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# **Glossary**

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The following abbreviations and acronyms are used throughout this explanatory memorandum.

<i>Abbreviation</i>	<i>Definition</i>
CGT	Capital gains tax
GST Act	<i>A New Tax System (Goods and Services Tax) Act 1999</i>
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>



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## **General outline and financial impact**

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### **Removal of capital gains tax trust cloning exception and provision of limited fixed trust roll-over**

Schedule # to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to repeal the exception to capital gains tax (CGT) events E1 and E2 widely known as the ‘trust cloning’ exception. Schedule # also provides a limited CGT roll-over for the transfer of assets between trusts with the same beneficiaries with the same trust interests.

Schedule # clarifies that a mere change of the trustee of a trust does not change the entity that is the trustee for the purposes of the ITAA 1997 and the *A New Tax System (Goods and Services Tax) Act 1999* (GST Act).

***Date of effect:*** The amendments apply to CGT events happening after 31 October 2008

***Proposal announced:*** The then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs announced in Media Release No. 092 of 31 October 2008 the repeal of the trust cloning exception. He subsequently announced in Media Release No. 048 of 12 May 2009 that the Government would provide a limited CGT roll-over for fixed trusts.

***Financial impact:*** Unquantifiable, but expected to be small.

***Compliance cost impact:*** These amendments are expected to have a low impact for both implementation and ongoing compliance costs.



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## **C**hapter #

# **Removal of capital gains tax trust cloning exception and provision of limited fixed trust roll-over**

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### **Outline of chapter**

1.1 Schedule # to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) by repealing the exception to capital gains tax (CGT) events E1 and E2 widely known as the ‘trust cloning’ exception. Schedule # also provides a CGT limited roll-over for the transfer of assets between trusts with the same beneficiaries with the same trust interests. These amendments apply to CGT events that happen after 31 October 2008.

1.2 Schedule # clarifies that a mere change of the trustee of a trust does not change the entity that is the trustee for the purposes of the ITAA 1997 and the *A New Tax System (Goods and Services Tax) Act 1999* (GST Act).

1.3 All references to legislative provisions in this chapter are references to the ITAA 1997 unless otherwise stated.

### **Context of amendments**

1.4 The repeal of the trust cloning exception is consistent with the policy principle of taxing capital gains that arise where there is a change in ownership of an asset, as typically occurs on the creation of a trust over a CGT asset (CGT event E1) and on transferring a CGT asset to an existing trust (CGT event E2).

1.5 The removal of the trust cloning exception will also prevent taxpayers using the exception to eliminate tax liabilities on accrued capital gains, which will help ensure equity and the integrity of the tax system.

1.6 The limited CGT roll-over for eligible trusts will facilitate the efficient restructuring of businesses and investment funds held in such trusts by ensuring that CGT considerations are not an impediment to the restructure.

1.7 The CGT regime may provide a CGT roll-over where there is a change in legal ownership but no change in underlying ownership. Providing a limited CGT roll-over for the transfer of assets between eligible trusts with the same beneficiaries is consistent with that approach.

1.8 Roll-over is not always provided where there is no change in underlying ownership. Other considerations are important, such as ensuring tax system integrity and the existence of alternatives in the income tax laws.

## **Summary of new law**

1.9 Part 1 of Schedule # to this Bill amends the ITAA 1997 by repealing the CGT trust cloning exception.

1.10 Part 2 of Schedule # to this Bill inserts Subdivision 126-G into the ITAA 1997 to provide a limited CGT roll-over for the transfer of assets between eligible trusts. Broadly, the effect of the roll-over is to defer the making of any capital gain or capital loss in respect of the asset transfer. The cost base of beneficiaries' interests in the transferring trust is apportioned across their interests in both trusts.

1.11 To be eligible, both trusts must have the same beneficiaries with the same entitlements and no material discretionary elements. Further, the receiving trust must be a 'cleanskin' trust, meaning:

- a newly created trust; or
- a trust with no CGT assets other than a small amount of cash or debt.

1.12 Part 3 of Schedule # to this Bill clarifies that a mere change of trustee of a trust does not change the entity that is the trustee for the purpose of the ITAA 1997 and the GST Act.

## **Comparison of key features of new law and current law**

<i>New law</i>	<i>Current law</i>
The transfer of an asset from one trust to a new or existing trust will trigger a CGT event.	The transfer of an asset from one trust to a new or existing trust that has the same beneficiaries and terms does not trigger a CGT event.
Roll-over may be chosen to disregard	The transfer of an asset to a trust

<i>New law</i>	<i>Current law</i>
any capital gain or capital loss arising from the transfer of an asset from a trust (the 'transferring trust') to a new or existing trust (the 'receiving trust'), provided: <ul style="list-style-type: none"><li>• both trusts have the same beneficiaries with the same entitlements;</li><li>• both trusts have no material discretionary elements;</li><li>• the receiving trust is a 'cleanskin'; and</li><li>• no exceptions apply.</li></ul>	typically triggers CGT consequences, unless both trusts have the same beneficiaries and terms.

