VIC Tax Forum

Family trust elections – Stairway to heaven or highway to hell?

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1. Introduction

Family trust elections (**FTEs**), and the related interposed entity elections (**IEEs**), have been a feature of the tax law for more than 25 years with the rules effectively unchanged since 2007.

Prior to 9 May 1995 there were no restrictions on trusts carrying forward tax losses. In the 1995-1996 Budget the Government announced restrictions on trusts carrying forward losses. The Senate rejected those measures and in the 1997-1998 Budget the Government reannounced the measures in a modified form.

In 1998, a package of legislation that introduced the trust loss measures, FTEs, IEEs, and family trust distribution tax (**FTDT**) received royal assent, the:

- *Taxation Laws Amendment (Trust Loss and Other Deductions) Act 1998*;
- *Family Trust Distribution Tax (Primary Liability) Act 1998*; and
- *Family Trust Distribution Tax (Secondary Liability) Act 1998*.

The Explanatory Memorandum to that package made it clear that *“[FTDT] ensures that the tax benefit of losses of a family trust cannot be transferred to non-family members*”.

That is, the legislation conferred benefits and penalties by reference to a family and a family group.

FTEs and IEEs can offer considerable tax advantages for family groups. However, FTEs are a double-edged sword with nasty consequences – for example, FTDT – for non-compliance.

The FTE, IEE, and FTDT rules are complex, and the Australian Taxation Office (**ATO**) has said that FTEs and IEEs are an area of compliance focus. That there is little case law or ATO guidance adds to the complexity.

This paper addresses the operation of the family trust regime providing an overview of what is an FTE and an IEE; how to make them; and importantly, the implications and consequences of making an election.[1] Through that analysis, it will be evident how an incorrect decision or nomination of test individual could affect the options of the group in the future.

This paper is intended to be practical whilst still addressing technical issues. Not all the detail in these materials will be covered during the presentation.

This paper focuses primarily on discretionary trusts. The trust vehicle most often encountered by practitioners.

In these materials, **ITAA 36** is a reference to the *Income Tax Assessment Act 1936* (Cth), **ITAA 97** is a reference to the *Income Tax Assessment Act 1997* (Cth), and **TAA 53** is a reference to the *Taxation Administration Act 1953* (Cth).

[1] This paper draws on the paper, “Family trust elections, trust losses, and family change” 2023 by Daniel Smedley and Neil Brydges of Sladen Legal. Any errors are the authors alone.

2. What is an FTE?

2.1 What is an FTE?

For taxation purposes, a trust is a family trust at any time when an FTE in respect of the trust is in force. The trustee of the trust may make an election (the FTE) that the trust is a family trust at all times after the beginning of a specified year for the purposes of the ITAA 36 and ITAA 97.

That is, in the absence of an FTE, a trust is not a 'family trust' for taxation purposes. It does not matter whether the trust is a discretionary trust, unit trust, hybrid trust, or some other form of trust:

- if an FTE is in force, the trust is a family trust for taxation purposes;
- if an FTE is not in force, the trust is not a family trust for taxation purposes (irrespective of the amount of family control).

The trustee of the trust makes the FTE, and specifies the income year, which could be an earlier income year, from which the election is in force from the beginning of that year. The FTE must nominate an individual as the individual whose family group is taken into account in relation to the FTE.

The FTE must nominate an individual (the test individual) as the individual whose family group is to be taken into account in relation to the FTE. It must also contain such other information, as the Commissioner requires.

Apart from being specified in the FTE, there are few requirements for the individual apart from being alive at the time the trustee makes the FTE (see ATO Interpretative Decision ATO ID 2014/3). This means the relevant individual may be able to be specified even if they are under a legal disability (that is, they may be a minor or incapacitated).

For the purposes of the trust loss provisions, specific relatives and entities that have made an IEE or an FTE nominating the same test individual will fall within the family group of the test individual.

An FTE is irrevocable (subject to certain exceptions) and, therefore, its implications will continue to apply whilst the trust exists.

2.2 What is an IEE?

If the trustee of a trust makes a FTE, a company, the partners in any partnership, or the trustee of any trust, may make an election (the IEE) that the company, partnership or trust is to be included at all times after a specified day in a specified income year in the family group of the test individual specified in the FTE.[2]

Subject to certain exceptions, the IEE is irrevocable[3] and an IEE will continue to exist even if the family trust to which is it made ceases to exist.[4]

2 Subsection 272-85(1) of Schedule 2F of the ITAA 36.

3 Section 272-85 of Schedule 2F of the ITAA 36.

4 ATO Interpretative Decision ATO ID 2013/21.

The company, partners, or trustee that is making an IEE can make multiple IEEs in respect of different trusts that have IEEs in place, but only if the test individual specified in each of the IEEs is the same.[5] Despite this, you can disregard an IEE which has been revoked for this purpose. [6]

The specified income year can be an income year before the current income year. However, to do so requires: [7]

1. at all times from the beginning of the specified income year up until 30 June in the income year before the one during which the election is made, the company, partnership or trust passes the family control test (see below); and
2. in the case of a trustee, any distributions of, or conferrals of present entitlements to, income or capital of the trust have been made to, or on, the test individual or members of the test individual's family group.

2.3 The concept of a test individual/primary individual

The legislation refers to a person as either a "*test individual*" (in relation to the definition of the "family" in section 272-95 of Schedule 2F of the ITAA 36) or "*primary individual*" (elsewhere in Schedule 2F of the ITAA 36). Both terms refer to the same person, being the person named in the FTE and whose family group is taken into account for the purposes of determining whether distributions of income and capital made by family trusts or interposed entities will be subject to FTDT. Accordingly, the selection of an appropriate test individual/primary individual is particularly important.

In this paper, we will refer to the person as the test individual to avoid confusion with primary beneficiaries under the trust deed.

2.4 Test individual's family and family group

The "*family group*" of the test individual specified in the FTE includes the following entities in relation to a conferral of a present entitlement to, or a distribution of, income or capital upon or to the entity: [8]

1. a member of the test individual's "*family*" (see below);
2. a person who was a spouse of either the test individual or of a member of the test individual's 'family' before a "*breakdown in the marriage or relationship*";
3. a person who was the spouse of the test individual or of a member of the test individual's 'family' immediately before the death of the test individual or member of the test individual's 'family', and is now the spouse of a person who is not a member of the test individual's 'family';
4. a person who was a child of the spouse of either the test individual or of a member of the test individual's 'family' before a "*breakdown in the marriage or relationship*" of the test individual or the member of the test individual's 'family';

5 Subsection 272-85(7) of Schedule 2F of the ITAA 36.
6 Subsection 272-85(8) of Schedule 2F of the ITAA 36.
7 Subsection 272-85(4A) of Schedule 2F of the ITAA 36.
8 Section 272-90 of Schedule 2F of the ITAA 36.

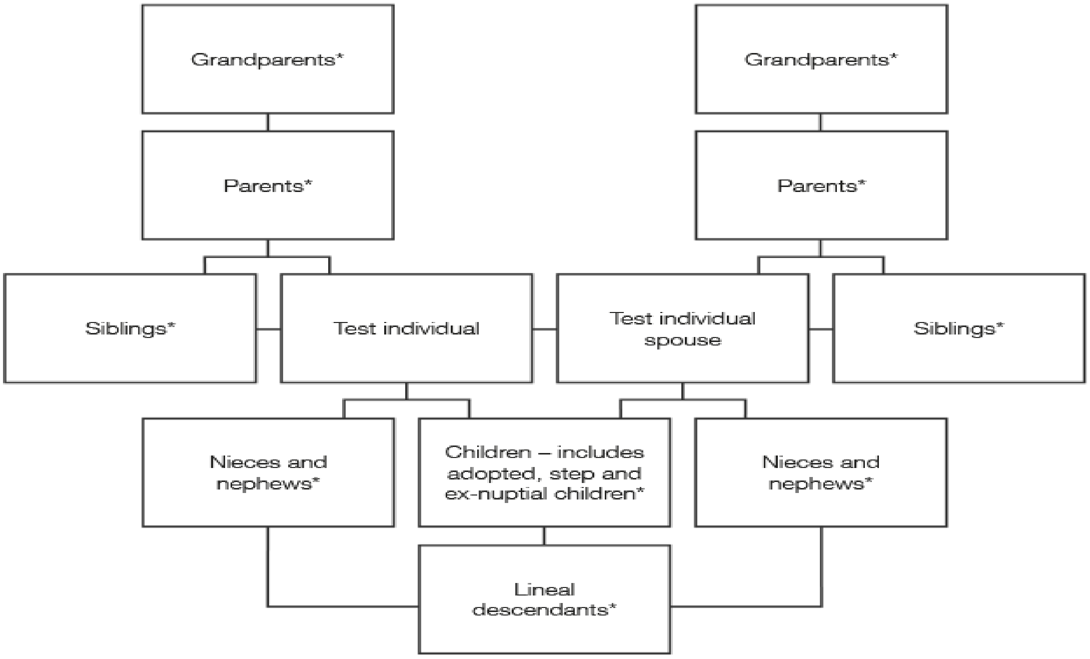
5. the trust in respect of which the FTE was made;
6. a trust with the same test individual in its FTE;
7. a company, partnership, or trust that has made an IEE (see below), but only to the extent that when the conferral takes place, or the distribution is made, the IEE is in force;
8. a company, partnership, or trust where any combination of the following has fixed entitlements directly or indirectly, and for their own benefit, to all the income and capital of the company, partnership, or trust;
    1. the test individual;
    2. the test individual's 'family'; and
    3. the trustees of one or more family trusts, provided the test individual is specified in the FTE of each of those family trusts;
9. certain funds and tax-exempt bodies;
10. certain institutions where there are no living beneficiaries; and
11. if the test individual and all the members of their 'family' are deceased, the deceased estates of the test individual and the members of the test individual's 'family'.

