is not a separate legal entity.

Taking the assessable income of a trust estate as a starting point, s 95(1) then provides that all allowable deductions, other than those specifically excluded by the subsection, are to be subtracted to arrive at the "net income". Unlike the initial part of the subsection, this latter part of the definition fails to specify a taxpayer entity in respect of which those deductions are determined. This might cause

² See further, *Liedig v FCT* 94 ATC 4269 at 4276; *Prestige Motors Pty Ltd v FCT* 93 ATC 5021 at 5023; and *Dwight v FCT* 92 ATC 4192 at 4196-4197.

difficulties in cases where the allowability of a deduction is qualified by reference to certain criteria to be met by a taxpayer.³

However, it does not appear to have troubled the courts which have, on occasions, commented upon the definition. The courts seem to merely assume that the deeming of the trustee as a taxpayer in the initial part of the definition applies also for the purpose of determining allowable deductions. For example, Hill J of the Full Federal Court in *Prestige Motors Pty Ltd v FCT*⁴ said:

The "net income" of a trust estate is to be calculated on the assumption that the trustee is a taxpayer by taking the total assessable income (calculated assuming also the trustee to be a resident) and subtracting therefrom all allowable deductions other than those specifically referred to in the subsection.⁵

TAX TREATMENT OF TRUST LOSSES

As presently enacted, Division 6 does not contain any provisions dealing expressly with trust losses, or which specifically address the consequences of allowable deductions exceeding the assessable income of a trust estate. The latter issue was considered in *Doherty v FCT*⁶ where the High Court held that if, in a year of income, allowable deductions exceed the total assessable income of a trust estate, the share of a trust loss cannot be offset against other income derived by a beneficiary in that income year.

In that case, the taxpayer was entitled to an interest in pastoral properties under the will of her deceased brother. The trustees of the estate incurred a loss in carrying on a pastoral business on the properties. The taxpayer sought to claim a share of the loss as an allowable deduction against assessable income derived by her otherwise than from the trust estate. The claim was made under s 26 of the Income Tax Assessment Act 1922-1930 (Cth) which provided that where a loss was made in an income year by a person in carrying on a business, the person was entitled to a deduction of the loss from

³ Refer further *Butterworths Australian Tax Practice Commentary* at paragraph 95/65 and see later the discussion with respect to losses incurred by corporate trustees.

⁴ 93 ATC 5021.

⁵ Ibid at 5023. See also the comments of the Full High Court in *Fletcher v FCT* 91 ATC 4590 at 4956 with respect to the similarly framed definition of "net income" in relation to a partnership in s 90 of Division 5 of the Act.

⁶ (1933) 2 ATD 272.

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the net assessable income derived by the person in that year. The Commissioner disallowed the deduction and the taxpayer subsequently appealed to the High Court.

The case was decided by Starke J who could not agree that the beneficiaries under the will were the persons who carried on the business either at law or in equity, or could be treated under the Act as if they had carried it on. Moreover, His Honour said that the trust income was to be "kept in a separate compartment, so to speak, and it is from the trust income (if any) and not from other income that the deduction is allowed".⁷ Hence, the trust loss was not deductible against other assessable income derived by the taxpayer in the income year. Put in another way, the trust loss was not distributable amongst the beneficiaries of the trust estate. This can of course be contrasted to a partnership loss which is distributable amongst partners by virtue of the specific provisions of s 92(2) of Division 5 of the Act.

While it is noted that *Doherty's* case was decided under the former Income Tax Assessment Act, it is submitted that the reasoning of Starke J would apply under Division 6 of the present Act which, by and large, adopts the scheme of its predecessor. Having said this, however, it is further noted that *Doherty's* case did not address the question of how the trust loss was otherwise to be treated. Nevertheless, it is submitted that there is little doubt that the trust loss remains in a "separate compartment" to be carried forward and offset against assessable income of the trust estate in a future income year. This matter is further addressed below.

Carry forward of past year trust losses

Neither in Division 6 nor elsewhere in the Act is there presently a specific provision allowing a trust loss to be carried forward and allowing a deduction in respect of past year losses to a trust or trust estate. However, it is submitted that it is clear from the terms of the definition of "net income" in s 95(1) that the carryforward of a trust loss is permitted in calculating the "net income" of a trust estate.

First, the definition requires the subtraction from the assessable income of a trust estate of "all allowable deductions" other than those specifically excepted. This would generally include past year

⁷ Ibid at 274.

losses allowable as deductions under s 79E, 79F, 80, 80AAA and 80AA. Secondly, the specifically excepted deductions refer to past year losses that are deductible under these sections which are required to be met out of the corpus of a trust estate in respect of a beneficiary who has no beneficial interest in that corpus or in respect of a life tenant. These exceptions presuppose that such past year losses would have otherwise been able to be carried forward and deducted from assessable income in arriving at the "net income" of the trust estate.

Continued existence of "a trust estate"

It is apparent from the definition of "net income" in s 95(1) that the first requirement for the carry forward of a past year trust loss is the continued existence of "a trust estate". A review of Division 6 shows that the expression "trust estate" is central to its provisions, yet surprisingly, the expression is not defined in the Division or elsewhere in the Act. The meaning of the expression is examined later, but it suffices to say at this point that its meaning is not settled.

While not proffering a definition of "trust estate", Mr AH Slater QC states that the existence of trust property is critical to the existence of a trust estate.⁸ If there is no trust property, there cannot be an estate held in trust. Consequently, if the trust property has been wholly lost, Mr Slater states that the taxpayer which incurred the trust loss has gone out of existence, and the loss cannot be claimed as a deduction.⁹ Therefore, some property must still exist, which is held under the trust obligations, for a trust loss to be carried forward.

Application of past year loss provisions

It is also apparent from the definition of "net income" that a second requirement for the carry forward of a past year trust loss is that the past year loss provisions in s 79E etc apply. These provisions allow a deduction for so much of the past year losses incurred "by a taxpayer" as has not been allowed as a deduction from the taxpayer's income in a previous year, depending upon the type of loss and the income year in which it was incurred.

⁸ "Current Issues Concerning Trusts" Paper given at the Taxation Institute of Australia, Second National Tax Retreat, October 1994, 40.

⁹ Ibid.

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In passing, it is noted that the past year loss provisions require that the relevant tax entity be a "taxpayer". This term is defined in s 6(1) as "a person deriving income or deriving profits or gains of a capital nature". It would seem to follow from this definition that a person is a "taxpayer" only if the person derives such income, profits and gains in both a legal and beneficial capacity. Consequently, a person who is a trustee and who derives such income, profits or gains in a legal capacity, but not in a beneficial capacity, would not be a "taxpayer" by virtue of the definition, unless the contrary intention appears.

It might therefore be argued that a person who is a trustee that does not derive such income, profits or gains in a beneficial capacity is precluded from falling within the past year loss provisions and is unable to carryforward a trust loss. However, when regard is had to the context of s 95(1) and, in particular, the deeming of a trustee as a "taxpayer" and the express reference to past year losses in respect of certain beneficiaries being excepted from allowable deductions, it is submitted that it becomes clear that such an argument cannot be sustained.

The same "trust estate"

A third requirement is found in the framing of the definition of "net income" in s 95(1). The subsection requires that the total assessable income of a trust estate be determined and all allowable deductions (with certain exceptions) be subtracted from that total. Broadly speaking, where the allowable deduction is a past year loss, the loss is constituted under s 79E etc, by a taxpayer's allowable deductions exceeding assessable income and exempt income for a year of income. In the case of a trust loss, the reference to assessable income in the loss year, so to speak, is to the assessable income of the same trust estate. This trust estate must therefore also be the trust estate which exists in an income year in which the loss is sought to be carried forward and deducted from assessable income in calculating the "net income" of the trust estate.