## Detailed explanation of new law

### Abolishing the trust cloning exception

1.13 The trust cloning exception provided an exception to CGT events E1 and E2.

- CGT event E1 happens where a trust is created over a CGT asset by declaration or settlement.
  - The trust cloning exception to CGT event E1 applied where the trust was created by transferring the asset from another trust and the beneficiaries and terms of both trusts were the same.
- CGT event E2 happens where a CGT asset is transferred to an existing trust.
  - The trust cloning exception to CGT event E2 applied where the asset was transferred from another trust and the beneficiaries and terms of both trusts were the same.

1.14 Schedule # to this Bill repeals the trust cloning exception to CGT events E1 and E2. The other exception to CGT events E1 and E2 (that may apply when an asset is transferred to a relevant trust by a sole beneficiary of the trust that is absolutely entitled to the asset) will be retained. [Schedule #, item 1, subsection 104-55(5); and item 2, subsection 104-60(5)]

***The ‘trustee entity’ provision***

1.15 Subsection 960-100(2) of the ITAA 1997 states that the trustee of a trust is taken to be an ‘entity’ consisting of the person who is the trustee, or persons who are the trustees, at any given time. An identical definition exists in subsection 184-1(2) of the GST Act.

1.16 As part of the Tax Law Improvement Project, the Joint Committee of Public Accounts and Audit in *An Advisory Report on the Tax Law Improvement Bill No. 2 1997* (Report 356 of 1998) stated that the interaction of the proposed subsection 104-10(2) with the ‘entity’ provision in subsection 960-100(2) was unclear — that it was possible that a mere change of trustee of a trust was technically a ‘disposal’ and thus a CGT taxing point. The Committee recommended ‘clarification by way of amendment or the addition of guide material’ to the proposed subsection 104-10(2), which was subsequently provided in paragraph 104-10(2)(b) of the ITAA 1997.

1.17 In *AXA Asia Pacific Holdings Limited v Commissioner of Taxation* [2008] FCA 1834, Justice Lindgren, in interpreting subsection 184-1(2) of the GST Act, noted that ‘[t]his provision is concerned with continuity irrespective of changes that may occur in the identity of the trustee or trustees from time to time. Under the provisions, a change in the identity of a trustee of a trust does not mark a change in the entity, which is the ‘trustee of [the] trust’.’

1.18 The amendments reflect Justice Lindgren’s interpretation by adding a note to each of the ‘entity’ definitions that confirm that a mere change in the person who is the trustee does not mean there is a new trustee entity for tax purposes. That is, the trustee is still the same entity even if there is a change in the person who holds the office of trustee. *[Schedule #, items 13 and 14, subsection 184-1(2) of the GST Act; and items 18 and 19, subsection 960-100(2) of the ITAA 1997]*

1.19 Additional notes in CGT events A1, E1 and E2 explain that a mere change of trustee of a trust does not trigger a CGT event. This follows because the entity that is the trustee does not change for tax purposes and so does not give rise to any of these CGT events.

- The definition of disposal for CGT event A1 in subsection 104-10(2) is updated to remove the unnecessary exclusion of a mere change of trustee.

*[Schedule #, item 15, subsection 104-10(2); item 16, subsection 104-55(1); and item 17, subsection 104-60(1)]*

### **Example 1.1**

Steven and Amanda are the joint trustees of a trust. Steven and Amanda retire and Lachlan is appointed as the replacement trustee. Subsequently, Mikayla Pty Ltd is appointed as an additional trustee to Lachlan. No other changes are made and the property continues to be held on the same trust.

Although there is a change in legal ownership of the trust assets from Steven and Amanda to Lachlan, and then to Lachlan and Mikayla Pty Ltd as joint owners, no CGT event happens in respect of either transaction because there is no change in the entity that is the trustee of the trust for tax purposes.

### **Limited CGT roll-over for eligible trusts**

1.20 Schedule # also provides a CGT roll-over that permits deferral of a capital gain or capital loss made on the transfer of an asset from one trust (the transferring trust) to another trust (the receiving trust). The objective of this roll-over is to facilitate the efficient restructuring of businesses and investment funds held in eligible trusts by ensuring that CGT considerations are not an impediment to the restructure. [*Schedule #, item 8, section 126-220*]

1.21 The roll-over is available if these conditions are met:

- both trusts are eligible (paragraphs 1.24 to 1.39);
- the same beneficiaries have the same interests in both trusts (paragraphs 1.40 to 1.45); and
- no exception applies (paragraphs 1.46 to 1.61).

[*Schedule #, item 8, subsection 126-225(1)*]

1.22 These conditions aim to ensure that the asset transfer does not change the underlying ownership of the asset, and to maintain the integrity of the tax system.