The definition of "*family*" was expanded with effect from 1 July 2007. Before that date, a group of three trusts with the same test individual would require nine elections to ensure that all the trusts were members of each other's family groups (one FTE and two IEEs in each case). As a result of the amendments, from 1 July 2007 the IEEs are not required.

Since 1 July 2007, the 'family' – shown diagrammatically below - includes the test individual: [9] and

1. any parent, grandparent, brother or sister of the test individual or the test individual's spouse;
2. any nephew, niece or child of the test individual or the test individual's spouse;
3. any lineal descendant of a nephew, niece or child referred to in 1 or 2;
4. and the spouse of the test individual or of anyone who is a member of the test individual's family because of 1, 2, or 3.

9 Section 272-95 of Schedule 2F of the ITAA 36.



* All spouses of these family members

When determining who is a member of the 'family':

1. 'child' includes a stepchild, adopted child, exnuptial child, or child under the Family Law Act 1975, and 'spouse' includes a same sex or de facto spouse;

2. an adopted child, stepchild or exnuptial child of a person is taken to be a lineal descendant of that person for the purpose of determining the lineal descendants of that person or any other person;

3. a person who is no longer a member of an individual's "*family*" may still be a member of the individual's "*family group*" (see above); and

4. a person does not cease to a 'family' member merely because of the death of any other family member; and

5. section 960-255 of the ITAA 97 "*may be relevant*" to determining whether a 'parent', 'grandparent', 'brother' or 'sister' of the test individual or the test individual's spouse is within the 'family'.

Section 960-255 does two things when you trace relationships:

1. you treat stepchildren, adopted children, and exnuptial children as 'natural' children; and

2. you treat anybody who meets the definition of spouse as if the individual were legally married to the other individual.

2.5 **Selecting the test individual**

Broadly, the concept of family extends up to include grandparents and down to include the lineal descendants of a test individual (and certain other individuals).

The choice of a test individual must be made after significant consideration, particularly given the restrictions on the ability to revoke an election, vary a test individual and to make tax effective 'distributions' outside of the family group.

The selection of an appropriate test individual will principally depend upon the circumstances and dynamic of a family, the income producing activities of the trust and the anticipated income and capital distribution patterns of the trust. These issues will be explored further throughout this paper.

The Commissioner in ATO Interpretative Decision ATO ID 2014/3 makes it clear that the individual specified in the FTE must be alive at the time the trustee of the trust makes the FTE.

The death of test individual does not prevent any other trust, company, or partnership from making an IEE to be included in the test individual's family group.[10] Further, the death of the test individual does not terminate the FTE.

[10] See ATO Interpretative Decision ATO ID 2008/73 and subsection 272-80(11) of Schedule 2F to the ITAA 36.

3. How do you make an FTE?

3.1 When to make the elections - prior to 2005 income year

The FTE and IEEs were made in the trust's return of income for the specified year.

If the trustee, company, partnership or trust was not required to lodge a tax return for the income year in which the election was to be made, the election was made by written notification to the Commissioner in an approved form and given to the Commissioner within two months after the end of the income year specified, or such later day as the Commissioner allowed.

In Practice Statement Law Administration (General Administration) PS LA 2004/1 (GA) (now withdrawn) the Commissioner stated that in the tax return for the 2004 income year there was a once-off opportunity subject to certain conditions, to make a FTE or IEE in respect of prior years of income.

This extension of time was later further extended to 31 May 2007.

3.2 When to make the elections - 2005 income year and following

Tax Laws Amendment (2004 Measures No.7) Act 2005 (**TLAM7 2005**) commenced operation on 1 April 2005. Schedule 8 of TLAM7 2005 dealt with FTEs and brought about amendments to Schedule 2F of the ITAA 36.

The election must specify the test individual and elections must now always be made in writing in an "*approved form*".[11] The phrase "*approved form*" in subsection 272-80(2) to the ITAA 36 is defined in section 6 of the ITAA 36 to refer to the meaning given by section 388-50 of Schedule 1 to the *Tax Administration Act 1953*.

There is not a requirement in Schedule 2F to send the approved form to the ATO. However, if the form is not sent to the ATO, if a dispute arises, the onus of proof is on the taxpayer.[12]

The election must specify an income year – the "*specified income year*" – for which the election applies from, and the trust must pass the "*family control test*" (see below) at the end of the specified income year.[13]

A FTE or IEE may be lodged with retrospective application[14] but the earliest year this can apply to is the 2005 income year.[15] That is, the specified income year (not being a year earlier than the 2005 income year) may be a year before the one in which the election is made if:

1. the trust, company or partnership passes the family control test for that period; and

11 Subsection 272-80(2) of Schedule 2F of the ITAA 36.

12 See *Widdup v DCT* [2023] FCAFC 145 where circumstances like this arose.

13 Subsections 272-80(1) and 272-80(4) of Schedule 2F of the ITAA 36.

14 Subsection 272-80(4A) of Schedule 2F of the ITAA 36.

15 Item 5 of Schedule 8 of TLAM7 2005.

2. any conferral of present entitlement or distributions of income or capital of the trust by the trustee during that period has been made to the test individual or a member of the test individual's family group.

The trustee of a trust must not make more than one FTE in relation to a trust.[16] If an FTE is revoked, the trustee of the trust is prevented from making another FTE.[17]

3.3 Family control test

3.3.1 Family control test: trusts

To make the election, the trust must pass the family control test in section 272-87 of Schedule 2F of the ITAA 36 at the end of the specified income year.[18]

A trust generally passes the family control test if a group (generally defined as the test individual, one or more members of the test individual's family, defined in section 272-95 of Schedule 2F of the ITAA 36, or the test individual and one or more members of their family):

1. has the power to obtain, or is capable under a scheme of gaining, beneficial enjoyment (directly or indirectly) of the capital or income of the trust;
2. is able to (directly or indirectly), or is capable under a scheme of gaining, control of the application of the capital or the income of the trust;
3. is able to appoint or remove the trustee or the trustee of the trust is accustomed, under an obligation or might reasonably be expected to act in accordance with the directions, instructions or wishes of the group;
4. has more than a 50% stake in the income or capital of the trust; and
5. includes the only persons who under the terms of the trust can obtain the beneficial enjoyment of the income and capital of the trust.[19]

However, the family control test is complex in operation, and it is important that practitioners carefully consider the provisions of section 272-87 of Schedule 2F of the ITAA 36. For example, it is possible that the test can be satisfied by the test individual, one or more members of the test individual's family, or the test individual and one or more members of their family and one or more *legal or financial advisers* to the test individual or to a member of the test individual's family have the requisite level of control outlined in paragraphs (a) to (e) of subsection 272-87(2) of Schedule 2F of the ITAA 36.

16 Subsection 272-80(11) of Schedule 2F of the ITAA 36.

17 Subsection 272-80(11) of Schedule 2F of the ITAA 36 and ATO Interpretative Decision ATO ID 2008/73.

18 Subsection 272-80(4) of Schedule 2F of the ITAA 36.

19 Section 272-87 of Schedule 2F of the ITAA 36.

3.3.2 Family control test: partnerships or companies

A company or partnership in respect of which an IEE is proposed to be made passes the family control test if a group consisting of: [20]

1. the individual who is specified in the FTE to the IEE;
2. one or more members of the test individual's family;
3. the trustees of one of more family trusts, provided the individual is specified in the FTE of each of those family trusts; or
4. any persons covered by any combination of the three abovementioned bullet points.

have between them, directly or indirectly, and for their own benefit, **fixed entitlements to a greater than 50% share of the income or a greater than 50% share of the capital** of the company or partnership.

When there are two test individuals, two family groups, and companies owned by trusts in one family group, it is extremely problematic for those companies to make an IEE into the other family group.

[20] Subsection 272-87(3) of Schedule 2F of the ITAA 36.

4. Why make an FTE?

4.1 Trust loss measures

Schedule 2F of the ITAA 36 (the trust loss measures) contains various tests for determining whether a trust may deduct its current and prior year tax losses and certain debts. The applicable tests depend on the nature of the relevant trust.

The trust loss measures apply to tax losses made in prior and current income years. Section 995-1 of the ITAA 97 defines the term "*tax loss*" to mean losses worked out under various provisions of the ITAA 97. Broadly, where deductions for an income year exceed income, the excess is a tax loss. The trust loss measures do not apply in respect of capital losses.

The trust loss measures identify several types of trusts including:

1. fixed trusts;
2. non-fixed trusts;
3. family trusts; and
4. excepted trusts.

A trust is a fixed trust if persons have a "*fixed entitlement to all of the income and capital*" of the trust.[21] A trust is a non-fixed trust if it is not a fixed trust.[22]

A person has a "*fixed entitlement to a share of the income or capital*" of a trust if they have a vested and indefeasible interest in the share of the income or capital of the trust.[23] **This issue is considered in detail in 7.3 below**. As noted below, due to the judicial interpretation of the phrase "*fixed entitlement to a share of income or capital*" of a trust in section 272-5 of Schedule 2F of the ITAA 36, most unit trusts will be non-fixed trusts.