In other words, the definition of "net income" requires that the trust estate in the income year in which a past year loss is sought to be deducted is the same trust estate, arguably in the sense of being identical, that existed in the loss year in which the loss was incurred.¹⁰ Accordingly, critical to this third requirement is the

¹⁰ See also CCH 1995 *Australian Master Tax Guide* at para 31-570 which states that "care must be taken to ensure that there is a 'trust estate' and

meaning of the expression “trust estate” in s 95(1), and the effect on the identity of a “trust estate” of changes made after acquisition. These two issues are dealt with in greater detail later.

Past year losses in respect of certain beneficiaries

It should be recalled that even if the requirements of the past year loss provisions in s 79E etc are satisfied, a deduction for a past year loss still may not be allowable in calculating “net income” under s 95(1) in respect of certain beneficiaries, if trust law or the terms of the trust require such a loss to be met out of the corpus of the trust estate. The two types of beneficiaries in respect of which a past year loss is not deductible are a beneficiary who has no beneficial interest in that corpus and a beneficiary who is a life tenant. There is some uncertainty as to whether the disallowance of the past year loss impacts upon the calculation of “net income” for all beneficiaries, or only these two types of beneficiaries.¹¹

Past year losses and corporate trustees

A question that arises in determining the carry forward of a past year trust loss is whether the limitations contained in s 80A to s 80E of the Act can apply to such a loss. Broadly, these sections provide that a past year loss incurred “by a company” shall not be taken into account for the purposes of s 79E etc, unless the company satisfies a continuity of beneficial ownership test or a continuity of business test. The question is therefore especially relevant in the case of a trust estate having a trustee that is a company.

On one hand, it might be argued that the limitations in s 80A to s 80E must be satisfied for a past year loss to be deductible based upon the following reasoning. First, the definition of “net income” in s 95(1) deems a trustee to be a “taxpayer” which, in turn, is defined by reference to a “person”. The definition of “person” in s 6(1) expressly includes a company. Therefore, if a trustee is a company it would be consistent with these definitions for the trustee’s corporate status to attach to the status of the deemed taxpayer under s 95(1). Secondly, s 80A to s 80E apply where a loss is incurred “by a company” and in the case of a trust or trust estate having a corporate trustee, any loss incurred is in fact incurred by the company itself,

that this ‘trust estate’ is the same as the ‘trust estate’ which incurred the losses”.

¹¹ See further *Butterworths Australian Tax Practice Commentary* para 95/75.

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albeit that it is acting as trustee. This latter fact simply allows the company a right of indemnity out of the trust assets in respect of losses properly incurred in carrying out its trustee activities.

On the other hand, it could be argued that the definition of "net income" in s 95(1) deems a trustee to be "a taxpayer" and the identity and status of the trustee as a company or otherwise is simply not relevant. The deemed taxpayer is a hypothetical person and there is nothing in the subsection which would justify attributing to this hypothetical person any of the personal attributes or characteristics in fact possessed by the actual trustee of the trust estate. This argument is supported by the decision in *Union Fidelity Trustee Co v FCT*,¹² where the High Court held that the residence of the actual trustee in that case was irrelevant in calculating "net income" under s 95(1). In that case, Kitto J said:

In light of the definition of "taxpayer" the expression "calculated under this Act as if the trustee were a taxpayer in respect of that income" may be expanded to read "calculated under this Act as if the trustee were a person deriving that income". But the "as if" shows beyond question that the basis of calculation is to be a hypothesis different from the actual fact. Since the fact is that the trustee derived the income, the hypothesis that it was derived by "a person" must be that it was derived not by the trustee but by a hypothetical person as to whom none of the facts is postulated which would make him "resident".¹³

Barwick CJ went further and stated that the effect of the definition of "net income" in s 95(1) is that the provisions of the Act are to be applied to the actual income of a trust estate "as if it were the income of an individual deriving it".¹⁴ Thus, on this view, a trustee which is in fact a company would not be treated as such in applying the provisions of the Act for the purposes of calculating "net income".

As s 95(1) deems the trustee to be "a taxpayer", the application and operation of s 79E etc can be invoked to enable a past year loss to be carried forward and taken into account in calculating the "net income" of a trust estate. It is noted, moreover, that the application of these past year loss provisions is not made subject to s 80A to s 80E. Rather, s 80A to s 80E, where they apply, override the operation of the past year loss provisions. In order to apply in the first place,

¹² 69 ATC 4084.

¹³ Ibid at 4090.

¹⁴ Ibid at 4087.

s 80A to s 80E require the existence of a taxpayer that is in fact, or perhaps is deemed to be, "a company". If a taxpayer is a company and the limitations in s 80A to s 80E are not satisfied, s 80A would itself apply and operate to deny a deduction for a past year loss that is otherwise allowable under s 79E etc. However, as the deemed taxpayer under s 95(1) is not expressly attributed with company status, it is arguable that the threshold requirement of s 80A to s 80E of a taxpayer being "a company" would not be satisfied and the sections would not therefore apply.

It is submitted that this latter position constitutes the better view. Furthermore, the position is consistent with the intention underlying s 80A when it was introduced into the Act in 1944. That intention was to prevent trafficking in loss companies whereby in order to avoid income tax the shares of companies with carry forward tax losses were acquired. The Explanatory Memorandum states:

Whilst a company is an entity separate and distinct from its shareholders, the shareholders are the real owners of the business carried on by the company and there is no justification for the allowance of a loss sustained by an entirely different set of shareholders in earlier years.¹⁵

This clearly supports the view that the section was intended to apply to companies which carried on business in their own right and not in the capacity as trustee. In the latter case, the shareholders of the trustee company could not be regarded as the "real owners" of any business carried in trust for the beneficiaries. Rather, it is the beneficiaries who would more properly be regarded as the "real owners" of the business.

Accordingly, it is submitted that the limitations in s 80A to s 80E should not apply to the carry forward of a past year tax loss in undertaking the calculation of "net income" under s 95(1). This is certainly the position universally adopted without reservation by commentators who have referred to the question.¹⁶ It seems the only commentary in which the suggestion that the limitations may apply is, perhaps not surprisingly, found in the Australian Taxation Office Assessing Handbook titled "Trust".¹⁷ This suggestion is

¹⁵ At page 20.

¹⁶ See CCH 1994 *Australian Master Tax Guide* at para 31-570; Greenbaum, Rigney and Taylor, *Income Tax Law* (1991 Butterworths) 267; Rigney, *Australian Business Taxation* (1990 Butterworths) 180; Marks, *Alienation of Income* (2nd ed 1978 CCH) 456; and Grbich, Hutchins, Payes and de Wijn, *Winding up Trusts* (CCH) 18 and 125.

¹⁷ Volume 4 at paragraph 4.17.20.4.

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clearly out of step with the position taken by the Treasurer in the Press Release which accompanied the 1995/1996 Budget announcement of the new loss trust anti-trafficking measures. There the Treasurer expresses the view that s 80A to s 80E do not apply to the deductibility of trust losses.

The new Budget measures

The new rules announced in the 1995/1996 Federal Budget are intended to restrict the circumstances in which current year and prior year losses of trusts can be allowed as deductions under the Act. The new rules will apply to all types of trusts except for complying superannuation funds, approved deposit funds and pooled superannuation trusts. However, if such an entity makes investments in other trusts, the new rules will apply to the deductibility of losses of those other trusts. In the case of deceased estates, the operation of the rules will be deferred for a period of five years from the date of death of the deceased. The new rules will also apply to corporate unit trusts and public trading trusts.

In considering the Budget measures it is worth noting that, on one view, the new rules do not clarify the circumstances in which a trust loss qualifies for carry forward under the Act. This is because it is not made clear in the Budget announcement whether the new rules will have a positive operation in allowing a deduction for a trust loss where the rules are satisfied. If the new rules are to operate in a similar manner to the company loss provisions in s 80A to s 80E (which limit the deductibility of losses which would have otherwise been allowable under the general loss provisions in s 79E etc), the rules will have a negative operation which disallows a deduction for a trust loss if the relevant tests are not met. In other words, a trust loss must be otherwise allowable under s 95(1) and the general loss provisions in the Act before it can be affected by the new rules. Therefore, the new rules do not substitute the existing requirements, rather they provide additional requirements which must be satisfied to preserve the current and carry forward losses of a trust.