1.23 This part of the Explanatory Memorandum discusses those conditions, as well as the consequences for the trustees and beneficiaries if the roll-over applies.

#### ***Trusts eligible for the roll-over***

1.24 The trustee of the transferring trust and the trustee of the receiving trust must both choose the roll-over in order for it to apply. [*Schedule #, item 8, subsection 126-225(2)*]

1.25 For the trustees to choose the roll-over, the beneficiaries' interests in each trust must satisfy a number of requirements. Trusts that satisfy these requirements are sometimes referred to as 'fixed trusts'.

- However, the conditions for this roll-over do not employ the existing definition of 'fixed trust' in Schedule 2F to the *Income Tax Assessment Act 1936* (ITAA 1936).
- Furthermore, unlike the trust cloning exception, the roll-over does not require the terms of the two trusts to be precisely the same. However, any differences in terms that result in a difference in beneficiaries' interests will prevent the roll-over applying.

*CGT event E4 capable of happening to interests*

1.26 CGT event E4 must be capable of happening to all the units or interests in each of the trusts. *[Schedule #, item 8, paragraph 126-225(1)(c)]*

1.27 The purpose of this requirement is, broadly speaking, to ensure that so-called discretionary trusts cannot access the roll-over. This is because it is difficult to establish, with any degree of certainty, the real underlying ownership of the assets of a discretionary trust. It is equally difficult to test whether that ownership has been maintained.

*Interests in the trust must be vested*

1.28 Each membership interest held by a beneficiary in each of the trusts must be an interest in, or a right relating to, the income and/or capital of the trust, the nature and extent of which is capable of being ascertained solely by reference to the trust's constituent document. An interest that is vested in interest or possession will meet this requirement. *[Schedule #, item 8, paragraphs 126-230(1)(b) and 126-230(1)(c)]*

- All of the interests held by each beneficiary must meet this requirement. It is not sufficient that a beneficiary holds some interests that meet it and some that do not.
- The expression 'membership interest' is defined in section 960-135 to mean each interest or set of interests in an entity (or each right or set of rights in relation to the entity) by virtue of which the holder of those interests or rights is a member of that entity. A beneficiary, unitholder or object of a trust is a member of the trust: refer section 960-130.

1.29 The nature and extent of a beneficiary's interest would be capable of being ascertained solely by reference to the trust's constituent document if, for example, the beneficiary holds a unit in a trust which

confers a right to a proportionate share of the income and capital of the trust based on the number of units on issue.

1.30 However, the extent of an interest would not be capable of being ascertained solely by reference to the trust's constituent document if, for example, different beneficiaries have interests in the income and capital of the trust and the trustee has a discretion that permits them to characterise receipts and outgoings as being on either income or capital account.

*Interests in the trust cannot be defeated*

1.31 The roll-over is not available if a beneficiary's interests described above can be defeated by the actions of any person. The actions need not be those of the trustee, but may be those of any person (such as an appointor). More particularly, in order to obtain roll-over no entity can have the power to:

- materially alter the beneficiary's membership interests in the trust; or
- issue or redeem membership interests in the trust at a discount of more than 10 per cent of their market value.

*[Schedule #, item 8, subsection 126-230(2)]*

1.32 The following are examples of powers considered capable of materially altering a beneficiary's membership interests:

- A power to appoint the beneficiary's interest in the income or capital to another beneficiary.
- A power to accumulate trust income to capital (unless those otherwise entitled to the income have the same interests in the capital).
- A power to appoint new beneficiaries.
- A power to appoint any part of the trust property to a new trust with different beneficiaries.
- A power to issue new interests with rights attached that effectively change in any way the rights attached to interests already on issue.
- A power to amend the trust's constituent document to include a power capable of materially altering a beneficiary's membership interests.

1.33 Powers such as the following that merely facilitate the administration of the trust are not regarded as materially altering a beneficiary's membership interests:

- a power to round distributions or other amounts to whole cents per unit or interest;
- a power to alter the manner in which beneficiary entitlements are paid, for example, to determine that they be credited directly to beneficiaries' bank accounts; and
- a power to pay beneficiary entitlements at any time within a prescribed period.

1.34 The roll-over will also not be available if membership interests can be issued or redeemed at a discount of *more* than 10 per cent of their market value. Generally, the ability of any person to issue or redeem membership interests at a discount of 10 per cent or *less* to their market value would not amount to a power capable of materially altering a beneficiary's membership interests. But it may amount to such a power if, for example, the new interests could be issued with rights attached that in some way changed or cut across the rights attached to interests already on issue (as envisaged in the second last dot point of paragraph 1.32).

*Trustee's right of indemnity does not defeat beneficiary's interest*

1.35 A trustee's right of indemnity may take the form of a right to be reimbursed out of trust property for expenses paid by the trustee; or a right to appropriate trust assets to discharge a liability incurred by the trustee (referred to as a right of exoneration). See Dixon J in *Vacuum Oil Co Pty Ltd v Wiltshire* (1945) 72 CLR 319.