Under the trust loss measures in Schedule 2 F of the ITAA 36, family trusts are "*excepted trusts*".[24] Generally, excepted trusts are not required to satisfy any tests in order to claim tax losses and certain debt deductions.[25] Family trusts however remain subject to the income injection test.[26]

For a family trust to be an excepted trust for the purposes of the trust loss measures, the trust must have made its election to be a family trust before or at the beginning of the income year in which the trust incurred the loss.

Under the trust loss measures, fixed trusts and non-fixed trusts (if applicable) must satisfy the 50% stake test. The 50% stake test is the trust version of the continuity of ownership test for companies (discussed in 4.3 below). If a family trust has directly or indirectly, a fixed entitlement to a share of the income or capital of the main entity, the family trust is treated as if it had the fixed entitlement as an

21 Section 272-65 of Schedule 2F of the ITAA 36.
22 Section 272-70 of Schedule 2F of the ITAA 36.
23 Subsection 272-5(1) of Schedule 2F of the ITAA 36.
24 Section 272-100(a) of Schedule 2F of the ITAA 36.
25 For example, see subsections 267-20(1)(c) and 267-25(1)(c) of Schedule 2F of the ITAA 36.
26 Subsection 270-10(1)(d) of Schedule 2F of the ITAA 36.

individual and for the individual's own benefit.[27] This enables the main entity to satisfy the 50% stake test in cases where interests in the main entity are held by a non-fixed trust. In cases where interests in the main entity are held by fixed trusts, the main entity satisfies the 50% stake test without having to trace interests to the ultimate individual.

4.1.1 Trust loss tests

The trust loss tests applicable to a trust depend on the type of the trust. The relevant trust loss tests must be satisfied during the test period. Generally, the "*test period*" is the period from the beginning of the loss year until the end of the income year in which the tax losses are to be applied.

A **fixed trust** (other than a widely held unit trust):

1. must satisfy the 50% stake test for the test period[28] (the fixed trust 50% stake test); or
2. must satisfy the non-fixed trust stake test,[29] if the trust does not meet the 50% stake test (the alternative fixed trust 50% stake test).

Fixed trusts and non-fixed trusts (including family trusts):

1. must satisfy the income injection test.
2. A **non-fixed trust**:
    1. must satisfy the pattern of distributions test if applicable;30 and
    2. must not have been prevented from deducting the tax loss in an earlier income year because of a failure to meet the pattern of distributions test31; and
    3. in which there are individuals having more than a 50% stake in the income or capital of the trust, must maintain the same ownership32 (the non-fixed trust 50% stake test); and
    4. a group must not during the test period begin to control the trust directly or indirectly[33] (**the control test**).

Therefore, **importantly**, if no income is distributed in the loss year and there is no change in control/unit holders during the test period, then the **non-fixed trust** tests will likely be passed by a unit trust in any event.

This table summarises the types of trust and which tests to apply.[34]

27 Subsection 272-30(2) of Schedule 2F of the ITAA 36.
28 Section 266-40 of Schedule 2F of the ITAA 36.
29 Section 266-45 of Schedule 2F of the ITAA 36.
30 Section 267-30 of Schedule 2F of the ITAA 36.
31 Section 267-35 of Schedule 2F of the ITAA 36.
32 Section 267-40 of Schedule 2F of the ITAA 36.
33 Section 267-45 of Schedule 2F of the ITAA 36.
34 Source ATO website, last accessed on 9 March 2025.

Type of trust	50% stake test	Abnormal trading	Same business test	Similar business test	Pattern of distributions test	Control test	Income injection test
Non-fixed trust	✓				✓	✓	✓
Listed widely held fixed trust	✓	✓	✓	✓			✓
Wholesale widely held trust	✓	✓					✓
Unlisted very widely held fixed trust	✓	✓					✓
Unlisted widely held fixed trust	✓	✓					✓
Fixed trust but not widely held	✓						✓
Family trust							✓
Excepted trust[35]	n/a	n/a	n/a	n/a	n/a	n/a	n/a

The fixed trust 50% stake test (Subdivision 269-C)

If there are individuals who have between them directly or indirectly and for their own benefit fixed entitlements to a greater than 50% share of the income or capital of a trust, those individuals have "more than a 50% stake in the income or capital of the trust".[36]

The concept of a "*fixed entitlement*" is discussed in 7.3 below. A person holds a fixed entitlement to a share of income or capital of a company, partnership or trust indirectly if the person holds the entitlement indirectly through fixed entitlements to shares of the income or capital, respectively, of interposed companies, partnerships or trusts.[37]

Sections 272-25 and 272-30 of Schedule 2F of the ITAA 36 include special cases of fixed entitlements held directly or indirectly. Entities that are treated as having as individuals and for their own benefit directly or indirectly a fixed entitlement to a share of the income or capital of a company, partnership or trust include:

1. certain government bodies and special companies;38
2. complying superannuation funds, approved deposit funds and certain foreign superannuation funds;
3. family trusts; and
4. interposed listed public companies and widely held unit trusts in some cases.

A trust will pass the 50% stake test:[39]

1. at all times during a period; or
2. at two times;

if the same individuals have more than a 50% stake in the income of a trust and the same individuals (who may be different from those having more than a 50% stake in the income) have more than a 50% stake in the capital of the trust at those relevant times.

35 Other than family trusts.
36 Section 269-50 of Schedule 2F of the ITAA 36.
37 Section 272-20 of Schedule 2F of the ITAA 36.
38 Defined in section 272-140 of Schedule 2F of the ITAA 36.
39 Subsection 269-55(1) of Schedule 2F of the ITAA 36.

A widely held unit trust passes the 50% stake test if it is reasonable to assume that the requirements in subsection 269-55(1) of Schedule 2F of the ITAA 36 have been satisfied.[40]

The alternative fixed trust 50% stake test (section 266-45)

If a fixed trust does not meet the fixed trust 50% stake test, then the trust must always satisfy the following conditions during the test period:

1. non-fixed trusts (other than family trusts) must have held fixed entitlements to a 50% or greater share of the income or capital of the trust or both a fixed trust or a company (the holding entity) must have held directly or indirectly all of the fixed entitlements to income and capital of the trust and non-fixed trusts (other than family trusts) must have held fixed entitlements to a 50% or greater share of the income or capital of the holding entity;

2. the persons holding fixed entitlements to the shares of income and capital of the trust or holding entity must have always held those entitlements during the test period;

3. at the beginning of the test period individuals must not have had more than a 50% stake in the income or capital of the trust; and

4. each non-fixed trust (other than an excepted trust) that at any time in the test period held directly or indirectly a fixed entitlement to a share of the income or capital of the trust must satisfy the non-fixed trust 50% stake test (if applicable), the pattern of distributions test (if applicable) and the control test.

The non-fixed trust 50% stake test (section 267-40)

This test is the same as the fixed trust 50% stake test. It is difficult to conceive a situation where the 50% stake test would apply to a non-fixed trust.

Pattern of distributions test (section 267-35)

The pattern of distributions test will only apply where **a non-fixed trust** has distributed income and/or capital in the income year in which the tax loss is to be applied or within 2 months after the end of the income year, and in at least one of the six earlier income years.

The pattern of distributions test is the most difficult test to satisfy and considers whether there has been an effective change in those who benefit under the trust. The test compares trust distributions of income or capital of the year in which the tax losses are applied and all relevant previous income years. The trust will only pass the pattern of distributions test if it has not failed the pattern of distributions test in relation to the tax loss in a previous income year.

The test considers distributions made either directly or indirectly to individuals and therefore may require tracing of distributions to the ultimate individual recipient where there are entities interposed between the trust and the individual. Section 272-63 of Schedule 2F of the ITAA 36 provides that a trust distributes income or capital indirectly to an individual if it distributes the income or capital to a

[40] Subsection 269-55(2) of Schedule 2F of the ITAA 36.

company, partnership, or trust (the first interposed entity) interposed between the trust and the individual, and:

1. the first interposed entity distributes to the individual an amount or property attributable to that income or capital; or
2. another company, partnership or trust (the final interposed entity) distributes to the individual an amount or property that is attributable to the income or capital as a result of the distribution of an amount or property attributable to the income or capital to the final interposed entity by the first interposed entity or successive distributions of amounts or property attributable to the income or capital to and by any companies, partnerships or trusts interposed between the first entity and the final interposed entity.

A trust passes the pattern of distributions test for an income year if within 2 months after the end of the income year, the trust distributed, either directly or indirectly, to the same individuals, for their benefit, a greater than 50% share of all test year distributions of income and capital.[41] The distributions of income and capital may be made to different individuals.

A "*test year distribution of income or capital*" is the total of all income or capital distributions made by a non-fixed trust in any of the following periods,[42] provided the period does not start more than 6 years before the start of the income year in which the tax loss is to be applied:

1. the start of the income year (in which the losses are applied) until two months after its end;
2. if the trust distributed income before the loss year (trigger year) the closest year of income before the trigger year;
3. if point 2 does not apply and the trust distributed income in the trigger year, the trigger year;
4. if neither point 2 nor point 3 applies, the income year closest to the trigger year in which the trust distributed income;
5. each intervening year between the one in point 1 and the one in points 2, 3 or 4.