Outline of deductibility tests

In summary, the new rules will require the following tests to be satisfied for trust losses to be deductible:

- (1) Fixed trusts - continuity of beneficial ownership test and income injection test;
- (2) Widely held listed public unit trusts - continuity of beneficial ownership test and income injection test, *or* the same business test and income injection test;
- (3) Discretionary trusts - continuity of beneficial ownership test, continuity of control test and income injection test; and
- (4) Family trusts - family control test and income injection test.

Continuity of beneficial ownership test

The continuity of beneficial ownership test will be similar to the test applicable to companies, but with certain modifications. The test will require that more than 50% of the underlying beneficial interests in the income and corpus of the trust "can be" attributed to the same persons in the loss year as during the year in which the deduction is made and the intervening years (if any). Where entitlements to income or capital under the trust could be changed by a vote at a meeting of the beneficiaries, the continuity of beneficial ownership test will contain an additional requirement that more than 50% of the voting rights be held by the same person or persons in the loss year, the deduction year and the intervening years (if any). In applying these tests, changes in ownership arising on the death of a person will not be taken into account.

As in the case of companies, safeguarding provisions will apply to protect the continuity of beneficial ownership test from being manipulated so that different persons effectively obtain the benefit of more than 50% of the income or corpus of the trust, notwithstanding that the beneficiaries of the trust remain the same. For example, beneficiaries of the loss trust could enter into an arrangement to pass on the benefit of their income or capital entitlements under the trust to the persons who effectively acquire a majority controlling interest in the trust.

Income injection test

Trust losses will be deductible only if the trust satisfies the income injection test. The Treasurer's Press Release provides only sketchy details of the requirements of this test. It states that the test "will prevent a trust loss being deducted if consideration is received for the use of the loss and income is injected into the trust to be sheltered from tax by the loss". The Press Release then expands upon this in an annexure by stating that a trust will fail the income injection test

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“if it is clear that trust losses are trafficked under an arrangement”. By way of example only, it states that this would occur where:

- (a) consideration has been, or will be, given under an arrangement to the trust or a person connected with the trust;
- (b) the consideration is different from that which would have been given at arm's length under the arrangement if there were no trust losses;
- (c) the trust derives assessable income that is sheltered by the losses; and
- (d) a person not connected with the trust, or who became connected with the trust under the arrangement, derives a benefit under the arrangement.

The Press Release then indicates that the term “consideration” will be defined broadly to include forgiveness of debts and receipt of benefits.

Fixed trusts

A “fixed trust” will be defined as a trust in which the beneficiaries have fixed entitlements to shares of the income and corpus of the trust. The trustee has no discretion as to which beneficiaries benefit from the trust, or as to the share of the income or corpus to which beneficiaries are entitled. An example of such a trust would be a unit trust.

Widely held public unit trusts

Rules for defining a widely held public unit trust are to be adapted from those in s 103A of the Act which determine whether a company is a public company. In general, the rules will require that 20 or fewer persons should not:

- (a) hold, directly or through other entities, 75% or more of the units, and
- (b) be entitled to receive 75% or more of any capital or income distributions made by the unit trust.

A person and their relatives and nominees will be counted as one person for this purpose. Anti-avoidance provisions will ensure that

a few persons do not in fact control the trust while it appears to satisfy the widely held test.

Special rules will apply in testing changes of ownership of widely held public unit trusts. For such trusts that are listed, normal on-market transactions in units which are not associated with activity in the nature of a takeover or merger need not be examined in determining whether there is a 50% or greater change in beneficial interests. However, if there are significant changes in ownership of units outside normal trading, all changes (including changes from normal trading) have to be examined. The issue of additional units will not be treated as part of normal trading.

Widely held fixed unit trusts that are publicly traded, but not listed, will be required to test for continuity of ownership only once a year at the end of their accounting period, unless there is a significant change in ownership of units outside of normal trading during the year.

Discretionary trusts

A trust that is not a fixed trust will be a "discretionary trust". In the case of a discretionary trust, the continuity of beneficial ownership test as stated above may not be adequate as the income and capital entitlements in the trust are generally determined at the discretion of the trustee. Consequently, a modified continuity of beneficial ownership test will apply so that the pattern of trust distributions will also be taken into account in determining whether the discretionary trust satisfies the test. A change of beneficial ownership will be taken to have occurred where beneficiaries who received income or capital distributions in an income year did not receive, on the average, 50% or more of the income or capital distributions made in the last two preceding income years in which distributions were made.

Continuity of control test

In the case of discretionary trusts an additional continuity of control test applies. This will require that there is *no* change of controllers of the trustee. The Treasurer states that this continuity of control test will parallel the corresponding rule in the continuity of beneficial ownership test for companies that the same persons should continue to hold more than 50% of the voting power of the company.

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A person (which includes associates) will be taken to be a "controller" of a trust if:

- (a) the person has or could gain the power to obtain beneficial enjoyment of the income or corpus of the trust;
- (b) the person is or could become able to control, directly or indirectly, the application of the income or corpus of the trust;
- (c) the trustee is accustomed or under an obligation, or might reasonably be expected, to act in accordance with the directions, instructions or wishes of that person; or
- (d) the person can remove or appoint the trustee or any of the trustees.

For example, if the trustee is a company, a trust loss will be deductible only if the company is controlled in the loss year by the same person(s) who was the controller of the trustee company in the deduction year. The test will target the effective control of the company such as the power to appoint the directors of the company.

Family trusts

Special rules will be provided for family trusts to recognise their use in the conduct of small family business, but deal with circumstances in which they are used for loss trafficking. In general, losses may be deducted provided the continuity of control test is satisfied by members of the same family and those family members continue to benefit from the trust. However, losses will not be deductible if it is clear that there is trafficking in losses. This would be the case if the trust fails the income injection test.

A trust is a "family trust" if the beneficiaries comprise a natural person and members of their family. "Family" will be defined broadly to include a spouse or former spouse, parents, children, grandparents, grandchildren, brothers, sisters, nieces, nephews, or a spouse or former spouse of any of them. A company or trust could be a beneficiary if the shareholders or beneficiaries, as appropriate, are such natural persons. A natural person in the capacity of a trustee is excluded.

Date of effect

The new rules will apply to all trafficking in trust losses with effect from 7.30 pm AEST on 9 May 1995. For example, they will apply to consideration given or benefits provided after that time for being able to use a trust loss in connection with an arrangement that would result in the trust failing the income injection test.

The rules relating to changes in beneficial interests and control will also apply to changes occurring after 7.30 pm AEST on 9 May 1995. For example, a discretionary trust may have prior year losses that are available, under the law as it presently stands, for deduction in the 1994/95 income year. The trust will have to compare the position relating to ownership after 7.30 pm AEST on 9 May 1995 until the end of the 1994/95 year with the ownership and control immediately before 7.30 pm AEST on 9 May 1995. The losses cannot be deducted if the rules relating to change of ownership or control apply to deny the deduction.

MEANING OF "TRUST ESTATE"

As previously mentioned, the expression "trust estate" is not defined in the Act. Furthermore, it would appear that there is no accepted ordinary meaning of the expression as it is not one found in the legal dictionaries. However, the leading tax law commentaries have briefly addressed the question and there are decisions of the former Taxation Boards of Review which have considered the meaning of the expression. As will be apparent, there is a divergence of views as to the meaning of "trust estate".

The following have been suggested as possible meanings of the expression "trust estate" as it appears in Division 6 of the Act:

- (1) The expression is synonymous with "trust property";
- (2) "Trust estate" refers to an interest held in trust property; and
- (3) The expression merely means a "trust" as that term is understood in its ordinary sense.

Of course, given this apparent uncertainty as to the meaning of the expression, other possible meanings should not be ruled out.