1.36 A trustee's right to reimbursement or exoneration amounts to a proprietary interest in the trust's assets in the nature of an equitable lien over the assets. The charge of lien comes into existence when the trustee's right of indemnity arises, usually when the liability is incurred. The lien is a global one in the sense that it represents a first charge on the assets and the rights of beneficiaries are suspended until it is satisfied. The lien gives the trustee a proprietary interest in the trust's assets. Refer *Chief Commissioner of Stamp Duties for New South Wales v Buckle* (1998) 192 CLR 226.

1.37 It is therefore considered that a trustee's rights to be indemnified out of the trust property in respect of liabilities properly incurred in the administration of the trust does not defeat the beneficiaries' entitlements to income or capital; rather they represent a separate right which simply ranks ahead of the claims of beneficiaries.

*Additional requirements for receiving trust*

1.38 The receiving trust must have no CGT assets, other than a small amount of cash or debt, just before the transfer. This ensures the roll-over cannot be used to marry gain and loss assets. [Schedule #, item 8, paragraph 126-225(1)(b)]

1.39 Consistent with this ‘cleanskin’ approach, if the receiving trust has any revenue or capital losses just after the asset transfer time, they are effectively extinguished (ie they cannot be used). This is an automatic consequence of choosing roll-over and is discussed under the heading ‘Consequences for trustees’.

*The same beneficiaries must have the same interests in both trusts*

1.40 Both trusts must have the same ‘direct’ beneficiaries. In other words, the same entities, acting in the same capacities, must be beneficiaries of both trusts. It is not sufficient that the ‘indirect’ or ultimate beneficiaries of both trusts are the same. [Schedule #, item 8, paragraph 126-230(1)(a)]

1.41 Further, both trusts must have the same classes of membership interests. [Schedule #, item 8, paragraph 126-230(1)(d)]

- Membership interests constitute a class if they have the same, or substantially the same, rights. [Schedule #, item 9, subsection 995-1(1)]

*Beneficiaries must have the same interests — the market value test*

1.42 The market value test determines whether beneficiaries have the same proportionate membership interests before and after the transfer.

1.43 Under this test, for each beneficiary, the total market value (just after the transfer) of their interests in the transferring trust of a particular class and their corresponding interests in the receiving trust must equal the total market value (just before the transfer) of their interests of that class in the transferring trust. [Schedule #, item 8, paragraph 126-230(1)(e)]

1.44 This test ignores any small amounts of cash or debt held by the receiving trust (because the test could not be met if they were taken into account). It also ignores any carried forward tax losses or net capital losses of the receiving trust (because they will have been effectively extinguished if roll-over is chosen).

1.45 This test augments the ‘cleanskin’ approach. That is, if the market value test is satisfied, then this confirms that the receiving trust did

not hold assets with a market value before the transfer (or liabilities). The only asset of value it holds just after the transfer is the transferred asset.

### Example 1.2

TrustOne is an eligible trust with two beneficiaries: Sheila and Peter. There are two classes of units in the trust:

- Class A units entitle the holder to a share of the rental income from properties held by the trust; and
- Class B units entitle the holder to a share of the capital value of the properties held by the trust.

TrustTwo is also an eligible trust with the same beneficiaries. TrustTwo has two classes of units labelled Class 1 and Class 2, which have the same rights as Classes A and B respectively.

For each beneficiary, the number and market value of units in TrustOne is shown in table 1.1. Just before the transfer, the market value of all units in TrustTwo is zero (disregarding the small amount of cash held by TrustTwo).

**Table 1.1 Number and value of units in TrustOne**

<i>Beneficiary / Unit</i>	<i>Number of units</i>	<i>Market value of each unit</i>	<i>Total market value</i>
<i>Sheila</i>			
Class A units	1000	\$100	\$100,000
Class B units	1000	\$1,000	\$1,000,000
<i>Peter</i>			
Class A units	500	\$100	\$50,000
Class B units			

The trustee of TrustOne transfers two of its properties to the trustee of TrustTwo for no consideration. As a result, the market values of Class A and Class B units fall and the market values of Class 1 and Class 2 units increase.

**Table 1.2 Market value (MV) of units after the transfer**

<i>Beneficiary / Unit</i>	<i>MV of units in TrustOne</i>	<i>MV of units in TrustTwo</i>	<i>Total market value</i>
<i>Sheila</i>			
Class A / 1	\$80,000	\$20,000	\$100,000
Class B / 2	\$900,000	\$100,000	\$1,000,000
<i>Peter</i>			

Class A / 1	\$40,000	\$10,000	\$50,000
Class B / 2			

Roll-over is available because the total market value of the interests within each pair of the matching classes is the same before and after the transfer.