If the trust does not distribute to an individual the same percentage of income or capital for every test year distribution, then the trust is taken to have distributed to the individual for every test year distribution, the smallest percentage that it distributed to the individual for any of the test year distributions.[43]

<u>Example: pattern of distributions test</u>

The ABC Trust is a discretionary trust. The ABC Trust commenced its business in February 2018 and was profitable in each year until it made a tax loss of $20,000 (the tax loss) for the income year ended 30 June 2020.

The ABC Trust is a unit holder in XYZ Unit Trust which, in accordance with the terms of the XYZ Unit Trust deed, has made distributions of income and capital to the ABC Trust in each of the 2018 and 2019 income years in proportion to the ABC Trust's unit holding in the XYZ Unit Trust.

[41] Section 269-60 of Schedule 2F of the ITAA 36.
[42] Section 269-65 of Schedule 2F of the ITAA 36.
[43] Section 269-70 of Schedule 2F of the ITAA 36.

The ABC Trust proposes to apply the tax loss in the income year ended 30 June 2021 and will have distributable income of $100,000 after applying the carry forward losses.

The trustee of the ABC Trust made the following distributions of income and capital in each income year:

BENEFICIARY	PERCENTAGE OF INCOME DISTRIBUTION				PERCENTAGE OF CAPITAL DISTRIBUTION			
	2018	2019	2020	2021	2018	2019	2020	2021
Anna	50%	90%	-	80%	0%	0%	-	60%
Becky	30%	0%	-	10%	20%	80%	-	20%
Clara	20%	10%	-	10%	80%	20%	-	20%

The ABC Trust has not made an FTE and there has not been a change in control.

The ABC Trust is a non-fixed trust as no persons have either directly or indirectly fixed entitlements to all the income and capital of the Trust. Accordingly, the 50% stake test does not apply.

The pattern of distributions test will apply for the test period commencing with the 2019 income year, ending in the 2021 income year, and including all intervening income years. The ABC Trust will pass the pattern of distributions test if the same individuals received a greater than 50% share of all income distributed in each test year and if the same individuals received a greater than 50% share of all capital distributed in each test year. In determining this, the smallest percentage of income or capital distributed to an individual for every test year distribution is taken into account.

In relation to the distributions of income made in each year the smallest percentage received by:

1. Anna was 50%;
2. Becky was 0%; and
3. Clara was 10%.

The same persons (being Anna and Clara together) received a greater than 50% share of the income in each year.

In relation to the distributions of capital made in each year the smallest percentage received by:

1. Anna was 0%;
2. Becky was 20%; and
3. Clara was 20%.

The same individuals did not receive a greater than 50% share of all capital distributions therefore the ABC Trust fails the pattern of distributions test and cannot claim the loss in the 2021 income year or in any later income year.

Control test (section 269-95)

A group must not during the test period begin to control the trust directly or indirectly.[44] If the trust is controlled by a group prior to the commencement of the test period and continues to be controlled by that group throughout the test period, then the control test would not be breached.

Subsection 269-95(2) of Schedule 2F of the ITAA 36 details circumstances in which a change in control due to death, incapacitation or relationship breakdown will not breach the control test.

Control of a non-fixed trust

A group controls a non-fixed trust if:[45]

1. the group has the power to obtain beneficial enjoyment directly or indirectly of the capital or income of the trust;
2. the group is able directly or indirectly to control the application of the capital or income of the trust;
3. the group is capable under a scheme of gaining the beneficial enjoyment in point 1 or the control in point 2;
4. the trustee is accustomed, under an obligation or might reasonably be expected to act in accordance with the directions, instructions or wishes of the group;
5. the group can remove or appoint the trustee; or
6. the group acquires more than a 50% stake in the income or capital of the trust.

A "*group*" is defined as:[46]

1. a person; or
2. a person and one or more associates; or
3. two or more associates of a person.

Depending on the terms of the trust deed, the control test may be breached where there is a change in unit-holding percentages in a unit trust.

Business continuity test (Subdivision 269-F)

The business continuity test in Subdivision 269-F of Schedule 2F of the ITAA 36 is an alternative test that applies if a listed widely held trust fails the 50% stake test (due to abnormal trading in units).

If there is abnormal trading the trust must pass the 50% stake test at the beginning of the test period and immediately after the abnormal trading.[47] If it fails the 50% stake test then at all times after the

[44] Section 267-45 of Schedule 2F of the ITAA 36.
[45] Subsection 269-95(1) of Schedule 2F of the ITAA 36.
[46] Subsection 269-95(5) of Schedule 2F of the ITAA 36.
[47] Subsection 266-125(1) of Schedule 2F of the ITAA 36.

first abnormal trading and before the end of the test period the trust must pass the business continuity test in relation to the time before the abnormal trading.[48]

The business continuity test consists of two separate parts:

1. the same business test; and
2. the similar business test.

Same business test

A listed widely held trust passes the same business test during a period (the same business test period) in relation to a time (the test time) if throughout the same business test period it carries on the same business as it carried on immediately before the test time.

However, the trust will not pass the same business test in any of the following cases:

1. If at any time during the test period, it derives assessable income from a business of a kind that it did not carry on before the test time or a transaction of a kind that it had not entered into in the course of its business operations before the test time.
2. If before the test time it started to carry on a business it had not previously carried on or in the course of its business operations entered into a transaction of a kind that it had not previously entered into and did so for the purpose or purposes including that of being taken to have carried on throughout the same business test period the same business as it carried on immediately before the test time.
3. If at any time during the same business test period it incurs expenditure in carrying on a business of a kind that it did not carry on before the test time or as a result of a transaction of a kind that it had not entered into in the course of its business operations before the test time.

For income years beginning on or after 1 July 2015, a listed widely held trust can pass the business continuity test through the similar business test, even if it fails the same business test, so long as the tax loss or the debt was incurred in an income year starting on or after 1 July 2015.

Similar business test

A listed widely held trust passes the business continuity test during a period (the business continuity test period) in relation to a time (the test time) if throughout the business continuity period it carries on a business that is similar to the business it carried on immediately before the test time.

However, the trust does not pass the business continuity test if before the test time, it did one of the following for the purpose of being taken to have carried on throughout the business continuity test period a business that is similar to the business it carried on immediately before the test time:

1. it began to carry on a business it had not previously carried on; or
2. in the course of its business operations, it entered into a transaction of a kind into which it had not previously entered.

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48 Subsection 266-125(2) of Schedule 2F of the ITAA 36.

Income injection test (Division 270)

The income injection test[49] applies to fixed and non-fixed trusts. However, excepted trusts (other than family trusts) do not need to satisfy the test. Broadly, the income injection test deals with schemes by which income is injected into trusts with tax losses or other deductions so that the tax payable on the income is reduced or eliminated.

Pursuant to section 270-10 of Schedule 2F of the ITAA 36, the test will apply where:

1. the trust has an allowable deduction; and
2. there is a scheme under which the following happened:
    1. the trust derives an amount of assessable income (scheme assessable income) in the income year; and
    2. an outsider to the trust directly or indirectly provides a benefit to either the trustee or beneficiary of the trust or an associate of either. (The benefit may constitute all or any of the scheme assessable income); and
    3. the trustee or beneficiary or associate thereof either directly or indirectly provides a benefit to the outsider of the trust or an associate of the outsider (the benefit may constitute all or any part of the deduction); and
    4. it reasonable to conclude that either:
        1. the trust derived the scheme assessable income;
        2. the outsider provided the benefit; or
        3. the trustee, beneficiary or associate thereof provided the benefit,

    wholly or partly but not merely incidentally because the deduction would be allowable.[50]

Broadly, where the conditions in subsection 270-10(1) of Schedule 2F of the ITAA 36 are satisfied, no deduction is allowable against the scheme assessable income in the income year being examined, with the result that the net income of the trust for the income year is increased to equal the full amount of the scheme assessable income.[51] The tax loss to which the deduction relates continues to be carried forward and may be applied against the trust's ordinary assessable income in future income years.

Outsiders

An outsider to a trust, other than a family trust, is any person other than the trustee of the trust or any person with a fixed entitlement to a share of the income or capital of the trust.[52]

An outsider to a family trust is a person other than[53]:

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49 Division 270 of Schedule 2F of the ITAA 36.

50 Subsection 270-10(1) of Schedule 2F of the ITAA 36.

51 Section 270-15 of Schedule 2F of the ITAA 36.

52 Subsection 270-25(2) of Schedule 2F of the ITAA 36.

53 Subsection 270-25(1) of Schedule 2F of the ITAA 36.

1. the trustee of the trust,
2. a person with a fixed entitlement to a share of the income or capital of the trust;
3. the individual specified in the trust family election (the test individual);
4. a member of the test individual's family;
5. a company, partnership or trust that made an IEE to be included in the test individual's family group;
6. a trust that has made FTE nominating the same test individual as the family trust; or
7. a fixed trust, partnership or company (the entity) where at all times while the scheme was being carried out, the test individual or one or more members of the test individual's family or the trustees of one or more family trusts having the same test individual as the trust, or any combination thereof, had fixed entitlement directly or indirectly for their own benefit to all of the income and capital of the entity.