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The commentaries

The CCH *Australian Federal Tax Reporter* (AFT Reporter) states that in its ordinary sense the expression "trust estate" would appear to be synonymous with trust property.¹⁸ The AFT Reporter cites the following passage from *Halsbury's Laws of England*:

The property affected by a trust, called the "trust property", or "trust estate", must be vested in the trustee, whether the property is a legal estate or an equitable interest in which case the legal title will be vested in some other person.

The AFT Reporter suggests that after the decision of the Full High Court in *FCT v Everett*¹⁹ it would appear to be clear that this is the sense in which expression "trust estate" is used in Division 6 of the Act.²⁰

The AFT Reporter points out that prior to *Everett's* case the former Taxation Boards of Review had expressed conflicting views as to the meaning of "trust estate". Thus, in *Case 93*, Chairman Gibson said that he understood the expression "to mean, and mean only, the 'legal estate' which is vested in the trustee ... (as such) or, in other words, the trust property".²¹ However, in *Case K69*, Member Webb expressed a different view, namely, that "the words 'trust estate' mean or describe an interest or estate in certain trust property and not the property itself".²² The AFT Reporter adds that in light of *Everett's* case this view of Member Webb must be regarded as incorrect.

The Butterworths *Australian Tax Practice Commentary* (ATP Commentary) also refers to these conflicting views of the Boards of Review.²³ In addition, the Commentary refers to *Case 40*; where another view was expressed that the word "estate" in the expression adds nothing to the word "trust" and is therefore unnecessary.²⁴ The ATP Commentary then cautions against reading

¹⁸ At paragraph 50-517.

¹⁹ 80 ATC 4076.

²⁰ See also CCH 1995 *Australian Master Tax Guide* at 31-570 which states "the same 'trust estate' ... necessitates there being trust assets still in existence subject to the trust in respect of which the losses were incurred."

²¹ (1950) 1 TBRD *Case 93* at 423.

²² (1960) 10 TBRD *Case K69* at 179.

²³ At paragraph 95/30.

²⁴ (1969) 15 CTBR(NS) *Case 40* at 259-260 per Chairman Dubout. These cases, as well as some other cases of the Boards of Review, are discussed in an article by Giugni PD, "Planning a Trust: Unravelling the Confusion" 25 *Taxation in Australia* 110.

too much into *Everett's*²⁵ case which it argues was not directly addressing the issue of the scope of the expression "trust estate".

However, the ATP Commentary is somewhat unhelpful in that it fails to adopt a position as to the meaning of the expression, unlike the AFT Reporter. The ATP Commentary merely concludes that what would appear to be able to be said with certainty is that where there is property the subject of a trust then a "trust estate" will exist. The operation of Division 6 does not appear to be affected whether the expression is taken to refer merely to the trust property or to the entirety of the trust relationship.

The court authorities

The meaning of the expression "trust estate" has been considered in some court cases although not in the context of the carrying forward of trust losses. Once more, there appears in these cases a divergence of views as to the meaning of the expression. *Everett's*²⁶ case has already been mentioned, where comments were made by the majority of the High Court which support the view that "trust estate" is synonymous with trust property. This view is also supported by the majority of the Full Federal Court in *FCT v Walsh (PJ & BJ)*,²⁷ and by the minority of the High Court in the recent case of *Registrar, Accident Compensation Tribunal (VIC) v FCT*.²⁸ However, a different view was expressed in a unanimous decision of the Full Federal Court in *FCT v Totledge Pty Ltd*.²⁹

In *Everett's*³⁰ case, the taxpayer purported to assign to his wife 6/13ths of his share in a partnership, together with the right to receive an appropriate share of the profits attaching to that share. A majority of the High Court held that the assignment was effective for tax purposes and constituted the taxpayer a trustee of the partnership share assigned and the wife a beneficiary under that trust.

The Commissioner had argued that the income payable to the wife was not "the net income of a trust estate" within the meaning of s 95(1). The majority noted that this argument was:

²⁵ 80 ATC 4076.
²⁶ Ibid.
²⁷ 83 ATC 4415.
²⁸ 93 ATC 4835.
²⁹ 82 ATC 4168.
³⁰ 80 ATC 4076.

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based very largely on the proposition, founded on the judgment of Kitto J in *Stewart Dawson Holdings Pty Ltd v FCT* ... that income derived by a trustee from his own property or by means of his personal exertion, "income with respect to which a trust arises at the moment of derivation", does not answer the statutory description. Kitto J was making the point that when a person establishes a trust of his future income simpliciter, the income when it is derived is the subject matter or corpus of the trust, not the fruit of it. To use the terminology of section 95, it is because the income is the "trust estate" that it cannot be "the net income of" that trust estate. His Honour's remarks do not touch the case where an immediate trust is established of a proprietary right which yields or earns future income. Then the income is accurately described as income of a trust estate.³¹

This latter situation was found by the majority to exist in the circumstances of the case.

The majority then referred to a passage in the judgment of Rich and Dixon JJ in *Howey v FCT* where their Honours stated:

the references to "income of the trust estate" ... suggest that the person who answers the description of "trustee" must stand in some relation to the proprietary right in virtue of which the income arises, even although he need not be a trustee in the proper sense.³²

While suggesting the observations of their Honours did not apply, the majority stated that it was the interest in the partnership by virtue of which the income arose, and this interest was vested in the taxpayer as trustee. Consequently, the income was properly described as "net income of a trust estate" within the meaning of s 95(1).

The majority in *Everett's*³³ case thus appeared to simply equate trust corpus with "trust estate" under s 95(1). The statements of the majority cited above therefore appear to support the view that "trust estate" is synonymous with trust property.³⁴ It would seem to follow from this view that there must exist a trust in the ordinary sense for there also to exist a "trust estate" for the purposes of s 95(1). However, it should be borne in mind that the majority did

³¹ Ibid at 4082.

³² (1930) 1 ATD 139 at 141.

³³ 80 ATC 4076.

³⁴ See also comments of the Full Federal Court, 78 ATC 4595 at 4599, 4612 and 4619.

not attempt precisely to define or limit the meaning of the expression.

The circumstances in *Howey's*³⁵ case were that the taxpayer was assessed on certain money received by him under a trust, but not as a beneficiary. The money was paid to him to be expended for the benefit of actual beneficiaries under the trust. The assessment was made under the predecessor to s 99 on the ground that the taxpayer was a trustee of income of a trust estate to which no beneficiary was presently entitled. The taxpayer did not argue that he was not a trustee of a trust estate, but that separate assessments should be made in respect of each of the beneficiaries. The Full High Court rejected the taxpayer's argument and consequently upheld the assessment.

Although it was unnecessary to decide the matter, in the course of their judgment Rich and Dixon JJ said that it was by no means clear that the assessment could be supported under the section in question. Their statement by way of obiter, which was cited in *Everett's*³⁶ case, was made to explain why the money received by the taxpayer was not "income of a trust estate" of which he was a trustee. In the circumstances, the taxpayer was merely an intermediary between the actual trustee of the trust estate and the beneficiaries and was empowered to deal only with income paid to him by the trustee.

The obiter of Rich and Dixon JJ does not appear specifically to support any of the three possible meanings of the expression "trust estate" previously mentioned. What it does indicate is that their Honours clearly thought the expression was not limited to situations where a trust exists in the ordinary sense. Rather, their comment that the person who answers the description of trustee "need not be a trustee in the proper sense" clearly contemplates that the expression "trust estate" had a broader scope than a trust in the ordinary sense.

The view that "trust estate" is synonymous with trust property is also supported by the majority in *FCT v Walsh (PJ & BJ)*.³⁷ In that case, the taxpayers were the trustees of a family trust of which the sole beneficiary was less than 16 years of age. The taxpayers held as trustees units in a unit trust. The trustee of the unit trust entered into a partnership which acquired and sold land at profit. The profit was distributed to the unit holders and the taxpayers received a share in their capacity as trustee. The taxpayers were

³⁵ (1930) 1 ATD 139.

³⁶ 80 ATC 4076 at 4082.

³⁷ 83 ATC 4415.