### ***Exceptions***

1.46 In certain situations, roll-over is not available.

#### *Foreign trust and not taxable Australian property*

1.47 Roll-over is not available if the receiving trust is a foreign trust for CGT purposes and the transferred asset is not taxable Australian property. Permitting roll-over in these circumstances would effectively allow a CGT exemption for any accrued capital gain, rather than a deferral. [Schedule #, item 8, subsection 126-235(1)]

#### *Trusts taxed like companies*

1.48 Roll-over is not available if either trust is a corporate unit trust or a public trading trust at any time in the income year that the transfer occurs. Companies are not eligible to choose this roll-over and, on that basis, trusts that are taxed like companies also cannot choose the roll-over. [Schedule #, item 8, subsection 126-235(2)]

- In order to transfer assets between related companies without immediate CGT consequences, companies are able to form (and head) a consolidated group.

#### *Trusts have not made the same tax choices*

1.49 Roll-over is not available unless both trusts have the same tax choices (or elections) in force just after the transfer. This applies to any choice made under the tax laws where the *absence* of the same choice in the other trust would or could have an ongoing impact on the calculation of any entity's net income (worked out under sections 90 or 95 of the ITAA 1936) or taxable income. [Schedule #, item 8, subsection 126-235(3)]

### **Example 1.3**

Further to example 1.2, the trustee of TrustOne has made a family trust election. The individual specified in the election is Sheila.

To be able to choose the roll-over, the trustee of TrustTwo must also make a family trust election with Sheila as the test individual.

1.50 It does not matter whether the *presence* of the original choice in one trust may have an ongoing impact on the calculation of the trust's net income (or any other entity's net income or taxable income). What matters is whether the *absence* of the mirror choice in the 'other trust' has that impact or potential impact.

#### **Example 1.4**

Further to example 1.3, in a previous income year, the trustee of TrustOne chose a CGT roll-over (under Subdivision 124-B of the ITAA 1997) when a property of the trust was destroyed. The trustee of TrustOne purchased a replacement property with an insurance payout.

The trustee of TrustTwo does not need to make a 'mirror choice' of the Subdivision 124-B roll-over. This is because the absence of such a choice will not affect the calculation of TrustTwo's net income (nor the net income or taxable income of any other entity).

That is, the Subdivision 124-B choice affects the tax position of TrustOne (because it determines the cost base of the replacement asset in the hands of the trustee of TrustOne). But its impact is confined to TrustOne; and its absence in TrustTwo has no bearing on TrustTwo's net income (or the net income or taxable income of any other entity).

This will be the case even if the replacement asset is one of the transferred assets in respect of which the trusts now seek to apply the roll-over discussed in this Explanatory Memorandum.

#### **Timing of making a mirror choice**

1.51 Generally, mirror choices (if required) must be in force just after the transfer time. However, the roll-over will still be available if:

- the trustee makes the mirror choice before the first time the choice matters for tax purposes; or
- it would not be reasonable to require the making of the mirror choice.

*[Schedule #, item 8, subsection 126-235(4)]*

1.52 The purpose of this reasonableness test is to provide limited flexibility where a trustee cannot make the mirror choice, and the absence of the choice would or could have only an immaterial effect on any entity's net income or taxable income.

### **Example 1.5**

MarketTrust is a managed investment trust. The trustee of MarketTrust makes the deemed capital account election (proposed but not yet enacted).

In September of the following income year, the trustee of MarketTrust transfers a commercial property to a newly created trust, PropertyTrust. Both trusts are eligible for the roll-over, and have the same beneficiaries with the same proportionate membership interests.

The trustee of PropertyTrust buys and sells 10 commercial properties between September and May.

Before lodging an income tax return for that income year, the trustee of PropertyTrust makes the deemed capital account election.

As the lodgement of the tax return is the first time the election matters for tax purposes, both trusts can choose the roll-over.

However, if the trustee of PropertyTrust did not make the capital account election, then roll-over is not available in respect of the property transferred from MarketTrust.

1.53 Where it is necessary for a trustee to make a mirror choice to be able to choose this roll-over, the trustee must still be able to make the choice under the primary provisions that govern when, why and how the choice can be made. Nothing in this roll-over (including the transitional provisions) allows a trustee to make a choice they could not otherwise have made.

1.54 If (for whatever reason) it is not possible to make the mirror choice, then the roll-over will not be available, unless it would not be reasonable to require that a mirror choice be made (see paragraph 1.51).

#### Consequences of making a mirror choice

1.55 Any restrictions or conditions that apply to the original choice (or first choice) will apply in a corresponding way to the mirror choice.

1.56 That is, if, just after the transfer time, the trustee that made the first choice cannot revoke or vary that choice, a trustee that makes a mirror choice also cannot revoke or vary that choice. Alternatively, if the first choice can be revoked or varied, but there are tax consequences in doing so, then those consequences will apply if the mirror choice is revoked or varied. *[Schedule #, item 8, subsection 126-235(5)]*

1.57 This will be the case regardless of whether the circumstances might otherwise have allowed the mirror choice to be revoked or varied;

or have allowed it to be revoked or varied without attracting the tax consequences relevant to the first choice.