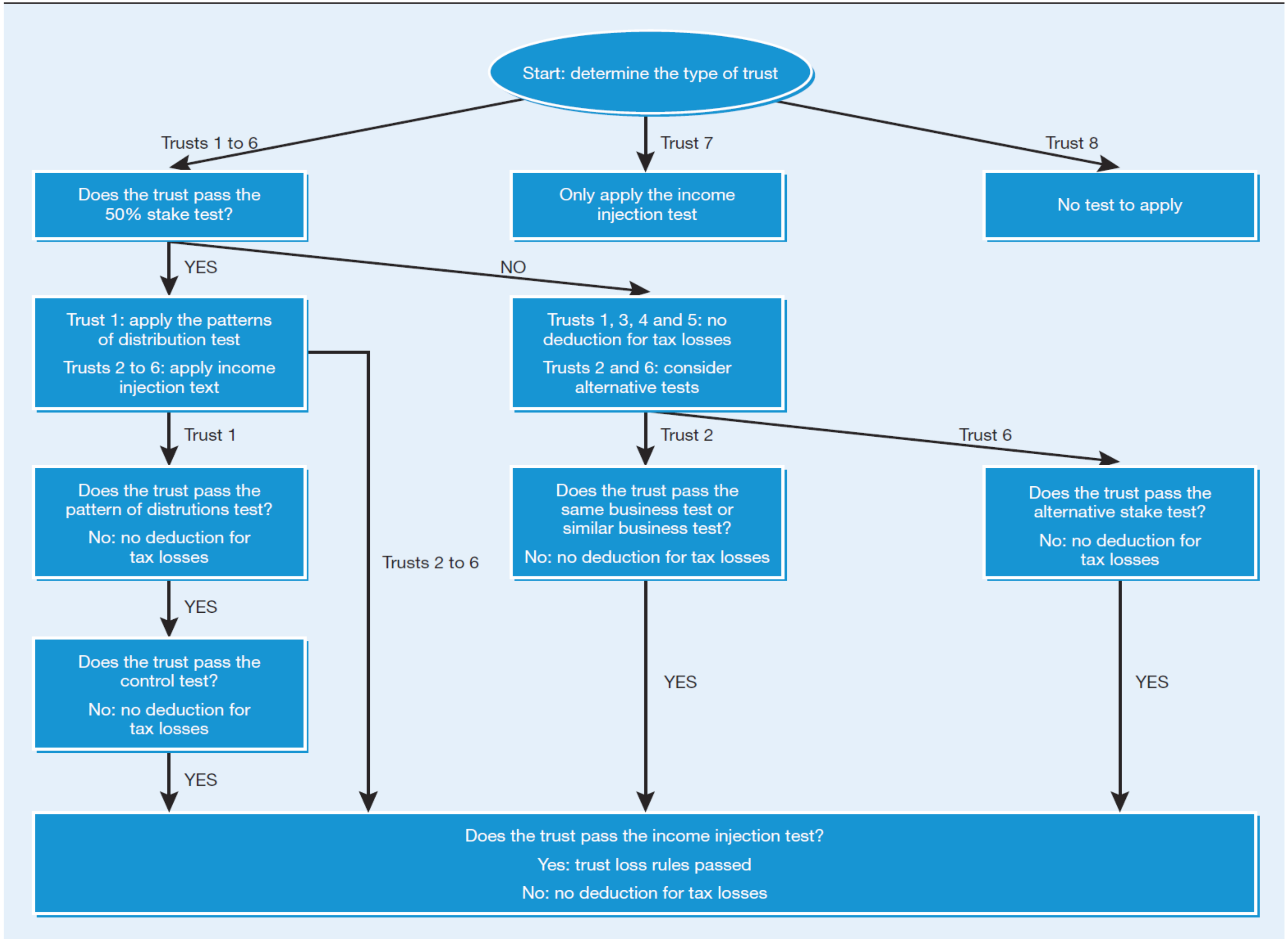
Scheme assessable income

Income derived by a trust upon commercial and/or arm's length terms or as an existing beneficiary of another trust, generally would not constitute scheme assessable income.

The maze of the trust loss provisions

This table summarises the application of the trust loss rules in Schedule 2F of the ITAA 36:[54]

[54] Source, Kelvin Yuen, Navigating the trust loss provisions maze, The Tax Institute, Taxation in Australia, April 2019. Key: Trust 1 – Non-fixed Trust; Trust 2 – Listed Widely held Fixed Trust; Trust 3 – Wholesale Widely Held Trust; Trust 4 – Unlisted Very Widely Held Fixed Trust; Trust 5 – Unlisted Widely Held Fixed Trust; Trust 6 – Fixed Trust But Not Widely Held; Trust 7 – Family Trust; Trust 8 – Excepted Trust (except a family trust).


Start: determine the type of trust
Trusts 1 to 6
Trust 7
Trust 8
Does the trust pass the 50% stake test?
Only apply the income injection test
No test to apply
YES
NO
Trust 1: apply the patterns of distribution test
Trusts 2 to 6: apply income injection text
Trusts 1, 3, 4 and 5: no deduction for tax losses
Trusts 2 and 6: consider alternative tests
Trust 1
Trust 2
Trust 6
Does the trust pass the pattern of distrutions test?
No: no deduction for tax losses
Trusts 2 to 6
Does the trust pass the same business test or similar business test?
No: no deduction for tax losses
Does the trust pass the alternative stake test?
No: no deduction for tax losses
YES
Does the trust pass the control test?
No: no deduction for tax losses
YES
YES
YES
Does the trust pass the income injection test?
Yes: trust loss rules passed
No: no deduction for tax losses

4.2 Franking credit trading rules

A beneficiary of a discretionary trust is precluded from accessing franking credits attributable to dividends paid on shares acquired by the trust after 31 December 1997 received through distributions from the trust where the total of the beneficiary's franking credits (from all sources) exceeds $5,000.[55]

Assume a trustee of a trust acquired shares after 31 December 1997, received a franked dividend attributable to those shares in the income year ended 30 June 2015, and then made a distribution to a beneficiary of the amount of the franked dividend. If the amount of the franking credits to which the beneficiary was entitled were less than $5,000, and the beneficiary received no other franking credits for the income year, the beneficiary would be entitled to access the franking credits. However, if the amount of the franking credits were $3,000 and the beneficiary received other franking credits for the income year totalling $3,000, the $5,000 ceiling would be breached.

The tax treatment outlined above is the result of specific rules contained in Division 1A of Part IIIAA of the ITAA 36 (**Division 1A**). Division 1A was repealed with effect from 1 July 2002 but continues to apply due to the meaning of "*qualified person*" and amendments to paragraphs 207-145(1)(a) and 207-150(1)(a) effected by the *Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006*.[56]

Broadly, a taxpayer may only claim franking credits if it is a "*qualified person*" in relation to the franked dividend. To be a qualified person a taxpayer must satisfy two rules:

1. the holding period rule; and
2. the related payments rule.[57]

Special rules apply for franked dividends received through a non-fixed trust. Discretionary objects are treated as having an "*interest*" in the shares held by the trust in respect of which the dividend is paid.[58] The following is a consideration of how a taxpayer, being a beneficiary of a non-fixed trust, may be entitled to claim franking credits on franked dividends received through interposed non-fixed trusts.

The related payments rule requires the beneficiary (or associate) not to make a payment that transfers the economic benefit of a dividend to another person. Broadly, the holding period rule requires a beneficiary to have held its interest in the shares for a continuous period of not less than 45 days during the period commencing on:

1. the day after the beneficiary acquired the interest in shares and ending on the 45th day after the day on which the interest became ex dividend, where a related payment was not made; or
2. the 45th day before the day on which the interest in shares became ex dividend and ending on the 45th day after the day on which the interest in shares became ex dividend, where a related payment was made.

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55 See Herr, Zena 'Trusts and imputation credits' (2004) 39(5) *Taxation in Australia* 259.

56 Taxation Determination TD 2007/11.

57 Former section 160APHO of the ITAA 36.

58 Former section 160APHG of the ITAA 36.

In calculating the number of days for which a beneficiary continuously held the interest in shares, any days on which the beneficiary acquired or disposed of the interest and the days on which the beneficiary had materially diminished risks of loss or opportunities for gain in respect of the interest, are not taken into account.

Generally, a beneficiary is taken to have materially diminished risks of loss or opportunities for gain on a particular day in respect of an interest in shares if the beneficiary's net position on that day in relation to the interest has less than 30% of the risks and opportunities.[59] The net financial position of a taxpayer is determined using the financial concept known as a delta, which measures changes in value of shares[60].

A beneficiary's interest in shares is worked out using the formula in section 160APHL of the ITAA 36. Former subsection 160APHL(7) provides that a taxpayer's interest determined under the formula has a long position with a delta of +1 in relation to itself. Former subsection 160APHL(10) specifies an additional position where an interest is held by a trust in respect of which an FTE has not been made. Broadly, a beneficiary of a trust which is not a family trust will be taken to have a short position equal to its long position and a long position equal to so much of the beneficiary's interest in the trust as is a fixed interest. Beneficiaries having no fixed interest will have a net position of zero (which is less than 30%) and materially diminished risks of loss and opportunities for gain for the entire test period and therefore cannot satisfy the holding period rule.

Beneficiaries of family trusts may however satisfy the holding period rule because former subsection 160APHL(10) does not apply, so that the beneficiary retains its long position with a delta of +1 in relation to itself.

4.3 Continuity of ownership test for companies

To be able to claim tax losses from prior years a company must satisfy either the continuity of ownership test (**COT**), the same business test, or the similar business test for losses incurred in an income year beginning on or after 1 July 2015. The same business test and similar business test only apply if the company fails the COT.