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assessed on the share of the profit under s 94, and in particular s 94(4) and (5). The Commissioner argued that the profit received by the unit trust constituted the "net income of a trust estate". The profit share distributed to the family trust therefore became assessable income of the family trust. This assessable income in turn was deemed under s 94(4) and (5) to include a share of the net income of the partnership. Thus, s 94 applied to the share of the net income of the partnership, as the sole beneficiary of the family trust was under 16 years of age.

The Full Federal Court held by a majority that the profit from the land sale received by the trustee of the unit trust was in extinguishment of its interest in the partnership. It was not received as income from its interest in the partnership. Thereafter, the profit share became part of the property under the unit trust. It itself became "trust estate" of the unit trust. The share of the profit received by the taxpayers was therefore not a share of the "net income of a trust estate", but was a distribution of the trust estate itself. Consequently, s 94(4) and (5) did not apply.

In the course of his judgment, Lockhart J stated:

The term "trust estate" is ... generally taken to mean the estate vested in a trustee, that is the trust property. In my view, this is the meaning of the term in Divisions 5 and 6.³⁸

Fitzgerald J³⁹ was of a like view. His Honour referred to the passage from *Everett's*⁴⁰ case cited above and continued, to say that the trustee of the unit trust:

did not here receive its share of the partnership profit in virtue of its interest in the partnership or the land, but in "exchange" for it. The income was the proceeds of realisation of the trust estate and became the trust estate of that trust, so that it could not have been "the net income" of that trust estate".⁴¹

McGregor J dissented and held that s 94(4) and (5) applied. In so holding, His Honour acknowledged that the amount received by the trustee of the unit trust could be regarded in one sense as the "trust estate", that is the sum total of all assets held by the trustee in that capacity. He noted that the amount was, however, received as the

³⁸ Ibid at 4427.

³⁹ Ibid at 4434-4437 generally.

⁴⁰ 80 ATC 4076.

⁴¹ 83 ATC 4414 at 4437.

trustee's share of the profit from a real estate venture and, even if it was a share of a trust estate, it also comprised the income of a trust estate. Thus, His Honour recognised that the meaning of the expression "trust estate" is, at least, ambiguous.

This ambiguity is reflected in the decision of Lockhart and Fitzgerald JJ, who formed the majority in holding that the share of the partnership profit received by the trustee of the unit trust was trust estate of that unit trust. Thus, notwithstanding that their Honours used the expression "trust estate" as if it were interchangeable with trust property, they still drew a distinction between, on the one hand, the trust estate comprised by the share of the partnership profit and, on the other hand, the unit trust itself.

Further support for the view that the expression "trust estate" is synonymous with trust property is found in the decision of the minority of the High Court in *Registrar, Accident Compensation Tribunal (VIC) v FCT*.⁴² The taxpayer was the Registrar of the Accident Compensation Tribunal and was assessed by the Commissioner under s 99 in respect of interest derived on compensation moneys held by him under workers compensation legislation. The taxpayer challenged the assessment on various grounds, one of which was that no trust existed which could form the basis of an assessment under Division 6 of the Act.

The High Court held by a majority of 4:3 that the Registrar was assessable under the provisions of Division 6. The majority saw the primary question at issue as whether the Registrar was a trustee of the compensation moneys, since the parties accepted that Division 6 subjected the interest to tax if he was in fact a trustee. The majority decided that the Registrar was a trustee in the ordinary sense since the Registrar held the compensation moneys for the benefit of persons entitled to that compensation.

The minority of the High Court approached the matter in a different way and relied upon the conclusion that there was no trust in the ordinary sense in deciding that Division 6 of the Act did not apply. The minority found that the Registrar did not hold the compensation moneys upon trust for the dependants of the injured worker as their right to receive payment was not enforceable in equity. The only right the dependants had was a statutory right under the workers compensation legislation.⁴³

⁴² 93 ATC 4835.

⁴³ Ibid at 4847.

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The minority then referred to the extended definition of “trustee” in s 6(1) and said:

A “trust estate” for the purposes of Division 6 of Part III ... must bear a corresponding meaning, that is, property of any kind held or controlled by a trustee in one or other of the capacities prescribed by the definition [of “trustee”].⁴⁴

As the Registrar did not hold the compensation moneys upon a trust in the ordinary sense, and was under no fiduciary duties to the dependants in respect of those moneys, the moneys were not a “trust estate” for the purposes of Division 6. There being no trust estate, the interest derived was not “income of a trust estate” within the meaning of that term in Division 6.⁴⁵

It is noted that while the approach of the minority of the High Court supports the view that a “trust estate” is synonymous with trust property, at the same time, it is apparent from that approach that the expression imports a broader concept than property which is the subject of a trust in the ordinary sense. As the statement quoted above⁴⁶ shows, the minority saw that the expression encompasses not only a trust in the ordinary sense, but also other relationships where a person holds property subject to fiduciary obligations. In this regard, the approach of the minority is consistent with the obiter of Rich and Dixon JJ in *Howey’s*⁴⁷ case.

Authority for a different meaning of the expression “trust estate” is found in the unanimous decision of the Full Federal Court in *FCT v Totledge Pty Ltd*.⁴⁸ The taxpayer in that case was the trustee of a business trading trust established as part of a scheme of arrangement to take control of certain assets of a business for the benefit of creditors to the business. The remainder of the business assets were transferred to a separate trust having a different trustee. This second trust was also established under the scheme of arrangement for the benefit of the business creditors. The taxpayer was assessed under s 99 on the ground that no beneficiary was presently entitled to the net income of the business trust.

The Full Federal Court held that s 99 did not apply as the trustee of the second trust was a beneficiary of the business trust who was

⁴⁴ Ibid at 4853.

⁴⁵ Ibid at 4855.

⁴⁶ Ibid at 4853.

⁴⁷ (1930) 1 ATD 139.

⁴⁸ 82 ATC 4168.

presently entitled to the net income of that trust. The Court expressed the view that it was:

clear that the assets which were vested in the taxpayer as trustee of the business trust constituted assets of a trust estate for the purposes of Part III Division 6 and that the income derived by the taxpayer ... constituted income of that trust estate for those purposes.⁴⁹

The Court relied upon this view to dismiss an argument by the Commissioner to the effect that the assessment could be justified pursuant to s 25 of the Act on the ground that there was in fact no "trust estate" for the purposes of Division 6.⁵⁰

The Full Federal Court therefore drew a distinction between the assets or property of a trust estate and the "trust estate" itself. The Court was clearly of the view that the expression "trust estate" means something other than trust property. Rather, it appears that the Court viewed the expression merely to mean "trust" in the ordinary sense. However, there is nothing in the judgment of the Court necessarily to indicate that the meaning of "trust estate" would be limited to this.

The context of Division 6

The meaning of the expression "trust estate", like any other expression, must depend upon the context in which it appears. It is therefore necessary to refer more closely to the provisions of Division 6 of the Act to determine whether they throw further light on the meaning of the expression. A shortcoming of the court authorities previously discussed is that they appear to have failed to undertake this step in the interpretation of "trust estate". It is submitted that, when this step is taken, it becomes apparent that "trust estate" is not intended simply to be equated with trust property, but that a different concept was, by and large, intended in the drafting of Division 6.

It is appropriate to begin with a consideration of s 95 which contains interpretative provisions specific to Division 6. First, it is noted that s 95(1) itself defines "net income" in relation to "*a* trust estate", and not simply in relation to "trust estate". The definition also refers to assessable income "*of the* trust estate", and not "*from* trust

⁴⁹ Ibid at 4172.

⁵⁰ Ibid at 4177-4178.

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estate". If "trust estate" is to be equated with trust property, the latter forms of expression would have been more appropriate in the drafting of the definition. The same could also be said of the provisions of s 97, 98 and 99 which are central to the scheme of Division 6. Furthermore, the definition of "net income" distinguishes between "*the corpus of the trust estate*" and "*the trust estate*" itself. The corpus of a trust estate would usually comprise the trust property. Such a distinction would therefore seem inappropriate if "trust estate" and trust property were one and the same.