1.58 The restrictions or conditions to which this rule applies are those that apply to the first choice just after the transfer time. Therefore, if either choice only becomes irrevocable or unchangeable because of events that occur after the transfer time, this has no effect on the other choice.

1.59 Alternatively, if tax consequences for revoking or varying either choice only arise because of events that occur after the transfer time, this has no effect on the other choice.

1.60 In other words, where the trustee revoking or varying the choice is the trustee that made the first choice, the consequences depend on the history of that trust before and after the transfer.

1.61 However, where the trustee revoking or varying the choice is the trustee that made the *mirror* choice, the consequences depend on:

- the history of that trust, after the time of the transfer; and
- the history of the other trust, up until the time of the transfer.

#### **Example 1.6**

Further to example 1.3, assume that the trustee of TrustOne cannot revoke the family trust election, because it has previously relied on the family trust election to carry forward and deduct tax losses.

As a result, the trustee of TrustTwo cannot revoke the family trust election, even if it has never used or relied upon the election.

#### ***Consequences for the trustees***

1.62 There are consequences for the trustee of the transferring trust (in respect of any capital gain or capital loss arising from the asset transfer); and for the trustee of the receiving trust (in respect of tax attributes relevant to the transferred asset in its hands).

#### ***Capital gain or capital loss disregarded***

1.63 If both trustees choose the roll-over, any capital gain or capital loss made by the trustee of the transferring trust in respect of the transferred asset is disregarded. *[Schedule #, item 8, subsection 126-240(1)]*

*Asset's cost base and reduced cost base*

1.64 The first element of the cost base and reduced cost base of the asset in the hands of the trustee of the receiving trust is equal to the cost base and reduced cost base of the asset in the hands of the trustee of the transferring trust just before the transfer. [Schedule #, item 8, subsection 126-240(2)]

*Asset's date of acquisition*

1.65 If the trustee of the transferring trust acquired the asset before 20 September 1985, the trustee of the receiving trust is taken to have acquired the asset before that date. [Schedule #, item 8, subsection 126-240(4)]

1.66 In other cases, the general rules in Subdivision 109-A of the ITAA 1997 apply. However, for the purposes of the CGT discount, the ownership period of the transferred asset in the receiving trust includes the period of ownership by the trustee of the transferring trust (see paragraph 1.88).

**Example 1.7**

To continue example 1.2, the trustees of both trusts choose the roll-over. The two properties transferred were called Beachside (acquired in 1991) and Bayside (acquired before 20 September 1985). The cost base and reduced cost base of Beachside in the hands of the trustee of TrustOne was \$20,000.

The trustee of TrustOne disregards any capital gain or loss made on the transfer of Beachside and Bayside to the trustee of TrustTwo.

The first element of the cost base and reduced cost base of Beachside in the hands of the trustee of TrustTwo is \$20,000. The trustee of TrustTwo is also taken to have acquired Bayside before 20 September 1985.

*Losses extinguished*

1.67 If the receiving trust has carried forward any net capital losses or tax losses made in an income year that ends before the transfer, they cannot be used to reduce the trust's capital gains or its assessable income after the transfer. The losses are effectively extinguished. [Schedule #, item 8, subsection 126-240(3)]

- This ensures the roll-over cannot be used to marry gains and losses. For example, it cannot be used to transfer gain assets under cover of the roll-over to a trust with capital or revenue losses.

1.68 For the income year that includes the transfer time, the trustee of the receiving trust makes a notional calculation as to whether it would have had a net capital loss or a tax loss if the income year had ended just before the transfer time:

- If there would have been a net capital loss, that amount is effectively extinguished by reducing the sum of capital losses at the end of the year by that amount (whether or not the trust is otherwise in a net capital gain or capital loss position).
- If there would have been a tax loss, that amount is effectively extinguished by reducing the sum of deductions at the end of the year by that amount (whether or not the trust would otherwise have been in a taxable income or a tax loss position).

#### *Consequences for beneficiaries*

1.69 Beneficiaries are required to adjust the cost base and reduced cost base of their interests in both trusts. Consistent with the approach for other CGT roll-overs, the acquisition date of their interests in the receiving trust will also change.

#### *Adjusting cost bases and reduced cost bases*

1.70 The first element of the cost base and reduced cost base of each membership interest in the transferring trust is a proportion of the sum of the cost bases of the parcel of interests in the transferring trust to which the interest belongs, just before the transfer. *[Schedule #, item 8, subsections 126-245(1) and 126-245(3)]*

- The proportion is what is reasonable having regard to the market value of membership interests in both trusts (or a reasonable approximation thereof), just after the transfer. *[Schedule #, item 8, subsections 126-245(2)]*

1.71 The remaining proportion of the sum of the cost bases of that parcel of interests is added to the first element of the cost base and reduced cost base of the corresponding parcel of interests in the receiving trust, divided evenly amongst the interests in that corresponding parcel. *[Schedule #, item 8, subsection 126-245(1) and (3)]*

- The trustee of the transferring trust must provide beneficiaries with sufficient information to make these calculations (see paragraphs 1.69 to 1.74).