Broadly, the COT requires that the same persons at all times during the ownership test period beneficially own shares carrying more than 50% of all voting, dividend and capital rights.[61] The ownership test period is the period from the start of the loss year to the end of the income year in which the tax losses are to be applied.[62]

Where shares are held by an entity as trustee of a trust, section 165-207 of the ITAA 97 provides that shares held by a trustee of a family trust will be deemed to be treated as if they were owned by a single notional entity that is a person including in the circumstance of a change of trustee. Without this modification, both the primary test and the alternate test are unlikely to be able to be satisfied.

A trust must be a family trust from the start of the ownership test period.

59 Former subsection 160APHM(2) of the ITAA 36.

60 Former subsection 160APHM(3) of the ITAA 36.

61 Section 165-12 of the ITAA 97.

62 Subsection 165-12(1) of the ITAA 97.

4.4 Rules for closely held trusts

Two sets of rules apply to closely held trusts imposing a further administrative burden in complying with the provisions of the tax law being the trustee beneficiary reporting rules[63] and the tax file number withholding rules.[64] In general, discretionary trusts are defined as closely held trusts and subject to these rules.[65]

Trusts that have made an FTE are excepted from the trustee beneficiary reporting rules.[66] However, there is no exception for family trusts to the tax file number withholding rules.[67]

4.5 Small business restructure roll-over

The *Tax Laws Amendment (Small Business Restructure Roll–Over) Act* 2016 (**TLA SBRRA**) received Royal Assent on 8 March 2016.

The TLA SBRRA amends the ITAA 97 to allow small businesses to defer the recognition of gains and losses arising from the transfer of active business assets as part of a genuine restructure of their ongoing business that occurs on or after 1 July 2016.

The TLA SBRRA extends capital gains tax (**CGT**) roll-over relief to transfers to and from a range of different entity types, including transfers of assets from a company to a sole trader, partnership, or trust. The small business restructure roll-over (the **Small Business Roll-Over**) is in addition to current roll-over relief available for individual sole traders, partnerships and trusts that convert to a company structure (Division 122 and Subdivision 124-N of the ITAA 97).

There are a number of conditions that are required to be satisfied in order for a taxpayer to access the Small Business Roll-Over.[68] One of those requirements is that the transfer of assets occurring as a result of the transaction must not materially change the ultimate economic ownership of the transferred assets.[69] Ultimate economic ownership will be a question of fact to be determined on the circumstances of each case. Where there is more than one ultimate economic owner, their proportionate economic ownership of the asset must also remain unchanged.

Ultimate economic ownership is not a defined term. The Explanatory Memorandum (**EM**) to the TLA SBRRA explains that the ultimate economic owners of an asset are individuals who, directly or indirectly, beneficially own an asset. As ultimate economic owners can only be individuals, a look through approach applies to identify the individuals that will ultimately benefit from the asset where a company, partnership or trust owns the asset.

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63 Division 6D of the ITAA 36.

64 Subdivision 12-E of the TAA 53.

65 Subparagraph 102UC(1)(b) of the ITAA 36.

66 Subparagraphs 102UK(1)(ca)(i) and 102UT(1)(c)(i) and of the ITAA 36.

67 Refer to subsection 102UC(4) of the ITAA 36 paragraphs (b), (c) and (d) of the definition of "*excluded trust*" and subparagraph 12-175(1)(c)(ii) of Schedule 1 of the TAA 53.

68 Section 328-430 of the ITAA 97.

69 Paragraph 328-430(1)(c) of the ITAA 97.

4.5.1 **Application to discretionary trusts**

Where assets are transferred to or from discretionary trusts, identifying the individuals who are the ultimate economic owners can be difficult as beneficiaries of discretionary trusts generally do not have an interest in any asset or income of the trust until the trustee has exercised its discretion to make an appointment.

The EM at paragraph 1.34 states that in some instances a discretionary trust will meet the requirements for ultimate economic ownership on the facts alone. The EM provides the example where a discretionary trust may be deemed to be non-fixed for tax purposes, but there is no practical change in the individuals who will economically benefit from the assets before and after the transaction. In these circumstances, the EM provides there will not have been a change in ultimate economic ownership on the facts.

However, there is a lack of clarity as to factors that will prove an individual has ultimate economic ownership of an asset in the discretionary trust context. Does the lack of clarity allow an ATO officer to assert that any of the following individuals is the ultimate economic owner of a discretionary trust's assets for the purposes of subsection 328-430(1)(c) of the ITAA 97:

1. an individual if the individual is a trustee;
2. the directors or shareholders of a corporate trustee;
3. the appointor or guardian of the discretionary trust;
4. the primary beneficiaries (and whether they are required to receive distributions); or
5. beneficiaries satisfying some pattern of distribution test?

The EM also fails to acknowledge a situation where there is no ultimate economic owner of an asset in a discretionary trust. The consequences for that business electing to use the SB Roll-Over to change to a structure where the ultimate economic ownership of the asset is easily determined, for example the position of shareholders in a company, would automatically make the business ineligible for the Small Business Roll-Over.

4.5.2 **Alternative test for discretionary trusts**

Section 328-440 of the ITAA 97 provides an alternative means for discretionary trusts to satisfy the requirement not to materially change the ultimate economic ownership as required by paragraph 328-430(1)(c). Section 328-440 states ultimate economic ownership of an asset will not change where:

1. the asset is transferred to, from or between discretionary trusts;
2. the transferor or transferee trust is a family trust with an FTE in place; and
3. every individual who had ultimate economic ownership of the asset before the transfer and every individual who has the ultimate economic ownership of the asset after the transfer are members of the family group of the discretionary trust.

The family group requirement of the alternative test provides a level of protection for discretionary trusts with a FTE in place, but the provisions still fail to address the key issue of what constitutes ultimate economic ownership of assets in a discretionary trust as discussed above.[70]

Further, section 328-440 applies for purposes of paragraph 328-430(1)(c) of the ITAA 97. There is doubt whether section 328-440 applies for paragraph 328-430(1)(a) of the ITAA 97 ("*genuine restructure of an ongoing business*") and the savings rule for purposes of paragraph 328-430(1)(a) in section 328-435 of the ITAA 97.

Effect of the Small Business Roll-Over

If the above conditions are satisfied, the SB Roll-Over will allow small businesses to change their legal structure without income tax consequences arising from the transfer of the asset.[71]

4.6 Business evolution

4.6.1 Startup phase

The importance of an FTE in the modern business environment is evident when considering even the simplest of startup ventures should they be conducted through a discretionary trust structure.

In a single discretionary trust structure, the ability to carry forward losses and recoup them against future income is reliant on passing the various trust loss tests in Schedule 2F of the ITAA 36. In a non-fixed trust, this results in the pattern of distributions test[72] being the key focus.

Where the trust moves from a period of incurring losses through to a period of profitability where those losses may be recouped, it is likely that the pattern of distributions test can be managed and passed. There will be no distributions in the earlier loss years to be considered. Therefore, by managing the distributions made in the profit years when the losses are recouped, the trust may be able to continue to satisfy the trust loss rules.

However, if there are distributions made during the loss years (which may occur as a result of the distinction between trust and tax law income, capital distributions or the extended meaning of distributions provided for in Schedule 2F as outlined above) the ability to recoup the losses against future income becomes more difficult to manage. In any event, carrying losses forward to recoup against future income will add continual complexity in managing the pattern of distributions, and taking particular care that there are no distributions made that fall within the extended meaning of distributions.[73]

70 In Private Binding Rulings 1052077111745 and 1052085490528 the ATO decided that the Small Business Roll-Over was not available as the ultimate economic ownership test was not satisfied in restructures involving trusts and companies in circumstances with characteristics similar to Example 12 in Law Companion Ruling LCR 2016/3.

71 More detail regarding the SB Roll-Over is available at: http://sladen.com.au/news/2016/2/12/small-business-restructure-rollover-and-discretionary-trusts.

72 Subdivision 269-D of Schedule 2F of the ITAA 36.

73 Section 272-60 of Schedule 2F of the ITAA 36.

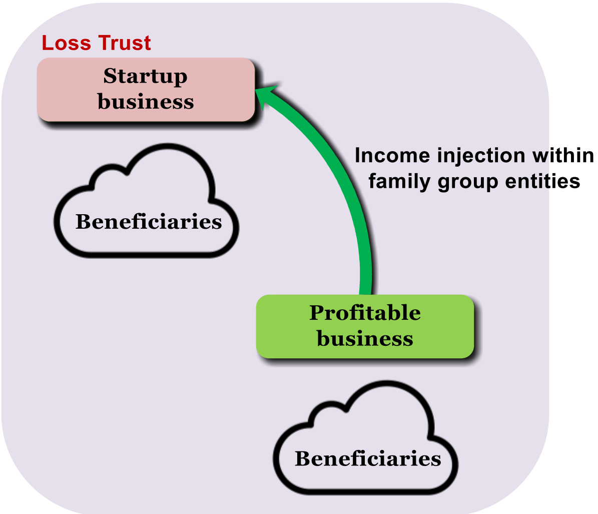
If the trust was to make an FTE, then its treatment as an excepted trust for the purposes of the trust loss rules will make the process of carrying the losses forward from the startup period to its future profitable period easier to manage.

4.7 Startup business with a second profitable business

Not all startup businesses stand alone. Many private family groups enter a new startup business venture with the support of an existing profitable business funding the initial stages of that new business.

In the scenario that both the startup business and the profitable business are being conducted by discretionary trusts, the ability to inject assessable income from the profitable business into the startup business (to be offset against the losses being incurred by the startup business) will significantly aid the cash flow and net tax outcome for the private family group.