Secondly, the definition of "resident trust estate" in s 95(2) contemplates that a trust estate can have a central management and control for the purpose of determining the residence of the trust estate. The concept of "central management and control" is well developed in the context of the residence of a company, and looks very much at where the real business activities of the company are transacted.⁵¹ The reliance upon this concept for determining the residence of a "trust estate" arguably indicates that a meaning other than trust property was intended by the definition.⁵²

There are also provisions in s 99A and 99B which are relevant to the present analysis and which support the view that "trust estate" was unlikely to have been intended to be synonymous with trust property. In particular, paragraph 99A(2)(a) refers to a trust estate "*that resulted from*" a will or intestacy. Subsection 99B(1) refers to an amount being "*property of a trust estate*" paid to, or applied for the benefit of a beneficiary of the trust estate. A reference to an amount being "*property of the trust estate*" as it represents corpus of the trust estate is also contained in s 99B(2). The subsection also refers to "*amounts derived by the trust estate*": paragraph 99B(2)(a). At the same time, however, paragraphs 99A(2)(b), (c) and (d) make reference to a trust estate that "*consists of the property of*" a bankrupt person, or of certain other kinds of property.

It is also interesting to note the provisions of s 102. Subsections 102(1) and (2A) use the term "trust", seemingly in its ordinary sense, rather than the expression "trust estate". Subsection 102(2A) also draws a distinction between "*property the subject of a trust*" and the trust itself. Finally, s 102(2) refers to "*the trust*", again seemingly in its ordinary sense, and "*the trust estate*" as though they are one and the same thing.

⁵¹ *De Beers Consolidated Mines Ltd v Howe* [1906] AC 455; *Koitaki Para Rubber Estates Ltd v FCT* (1942) 6 ATD 82.

⁵² See also reference to resident trust estate in s 99.

Comments on the possible meanings of "trust estate"

It cannot be doubted from the foregoing discussion that the precise meaning of the expression "trust estate" is neither settled nor free from uncertainty. While the weight of court authority is in favour of "trust estate" being synonymous with trust property, it should be noted that in none of the cases was the precise meaning or the scope of the expression a live issue in dispute. The courts did not address the question of whether a "trust estate" was constituted by trust property in all cases. Also, the discussion in the cases which adopt the view that the expression "trust estate" is synonymous with trust property seems to have failed to give close regard to the context in which the expression appears.

Moreover, it is submitted that the view that "trust estate" is synonymous with trust property is somewhat superficial and has difficulties. Some examples may be relied upon in support of this submission:

- (1) What if the property or assets of a trust have all been "turned over"? It would seem to follow that there would be a change in the trust property and therefore a change in the "trust estate". Yet, it is clear that such a change would not usually be regarded as resulting in a new "trust estate" for tax purposes, or a new trust in the ordinary sense unless the terms of the trust provide to the contrary.
- (2) What if a trust continues to hold exactly the same property or assets but there has been a change in the trustee, all the beneficiaries, the appointor and perhaps the terms of the trust deed as well? If "trust estate" is synonymous with trust property then it could be suggested that the "trust estate" is the same after such significant changes have been made. Yet, it is likely that such changes would usually be regarded as resulting in a new "trust estate" for tax purposes, and a new trust in the ordinary sense.
- (3) What if a trust has only one asset which it sells to a second separate trust, which has the same trustee and beneficiaries and no other property? Although the property of the second trust is exactly the same as that of the first, it could not seriously be suggested that losses incurred by the first trust would be available to the second trust. Clearly, the second

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trust would not be regarded as the same trust as the first, even though it holds the same trust property as that once held by the first trust.

The view that "trust estate" means an interest held in trust property and not the property itself also has difficulties. If pushed to its logical conclusion it would seem that the proposition arrived at is that a plurality of beneficiaries under a trust deed, who have an interest in trust property, necessarily involves a plurality of trust estates.⁵³ Also, it would seem to follow that there would be no "trust estate" where beneficiaries under a discretionary trust are mere objects, as it is settled that such objects do not hold any interest in the trust property.⁵⁴ Furthermore, this view of the meaning of "trust estate" would be contrary to the assumption which appears to underlie s 101 of the Act that only one trust estate exists in the case of a discretionary trust having a plurality of "specified beneficiaries" for whose benefit the discretion to pay or apply income may be exercised.

Of the three views previously mentioned, the third view that "trust estate" means a trust in the ordinary sense does not suffer from the difficulties mentioned. For this reason, it is submitted that this third view is the better of the three views advanced. However, all these views can be criticised as they limit the meaning of "trust estate" to circumstances where a trust in the ordinary sense exists.

It is submitted that the meaning, or rather concept, of a "trust estate" is not so limited, but is broader than a "trust" in the ordinary sense. That this is so is supported by the obiter of Rich and Dixon JJ in *Howey's*⁵⁵ case, and also the minority in *Registrar, Accident Compensation Tribunal (VIC) v FCT*.⁵⁶ These cases support the view that a "trust estate" would exist for the purposes of Division 6 where either a trust in the ordinary sense exists, or, absent such a trust, a person holds or controls property subject to fiduciary obligations. This view of the meaning of the expression "trust estate" is not inconsistent with the outcomes in any of the court authorities referred to previously. In each case, the court found that either there was or was not trust property which was the subject of a trust, and as a consequence, there was or was not a "trust estate" for the purposes of Division 6. It is also submitted that this meaning of

⁵³ As noted by Chairman Dubout in (1969) 15 CTBR(NS) Case 40.

⁵⁴ *Gartside v IRC* [1968] AC 533; *Re Weir* [1971] 1 Ch 145; *Re Goldsworthy* [1969] VR 843.

⁵⁵ (1930) 1 ATD 139.

⁵⁶ 93 ATC 4835.

"trust estate" would explain why the expression is used in Division 6 as opposed to merely referring to the term "trust".

Having made these submissions, it is conceded that the meaning of "trust estate" which has been advanced lacks the degree of precision that would seem to be necessary to determine whether the identity of a "trust estate" has been maintained for the purposes of carrying forward a past year trust loss. In the further discussion which follows, the situation of holding property under a fiduciary obligation is put to one side as it would rarely be the case that a "trust estate" comprised of such a relationship could be utilised for the purposes of loss trafficking. It is therefore proposed to deal only with a "trust estate" comprised of a trust in the ordinary sense.

THE EFFECT OF CHANGES AFTER ACQUISITION

If a "trust estate" comprises a trust in the ordinary sense, the question arises as to what are the effects of the possible changes listed in the introduction of this article on the identity of the trust. It would seem the effects could be to:

- (a) leave the "trust estate" intact so that it remains the same "trust estate";
- (b) leave the "trust estate" intact but create a second "trust estate"; or
- (c) bring the old "trust estate" to an end and create a new "trust estate".

There is little authority on the question, or indeed dealing generally with the question, of what factors identify one trust from another.

That this is so is perhaps not surprising, given that no definition of a "trust" appears to have been accepted universally as comprehensive and exact.⁵⁷ The authorities have tended to shy away from attempting to provide such a definition and instead proffer descriptions of the concept of a "trust". Thus, *Jacobs' Law of Trusts in Australia* states:

A trust exists when the holder of a legal or equitable interest in certain property is bound by an equitable obligation to hold his interest in that property not for his

⁵⁷ *Re Scott (dec'd)* [1948] SASR 193 at 196 per Mayo J.

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own exclusive benefit, but for the benefit, as to the whole or part of such interest of another person or persons or for some object or purpose permitted by law.⁵⁸

It is accepted by the authorities, however, that there are four essential elements present in all trusts, namely, a trustee, trust property, a beneficiary, and a personal obligation attaching to that property. Given the essentiality of these elements, it is considered that changes which affect any of them are more likely to be of consequence in determining the overall effect of the changes on the identity of a trust.

Changes to the trustee

As for changes affecting the trustee, or more specifically the identity of the trustee, it is submitted that they do not affect the identity of a trust. That this is so would seem clear from numerous authorities dealing with the appointment, removal and retirement of trustees. This submission is also supported by the deeming of a trustee as a taxpayer under the definition of "net income" in s 95(1). As previously indicated, the deemed taxpayer is a hypothetical person who is not attributed with the personal attributes of the actual trustee. The personal identity of the trustee, therefore, would not be relevant to the identity of a "trust estate".