1.72 A parcel of interests in the transferring trust (the ‘original parcel’) is one or more membership interests of the same class with the

same cost base and reduced cost base. [Schedule #, item 8, subsection 126-245(1)]

1.73 A corresponding parcel of interests in the receiving trust (the ‘new parcel’) is worked out using a two-step process. First, work out the proportion that the original parcel bears to the total interests of the relevant class in the transferring trust. Second, apply that proportion to the total interests in the matching class in the receiving trust. The result is the number of interests in the new parcel in the receiving trust.

1.74 If a beneficiary adjusts the cost base and reduced cost base of their interests in both trusts as a result of the roll-over, no other adjustments can be made under the ITAA 1997 or the ITAA 1936 because of something that happens in relation to the asset transfer from the transferring trust to the receiving trust. [Schedule #, item 8, section 126-250]

### Example 1.8

Further to example 1.7, assume that Sheila’s Class A units in TrustOne have different cost bases as a result of her purchasing them at two different times and prices. The Class A units are therefore separated into two parcels. The cost bases of these units and the corresponding units in TrustTwo are shown in table 1.3.

**Table 1.3 Corresponding units for each original parcel**

<i>Original parcel</i>	<i>Cost base</i>	<i>New parcel</i>	<i>Cost base</i>
600 Class A units	\$10 each	300 Class 1 units	\$0
400 Class A units	\$20 each	200 Class 1 units	\$0
1000 Class B units	\$200 each	100 Class 2 units	\$10 each

Sheila adds up the cost bases of each original parcel of units. She allocates this total between the original parcel and the new parcel based on the market values of each class of unit (table 1.4).

**Table 1.4 Allocation of cost base between parcels**

<i>Original parcel</i>	<i>Total cost base</i>	<i>Proportion of MV</i>	<i>Cost base of original parcel</i>	<i>Cost base to new parcel</i>
600 Class A units	\$6,000	80 per cent	\$4,800	\$1,200
400 Class A units	\$8,000	80 per cent	\$6,400	\$1,600
1000 Class B units	\$200,000	90 per cent	\$180,000	\$20,000

Sheila allocates the cost bases of each parcel of units evenly amongst the number of units in each parcel.

For units in TrustOne, the result becomes the first element of the cost base of each unit in each original parcel (table 1.5). The other elements of the cost bases of each unit are zero.

For units in TrustTwo, the result is added to the first element of the cost base of each unit in each new parcel (table 1.5).

**Table 1.5 Calculating the cost base of each unit**

<i>Membership interest</i>	<i>Cost base</i>
600 Class A units	$\$4,800/600 = \$8$
400 Class A units	$\$6,400/400 = \$16$
1000 Class B units	$\$180,000/1000 = \$180$
300 Class 1 units	$\$1,200/300 + 0 = \$4$
200 Class 1 units	$\$1,600/200 + 0 = \$8$
100 Class 2 units	$\$20,000/100 + \$10 = \$210$

Assume that each unit had the same cost base and reduced cost base before the transfer. Therefore, the amount worked out above as the first element of the cost base of each unit will also become the first element of the reduced cost base of each unit.

*Deemed acquisition date of interests in receiving trust*

1.75 Beneficiaries are deemed to have acquired their interests in the receiving trust at the transfer time. This is consistent with the ‘cleanskin’ approach. It prevents the potential avoidance of tax by receiving trusts with pre-CGT interests being loaded with post-CGT assets and the beneficiaries disposing of their pre-CGT interests (instead of the receiving trust disposing of its post-CGT assets). [Schedule #, item 8, subsection 126-245(4)]

1.76 There is one exception. Interests in the receiving trust will be taken to have been acquired before 20 September 1985 if corresponding interests in the transferring trust were acquired before that date. [Schedule #, item 8, subsection 126-245(5)]

1.77 For the purposes of the CGT discount, the ownership period of membership interests in the receiving trust includes the period of ownership of membership interests in the transferring trust (see paragraph 1.89)

**Example 1.9**

Further to example 1.8, suppose that Sheila also has 1000 Class A units that she acquired before 20 September 1985. She still has only 500 Class 1 units in the receiving trust. Taking this into account, the new allocation of units in TrustTwo is shown in table 1.6.

**Table 1.6 Corresponding units for each original parcel**

<i>Original parcel</i>	<i>Cost base</i>	<i>Corresponding parcel</i>	<i>Cost base</i>
600 Class A units	\$10 each	150 Class 1 units	\$0
400 Class A units	\$20 each	100 Class 1 units	\$0
1000 Class A units	—	250 Class 1 units	\$0

Also, because half of Sheila's Class A units in TrustOne were acquired before 20 September 1985, she is deemed to have acquired half (250) of the corresponding Class 1 units in TrustTwo before that date.