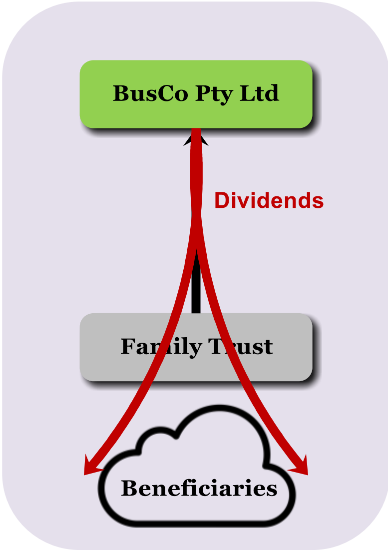
As noted above, the income injection test is broad in its application and is designed to pick up most schemes whereby income from a profitable trust is offset against the losses from the loss-making trust.



Where both the startup business and the profitable business are conducted by family trusts nominating the same test individual, both trusts will be within the same family group and therefore the injection of income from the profitable trust into the loss-making trust will itself not result in a liability under the income injection test as there is no benefit provided to an outsider.

Given the breadth of the provisions, it is still important to ensure that there is no inadvertent benefit being provided to an outsider because of the distribution pattern or operations of the trusts.

4.7.1 Trust conducted business rolled over to company



In some private businesses, the business evolves over time from a discretionary trust structure to a corporate structure.

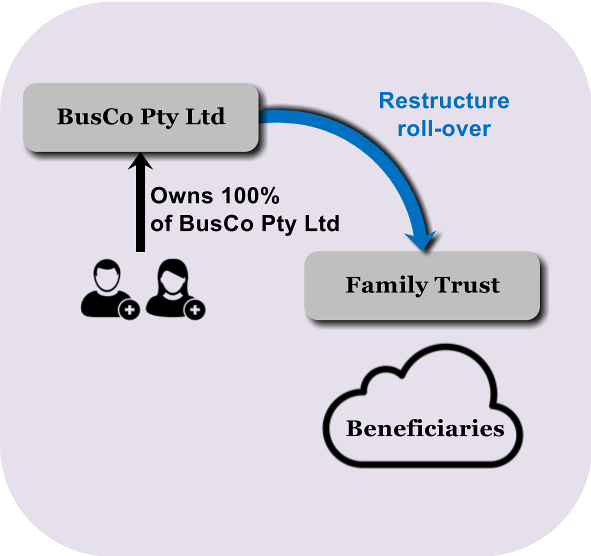
There is a myriad of reasons as to why a business may be better suited to the form of a discretionary trust in its initial stages and yet a corporate environment is more appropriate as the business grows. Some examples of the kind of scenarios that may lead to the requirement to incorporate include:

1. the business may require additional contributions to working capital and the ability to self-fund through retentions of profit may be more attractive to the family members than them having to source external funds to loan to the trust, or to manage subsisting UPEs;
2. the business may have substantial intellectual property which it is intending to develop and therefore wishes to obtain the benefit of the tax concessions available (only for companies) for research and development activities;
3. the business may want or need key staff or external parties to take specific equity interests in the business in the short to medium term; and
4. the business may be more attractive as a merger or acquisition target if the acquiring entity can identify a readily transferable equity structure such as shareholding in a company.
5. In this structure, the operation of the franking credit trading rules (described above) needs to be carefully considered.
6. Unless there are very few dividends being declared and paid by the corporate entity, or the beneficiaries of the trust met the small shareholder exemption (the $5,000 from all sources threshold test), the shareholding trust will need to make a FTE in order to pass through the franking credits on the dividends declared and paid by the corporate entity to the beneficiaries of the shareholding trust.

4.7.2 Company conducted business rolled over to a discretionary trust

In the reverse of the scenario addressed above, there are also circumstances where a business conducted by a company may be better suited to be conducted by a trust as the business evolves and grows.

In the past, such a transition may have resulted in the triggering of Federal and State taxation liabilities as a disposal from the corporate structure to the trust structure. In some instances, the combination of the various small business CGT concessions may have enabled such a transition to be made whilst deferring or eliminating the taxation liability. From 1 July 2016, the availability of the Small Business Roll-Over may further encourage businesses to make such a transition as they move from a straightforward individual owned company to a more sophisticated discretionary trust structure.



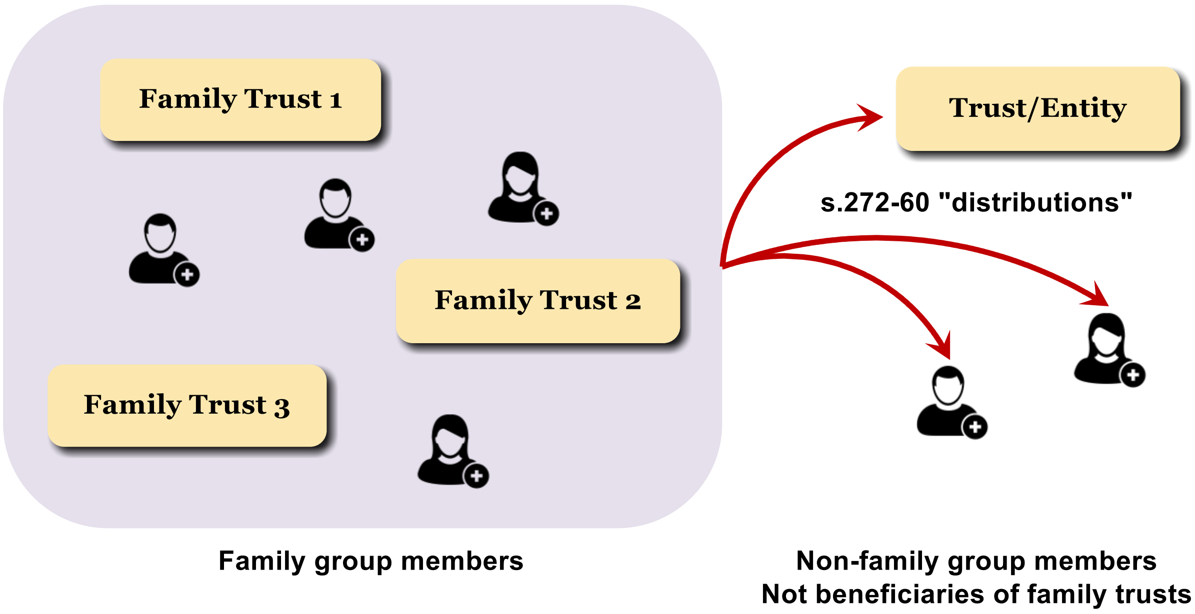
As discussed above in relation to the operation of the Small Business Roll-Over the ability to access that roll-over is dependent upon proving retention of the same ultimate economic ownership. Where a discretionary trust is involved, establishing retention of the same ultimate economic ownership will be difficult to achieve (despite the explanatory memorandum indicating that it is possible in limited fact scenarios) without the making of an FTE.

In a simple scenario where a couple are the only shareholders of a corporate trading vehicle, the transition to a family trust where one of the individuals is the test individual will ensure that both the recipient family trust and the individual shareholders are all members of the same family group thereby satisfying the requirement to retain the same ultimate economic ownership.

5. Family Trust Distributions Tax

5.1 Liability for FTDT

The primary consequence of making an FTE or an IEE is that any conferral of a present entitlement or distribution of income and capital made by the family trust or interposed entity to a person outside the test individual's family group (an outsider) will be subject to FTDT.[74]



FTDT, currently 47%, is imposed on the amount or value of the distribution or present entitlement.[75]

FTDT is not an income tax, nor is it 'assessed', it is a special tax imposed by the *Family Trust Distribution Tax (Primary Liability) Act 1998* when the conditions – distributions to an outsider – are met.[76] Apart from where the person who is liable for FTDT is a non-resident, [77] FTDT is not contingent on the Commissioner issuing a notice or document of any kind.

FTDT is due and payable:[78]

1. 21 days after the distribution or conferral;
2. 21 days after the election if the distribution or conferral was before the election was made; or
3. within such later date as the Commissioner, in "*special circumstances*", allows.

[74] Section 271-5 of Schedule 2F of the ITAA 36. See also sections 271-15, 271-20, 271-25, and 271-30 of the ITAA 36 for when a FTDT is imposed by distributions by family trusts or interposed entities.

[75] Section 4 of the *Family Trust Distribution Tax (Primary Liability) Act 1998*.

[76] See the explanatory Memorandum to the *Taxation Laws Amendment (Trust Loss and Other Deductions) Act 1998*.

[77] See sections 271-45, 271-50, 271-55, 271-60, 271-65, and 271-70 of Schedule 2F of the ITAA 36. .

[78] See section 271-75 of Schedule 2F of the ITAA 36. .

Because FTDT is not contingent on the Commissioner issuing an assessment, FTDT does not have an amendment period. That is, FTDT arises 'automatically' if there is a distribution to an outsider even if the distribution were outside the period of review for income tax purposes.

Where the trustee of the family trust is a company, the interposed entity is a company, or a partner a company, the directors of the company are jointly and severally liable for the FTDT.[79] Directors may avoid joint and several liability if: [80]

1. they did not take part in any decision to confer the entitlement or make the distribution; and
2. if they did take part in such a decision or were aware of the proposed decision to confer the entitlement or make the distribution, they took reasonable steps to prevent the making, of the implementation, of the decision.