Changes to trust property

In regard to changes affecting the trust property, it is submitted that the High Court case of *Truesdale v FCT*⁵⁹ stands out as being an important and relevant authority. The taxpayer was the trustee of three separate trusts which were established for the benefit of the children of a Mr King. Each trust was established under a deed of trust pursuant to which a nominal sum of money was settled upon the trustee. The trust deeds provided that the settled fund was to comprise that money "together with any other property or money which come into the hands of the Trustee on Account." Thereafter, Mr King contributed further amounts to the trustee which were used to purchase income producing property on behalf of the trusts.

⁵⁸ Meagher and Gummow (5th ed 1986 Butterworths) at 7 where the authors acknowledge this statement as a description of a trust and not a definition.

⁵⁹ 70 ATC 4056.

The Commissioner assessed the taxpayer as trustee under s 102 on the income derived from the property at the rate of tax which would have been payable if Mr King had derived the income in addition to other income derived by him. This was on the ground that Mr King had "created a trust" within the terms of s 102. Menzies J held that the section did not apply as Mr King had not created any trusts in making the contributions.

Menzies J said that the words "created a trust" in s 102 are not apt to describe the payment of money to a trustee to hold under a trust already constituted. His Honour then added:

There is an obvious difference between creating a trust in respect of property, on the one hand, and, on the other, transferring property to a trustee to hold upon the terms of an established trust. To read the section as if it applied to such a transfer would be, in the absence of a context, to expand it. Such a reading would be tantamount to saying that the transfer to the trustee of property to be held as part of the assets of an already constituted trust would be to create a second trust, whereas, from the point of view of both the trustee and of the beneficiary, there would be but one trust and the property transferred would be nothing more than an addition to the property of the trust.⁶⁰

Although this statement was made in the context of the scope of s 102, it is submitted that it supports the view that an addition or change in trust property does not result in the creation of a second trust where the addition or change is contemplated by the terms of the existing trust. Further support for this view is provided by the actual decision of the majority in *FCT v Walsh (PJ & BJ)*⁶¹ in which it is apparent that the unit trust in question remained in existence even though there was a change in the trust property held by the trust which arose from the realisation of its interest in the relevant partnership.⁶²

Changes to beneficiaries

There are some authorities dealing with the Variation of Trusts legislation which may be of assistance in considering the question of

⁶⁰ Ibid at 4059.

⁶¹ 83 ATC 4415.

⁶² A contrary view expressed by Mason JA (as he then was) in *Atwill v Commissioner of Stamp Duties* (1970) 92 WN (NSW) 869 at 878-879 should be noted but could be distinguished as having been made in a different context.

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the effect of changes made to the beneficiaries under a trust. Basically, this legislation vests in a court the power to vary a trust in certain circumstances where the trust deed does not authorise such a variation. In exercising this power, the courts have drawn a distinction between a variation which leaves the existing trust intact and one which results in the existing trust being replaced by a new trust, or in a resettlement. Only the former is within the power of the court. Given the absence of direct authority on the question presently at hand, it is submitted that authorities under the Variation of Trusts legislation would provide useful guidance, and some of them are now briefly discussed.

In *Re Towler's Settlement Trusts*,⁶³ the beneficiary became absolutely entitled to a share of a trust fund upon attaining 21 years of age. Wilberforce J refused to approve under the legislation a proposal to transfer the beneficiary's share to new trustees to hold it on protective trusts for the beneficiary's life, with the remainder passing to her children. His Honour took the view that, though presented as a variation, the proposal was in truth a complete new resettlement. The former trust funds were to be "got in" from the former trustee and held on totally new trusts such as might be made by an absolute owner of the funds. The substance of such a proposal went too far and was consequently beyond the power of the court.

In *Re Ball's Settlement*,⁶⁴ the settlor established a trust under which he had a life interest and also a power to appoint up to half of the trust fund to each of his two sons. Megarry J approved a proposal which deleted the settlor's life interest and divided the trust fund into two equal halves for each son. His Honour took the view that the difference between the terms of the trust and the proposal lay in detail rather than in substance. The resulting trusts were still in essence trusts of half of the fund for each of the two sons, with defined interests in place of the power of appointment.

While again acknowledging that these two cases were decided in a different context, it is submitted that they support the view that a change in respect of a beneficiary under a trust who has an absolute and indefeasible interest in the trust property is likely to result in the creation of a new trust where the change affects that interest. However, if a beneficiary has no interest in trust property, it is submitted that a change made in respect of the beneficiary is unlikely to result in a new trust. Difficult situations will arise

⁶³ (1963) 3 All ER 759.

⁶⁴ (1968) 2 All ER 438.

where the nature of a beneficiary's interest may be said to fall somewhere in between these two ends of the scale, so to speak.

Other changes

Megarry J in *Re Ball's Settlement* made the following statement:

If an arrangement changes the whole substratum of a trust, then it may well be that it cannot be regarded merely as varying that trust. But if an arrangement, while leaving the substratum, effectuates the purpose of the original trust by other means, it may still be possible to regard that arrangement as merely varying the original trusts, even though the means employed are wholly different and even though the form is completely changed.⁶⁵

Accordingly, changes to a trust which merely provide wholly different means and completely changed form do not result in a trust being replaced by a new trust, provided that the purpose of the original trust is still effected after the changes. In Megarry J's view, such changes affect the detail of a trust rather than its "substratum". However, Megarry J did not provide any real guidance on what is meant by the "substratum" of a trust. Presumably, it means the intention of the settlor at the time when the trust was settled.⁶⁶ It is submitted, therefore, that a change to the personal obligation attaching to trust property is unlikely to result in a new trust unless the change substantially impinges upon the purpose of the trust, as intended by the settlor of the trust.

It should be noted that at the time *Re Towler's Settlement Trusts*⁶⁷ and *Re Ball's Settlement*⁶⁸ were decided, it was probably relatively easy to identify the "substratum" of the types of trusts then usually employed. The cases concerned traditional English family trusts which tended to be fixed in nature with no or limited discretion as to the choosing of beneficiaries.⁶⁹ It may be questionable whether the approaches adopted in the cases are of much use today, given that modern day trusts, and discretionary trusts in particular, are commonly designed to ensure maximum flexibility as to the selection of beneficiaries. Moreover, modern day trusts usually provide broad

⁶⁵ Ibid at 442.

⁶⁶ Ford & Lee, *Principles of the Law of Trusts* (2nd ed 1990) 669.

⁶⁷ (1963) 3 All ER 759.

⁶⁸ (1968) 2 All ER 438.

⁶⁹ Ford & Lee, above n 66 at 659.

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powers to change the structure of a trust and the beneficial entitlements under the trust.

This is demonstrated by the case of *Kearns v Hill*⁷⁰ in the New South Wales Court of Appeal. At issue was whether a variation clause in a trust deed, which empowered the trustees to vary or amend any of the provisions contained in the deed, extended to alterations to the identity of beneficiaries under the deed. The trustees had purported to exercise the power of variation to add a further class of discretionary beneficiaries comprised of the children of the primary beneficiaries. The Court of Appeal upheld the variation as a valid exercise of the power vested in the trustee. The Court noted that it was impossible to discern in the trust deed any intention that the list of beneficiaries contained in it should remain perpetually inviolate. To the contrary, the deed was replete with references to persons who were not beneficiaries but were capable of becoming beneficiaries. It was therefore impossible to deny that the trustees' power to vary the trust deed extended to making changes to the identity of the beneficiaries.