Sheila allocates the cost base of each parcel (see table 1.4) amongst the number of units in table 1.6. The cost bases of the Class A units do not change from example 1.7. However, the cost base of each of the Class 1 units taken to have been acquired at the transfer time is:

- Parcel of 150 Class 1 units:  $\$1200/150 + 0 = \$8$
- Parcel of 100 Class 1 units:  $\$1600/100 + 0 = \$16$

***Trustee must give relevant information to beneficiaries***

1.78 The trustee of the transferring trust must provide certain information to each of its beneficiaries (as at the transfer time) in writing within three months of the end of the income year in which the transfer occurs. [*Schedule #, item 8, subsection 126-255(1)*]

- Beneficiaries need this information to be able to comply with their obligations under the income tax laws – for example, to determine the consequences of the roll-over for their membership interests in the transferring and receiving trusts.

1.79 The following information must be included in the notice given to each beneficiary (other information may also be included):

- the transfer time;
- the market value, just after the transfer time, of each class of membership interests in each trust in which the beneficiary holds an interest; and
- sufficient information to allow beneficiaries to calculate the parcel of interests in the receiving trust that corresponds to each original parcel of interests in the transferring trust. This requires the beneficiary to know:
  - the class of interests in the receiving trust that matches each class of interests in the transferring trust; and

- for each matching class, the number of interests in the receiving trust that equals one matching interest in the transferring trust.

*[Schedule #, item 8, subsection 126-255(2)]*

1.80 Failure to comply with this requirement is a strict liability offence, punishable by 30 penalty units. The purpose of this offence is to place trustees on notice against contravening the requirement to give beneficiaries the information they need to meet their obligations.

*[Schedule #, item 8, subsections 126-255(3) and 126-255(4)]*

1.81 If there are two or more trustees, each trustee is liable, although any trustee can discharge the obligation for all of the trustees. *[Schedule #, item 8, subsection 126-255(5)]*

*Roll-over consequences still apply for beneficiary if no notice given*

1.82 The consequences for beneficiaries explained in paragraphs 1.59 to 1.68 still apply even if the trustee of the transferring trust fails to comply with the requirement to give notice. That is, the obligation on the trustee of the transferring trust does not relieve a beneficiary of its obligation to make cost base and other adjustments in respect of its membership interests. *[Schedule #, item 8, subsection 126-255(6)]*

1.83 Beneficiaries should determine, to the best of their abilities, the information described in paragraph 1.79, in order to calculate the acquisition date, cost base and reduced cost base of each of their interests.

## **Application and transitional provisions**

1.84 These amendments will apply to CGT events happening after 31 October 2008. *[Schedule #, items 3 and 10]*

### ***Additional time for trustees making tax choices***

1.85 Trustees will have six months from the date of Royal Assent to make the mirror tax choices discussed in paragraph 1.49 above, notwithstanding that the absence of the election impacted on the assessment of the trusts or any other entity's income.

- However, a mirror choice may only be made under this transitional rule if it otherwise meets the requirements of the relevant choice provision and is within the time permitted by that provision.

- The Commissioner of Taxation can extend the six-month period.

*[Schedule #, item 11]*

***Transitional time for penalty provision***

1.86 To avoid any retrospective penalties from the failure of a trustee to provide beneficiaries with relevant information for a roll-over that occurs in the 2008-09 income year, the trustee will have six months from the date of Royal Assent to comply with the requirement to give information. *[Schedule #, item 12]*

## **Consequential amendments**

1.87 Consequential amendments will be made to the guide material in Subdivision 112-B of the ITAA 1997 to direct readers to the modified cost base rules in Subdivision 126-G. Subdivision 112-B lists situations when the general cost base and reduced cost base rules may be modified. *[Schedule #, item 5, section 112-54A]*

1.88 Consequential amendments will also be made to include the roll-over of the asset at the trust level in the table of same-asset roll-overs in Subdivision 112-D of the ITAA 1997. This will ensure that, for the purposes of the CGT discount, the ownership period of assets in the hands of the trustee of the receiving trust includes the period of ownership by the trustee of the transferring trust. *[Schedule #, item 6, section 112-150]*

1.89 Consequential amendments will also be made to the table in subsection 115-30(1) of the ITAA 1997. This will ensure that, for the purposes of the CGT discount, the ownership period of membership interests in the receiving trust includes the period of ownership of the corresponding membership interests in the transferring trust. *[Schedule #, item 7, section 115-30(1)]*

- Amendments will be made to the guide material in Subdivision 109-B of the ITAA 1997 to direct readers to this modified acquisition rule in section 115-30. *[Schedule #, item 4, section 109-55]*