Meagher JA, with whom Mahoney and Clarke JJA agreed, referred to the authorities which suggested that a power of variation did not extend to changes which destroyed the "substratum" of a trust. He found these authorities were not really helpful in the circumstances of the case where, either it was impossible to locate any substratum at all, or alternatively, the relevant substratum was the benefit of a person's descendants whose interests were being actively promoted by the change made by the trustees. Meagher JA pointed out that the deed of trust was:

an example of many such documents which have been commonly used for many years which are designed to deal with the disposal of family assets in such a way that the trustees are furnished with the most ample powers of management and disposition of the settled fund coupled with maximum flexibility in the use of those powers, so as to accommodate the settled fund to emerging and ever-changing economic and revenue considerations.⁷¹

Finally, His Honour also pointed out that each deed must be considered in its own particular context and no other deed executed in different circumstances and in different language can decide the position for a given deed.⁷²

⁷⁰ (1990) 21 NSWLR 107.

⁷¹ Ibid at 109.

⁷² Ibid at 111.

Effect of changes under the new Budget measures

Under the new loss trust anti-trafficking measures announced in the 1995/1996 Budget, changes made after the acquisition of a loss trust may result in the denial of deductions for the past year and current year losses of the trust. Whether this will be so in any particular case will, of course, depend upon the type of trust in question and whether the new rules of deductibility which apply to that type of trust are satisfied, given the actual changes made after acquisition. As at the time of writing, the answers to these questions can only be found in the information contained in the Budget announcement and, in particular, the accompanying Press Release of the Treasurer.

It seems to be clear from this information that a change affecting the trustee of a loss trust is only relevant to the continuity of control test for discretionary and family trusts as defined in the announcement. Moreover, a change in the identity of the trustee of a loss trust would not be material unless it is actually accompanied by a change which breaches the required continuity of control. It is also apparent that the continuity of control test will be stricter for discretionary trusts than for family trusts. For a discretionary trust to satisfy the test there must be *no* change in the controllers of the trust. In this regard, the Treasurer's statement that the test will parallel the continuity of control test for companies, where there can be a change of less than 50% in control without a company breaching the test, is on the face of it misleading. For a family trust, the continuity of control test is less stringent as the test would appear to be satisfied where there is a change in the controllers of a trust, as long as control remains with members of the same family.

As for a change to the trust property, regard would need to be had to the income injection test which applies to all types of trusts. Based on the sketchy details of this test contained in the Treasurer's Press Release, it would seem that the test would be breached where the change results in the trust deriving assessable income that is sheltered from tax by the losses of the trust, provided that consideration has been paid for the use of the losses as part of the acquisition of the loss trust. The precise details of the requirements of this test, as finally enacted, would no doubt be eagerly awaited where a loss trust has been acquired after the commencement time of the new rules.

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Finally, changes to beneficiaries would obviously be relevant to the continuity of beneficial ownership test under the new measures. Such changes would be likely to result in a breach of the test unless continuity of more than 50% of the "underlying beneficial interests" in the trust income and corpus, and of voting rights if those interests could be changed by a meeting of the beneficiaries, is maintained.

CONCLUSION

Although presently there are no specific sections in the Act dealing with the tax treatment of trust losses, it is clear that under the provisions of Division 6 such losses cannot be apportioned between and distributed to the beneficiaries of a trust estate. Rather, it is equally clear that trust losses are to be carried forward and recouped from the assessable income of a trust estate in a future year of income. It is not beyond question that the limitations contained in s 80A to s 80E, which apply to the carry forward of past year losses of companies, do not apply to trust estates having a corporate trustee. However, it is concluded that the better view is that the sections do not apply and that the calculation of "net income" under s 95(1) is to be made without regard to those limitations.

To carry forward a past year trust loss, the "trust estate" in the income year in which the loss is sought to be recouped must be the same "trust estate" that existed in the year in which the loss was incurred. The expression "trust estate" is ambiguous and there is a divergence of views as to its precise meaning. The view advanced in this article is that "trust estate" does not simply mean trust property or the interest held in such property. Rather, the view is taken that a "trust estate" exists where either a trust in the ordinary sense exists, or, absent such a trust, a person holds or controls property subject to fiduciary obligations. The concept of a "trust estate" therefore focuses more on the relationship between the trustee, trust property and the beneficiaries than on identity. Thus, the mere identity of the essential elements of a trust comprising a "trust estate" is not necessarily conclusive of the identity of the "trust estate" itself.

Taking each of the elements in isolation, it seems clear that the identity of the trustee is irrelevant to the identity of the trust estate. As for:

- (a) the identity of trust property,

- (b) the identity of the beneficiaries and the nature of their interest in trust property, and
- (c) the terms of the trust obligation or relationship,

it is submitted that all may be relevant factors in determining whether a "trust estate" has remained the same after any changes are made. It is further submitted that the intention of the settlor is likely to be another relevant factor to be considered in answering the question.

In view of these submissions, it is difficult to escape the conclusion that the question is ultimately one of fact and degree to be decided having regard to each of the factors identified. Moreover, the weight to be given to each factor will depend upon the terms of the trust and will, therefore, vary from case to case. Consequently, the terms of each trust, and in particular whether any changes made are contemplated by those terms, may well determine whether a "trust estate" has remained the same. In any case, the dividing line will be difficult to draw. The limited authorities referred to indicate, however, that a court seeking to draw this line and resolve the question will look to the substance of any changes made rather than merely rely on their form.

The resulting uncertainty underlying this approach would suggest that the trafficking in loss trusts is fraught with risk. Other difficulties that may be encountered under the Act are:

- (1) The operation of the specific "trust stripping" anti-avoidance provisions of s 100A in respect of the introduction of a new source of income to the loss trust;
- (2) The application of the general anti-avoidance provisions of Part IVA to the acquisition of the loss trust where it is acquired to take advantage of past year losses to shelter future assessable income from income tax, and to the diversion of an income source to the trust; and
- (3) The impact of s 99B and 99C of Division 6 and s 160ZM of the capital gains tax provisions in Part IIIA on the assessability of amounts subsequently distributed out of the loss trust.

Of course, the effect of the general trust law on the validity of any changes made, especially to beneficiaries under a trust, is another

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matter to be considered. All of these matters provide significant hurdles which must be overcome to successfully traffic in loss trusts.

These hurdles have been added to by the 1995/1996 Budget announcement introducing the loss trust anti-trafficking measures into the Act. It is quite clear from the information released by the Treasurer on the tests of deductibility that the new rules will prove to be a very effective measure in stamping out loss trust trafficking. Indeed, the very strict nature of the requirements under the tests raises the issue of whether the new rules go beyond what is necessary to achieve their purpose, and intrude upon cases where there is a bona fide takeover of a loss trust to restore profitability to the trust's underlying business or investment activities. In this regard, there would appear to be no good reason why the new rules should not reflect more closely the less onerous rules in s 80A to s 80E which apply to limit the deductibility of company losses. More specifically, a continuity of business exception to non-deductibility under the new rules would seem to be as equally appropriate to all types of trusts (not only widely held *listed* public trusts), as it is for all companies regardless of their classification. It may be that the income injection test will operate in a way which ameliorates the harshness of the new rules where it is clear that no consideration has been received or given in respect of the tax losses of a trust. But, this may prove difficult to establish in practice and, in any case, is an issue that arises only where the other stringent tests in the new rules have been satisfied.

It may also be noted that, while certain modifications have been made to the company continuity of beneficial ownership test to account for the different characteristics of trusts, the requirements of the test are undoubtedly stricter for loss trusts. For companies, the test in s 80A does not require an unbroken continuity of beneficial ownership.⁷³ However, the test for loss trusts requires that "beneficial ownership" continue unbroken from the loss year to the income year. This will require an examination of the "beneficial ownership" in the loss year, the income year *and* in any intervening income years.

It can be readily concluded from the uncertainty in determining whether a trust estate has remained the same where changes have been made after the acquisition of a loss trust, the other difficulties that may be encountered under the Act, and the introduction of the

⁷³ See the remarks of Mason J in *Kolotex Hosiery (Australia) Pty Ltd v FCT* 73 ATC 4094 at 4105 and Taxation Determination TD 94/38.

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A Loss of Trust

new loss trust anti-trafficking measures, that the tax risks involved in acquiring a loss trust are many.