While the Commissioner is not required to issue a notice, a person may make a written request to the Commissioner for a notice specifying the amount of the FTDT and the day it became, or becomes, due and payable.[81] The Commissioner on request must issue the notice provided the request is within 21 days of the distribution or such other period as the Commissioner allows.[82] The liability of a person or persons to FTDT and the due date for payment of the tax, "*are not dependent on, or in any way affected by, the giving of a notice in respect of the amount*." [83]

A person may object to the notice under Part IVC of the TAA 53.[84]

If the FTDT is not paid within 60 days of its due date, the general interest charge (**GIC**) is imposed on the unpaid FTDT. [85] For example, if a distribution to an outsider was made on 30 June 2024, FTDT would be due and payable on 21 July 2024 and, if the FTDT were not paid, GIC would be imposed from 19 September 2024.

Applications for remission of the GIC can be made under the TAA 53.[86]

5.2 Consequences of the existence of a FTDT liability

The amount of any distribution or present entitlement on which FTDT has been paid are non-assessable non-exempt income of the recipient of the distribution or present entitlement.[87] Section 170 of the ITAA 36 provides an unlimited period to amend assessments of the recipient of distributions subject to FTDT, effectively mirroring the unlimited period for imposing FTDT.

Where the distribution comprises a franked dividend component, the gross amount is also excluded from the assessable income of the recipient with the consequential loss of any franking credits. Further, where the distribution is paid to a non-resident, it will be exempt from withholding tax.

[79] See subsections 271-15(2), 271-20(2), 271-25(2), and 271-30(2) of Schedule 2F of the ITAA 36.

[80] See section 271-40 of Schedule 2F of the ITAA 36.

[81] See sections 271-90 and 271-95 of Schedule 2F of the ITAA 36.

[82] See section 271-90 of Schedule 2F of the ITAA 36.

[83] See section 271-90(4) of Schedule 2F of the ITAA 36.

[84] See section 271-90(6) of Schedule 2F of the ITAA 36.

[85] See section 271-80 of Schedule 2F of the ITAA 36. .

[86] Section 8AAG of the TAA 53.

[87] Section 271-105 of Schedule 2F of the ITAA 36.

If after conferring a present entitlement to income or capital to a person outside the test individual's family group, the family trust or interposed entity pays the income or capital in satisfaction of the entitlement, the distribution is disregarded for the purposes of FTDT.[88]

5.2.1 Extended meaning of distribution – TD 2017/20

Section 272-60 of Schedule 2F of the ITAA 36 extends the meaning of "*distribution*" to a range of non-arm's length transactions such a forgiveness of debt.

> **Section 272-60 of Schedule 2F of the ITAA 36**
>
> (1) A company, partnership or trust (an entity) also distributes income or capital to a person in circumstances not covered by section 272- 45, 272-50 or 272-55 if it:
>
> (a) pays (including by way of a loan) or credits money of the entity to the person, or reinvests such money for the person; or
>
> (b) transfers property of the entity to, or allows use of property of the entity by, the person; or
>
> (c) deals with money or property of the entity for or on behalf of the person or as the person directs; or
>
> (d) applies money or property of the entity for the benefit of the person; or
>
> (e) extinguishes, forgives, releases or waives a debt or other liability owed by the person to the entity.

Despite the extended meaning of distribution, the ATO's previous understanding outlined in *ATO* [Interpretative Decision ATO ID 2012/12] (now withdrawn) was that the extended meaning of "d*istribution*" only applied to beneficiaries of the trust, not to entities that are not beneficiaries.

> **ATO ID 2012/12 (withdrawn) - Reasons for Decision**
>
> A trustee distributes income or capital to a person in their capacity as a beneficiary of the trust pursuant to section 272-45.
>
> Section 272-60 provides an extended definition of 'distribution'. However, in relation to a trust, this provision only applies in relation to the things specified in paragraphs 272-60(1)(a) to 272-60(1)(e) **to the extent that they arise in a person's capacity as a beneficiary of the trust.**
>
> Writing off a trade debt owed by a person who is not a beneficiary of the trust would not come under consideration as a distribution of income or capital under section 272-60.
>
> [Emphasis added]

This implied that a non-arm's length transaction with a related entity would not be caught by the extended meaning of "*distribution*" if that related entity was not a beneficiary.

The professional bodies requested that ATO ID 2012/12 be converted to a public ruling or determination at the National Tax Liaison Group Trust Consultation Sub-group meeting on 24 April 2012, but this was not further advanced.

88 Section 271-35 of Schedule 2F of the ITAA 36.

The ATO withdrew ATO ID 2012/12 and the ATO position reversed with effect from 7 June 2017 with the release of Draft Taxation Determination TD 2017/D1, which was finalised by the ATO in November 2017 as Taxation Determination TD 2017/20.[89]

The ATO's view in TD 2017/20 on section 272-60 of Schedule 2F to the ITAA 36 confirms the ATO view that FTDT can apply where there is a distribution to a person who is not a beneficiary of the trust. As a result, trustees of family trusts who confer a benefit on a person who is not a beneficiary of the trust will be liable to pay FTDT on an amount which presumably would have been the amount the trust would have received on an arm's length transaction less any consideration actually provided in relation to the distribution.

Despite some commentators being of the view that the wide definition of "distribution" in section 272-60 (that includes nearly every non-arm's length transaction) should be limited to distributions to actual beneficiaries that extract value from the trust by these kinds of transactions, the Commissioner is of the view that the provision applies to non-beneficiaries too.

The Commissioner notes in TD 2017/20 that while the primary definition of distribution in section 272-45 of Schedule 2F of the ITAA 36 is specifically confined to distributions to a person in their "*capacity as a beneficiary of the trust*", the extended definition in section 272-60 is not limited by reference to the capacity of the person to whom the distribution is made. One day a court may have to decide whether the extended definition applies to persons who are not beneficiaries or just to beneficiaries but not "*in their capacity"* as beneficiaries.

The Commissioner clarifies in TD 2017/20 his view that in addition to the liability to FTDT, the meaning of distribution in section 272-60 is also relevant for the pattern of distributions test in subdivision 269-D of Schedule 2F of the ITAA 36.

The Commissioner provides the following example in TD 2017/20 for which the extended meaning of distribution applies to non-arm's length transactions with non-beneficiaries:

> **Example 2 - use of holiday home, not an incident of a business**
>
> 31. The Wonder Family Trust has made an FTE and Diana Prince is the specified individual. The trust owns a holiday home. The holiday home is used by Diana's friends, for no consideration, for four weeks in the year.
>
> 32. This transaction is not on arm's length terms nor an ordinary incident of a business being carried on by the trust. As no consideration is given in return for the use of the property, the full value of that use is a distribution within the extended meaning of 'distributes'.

In the above example, the family trust will need to pay FTDT on the value of the use which presumably will be the amount the trust would have received if Diana's friends had paid an arm's length rent.

In response to the issues raised in relation to example 2 above and whether the benefit in that example should have been properly provided to a beneficiary and then on-provided to the ultimate recipient, the ATO commented as follows:

> Whilst any transaction requires a proper examination of the surrounding facts and circumstances, it is the Commissioner's view that (in the context of the definition of 'distributes' in section 272-60 in Schedule 2F to the

89 ATO Interpretative Decision ATO ID 2004/162 includes another example of an amount that falls within the extended definition of distribution in section 272-60 of Schedule 2F of the ITAA 36.

> Income Tax Assessment Act 1936) an acquaintance of a beneficiary is capable of receiving a distribution of the kind described in Example 2.[90]

The Commissioner provides some limitation to the potential scope of this new interpretation by deeming certain transactions that they consider are "*genuine commercial dealings*" as giving rise to consideration being provided for the benefit. If there is consideration equivalent to the benefit provided, then there is no amount to which the FTDT would relate.

Whilst acknowledging that the issue is a question of fact to be determined in each case, the Commissioner states in TD 2017/20:

> "[20] …in practice the Commissioner will infer that the amount or value of a benefit provided to a person does not exceed the amount or value of the consideration given in return where the relevant transaction:
>
> - occurs on arm's length terms, and
> - is an ordinary incident of a business being carried on by the trust."

In Ruling Compendium TD 2017/20EC, the Commissioner states that he does not agree with the industry's suggestion that the 'practical safe harbour' in paragraph 20 of TD 2017/20 should be extended to all arm's length dealings regardless of whether the dealing was an incident of a business carried on.

TD 2017/20 includes a series of examples of situations where the Commissioner would consider that the benefit provided to a person does not exceed the amount or value of the consideration given in return. The examples include:

1. interest-free loans on arm's length terms by a business;
2. entertainment expense for arm's length clients of a business;
3. discounted fees for services provided on arm's length terms by a business; and
4. written-off bad trade debts (to the extent that a debt has on a bona fide assessment based on commercial considerations gone bad).

Considering the discussion above, trustees that have or are considering making an FTE should contemplate any non-arm's length transaction with an outsider of the family group that may be deemed to be a distribution within the meaning of section 272-60.

Trustees of trusts that have made FTEs may want to consider whether the current arrangements in place involve entities or individuals outside the relevant family group. Where arrangements between the trust and outsiders of the family group are not at arm's length and are not an ordinary incident of the business that the trust carries on, the Commissioner may apply his understanding in TD 2017/20 potentially exposing the trustee and the directors of a corporate trustee to a liability to FTDT.

Trustees that are considering revoking an FTE due to the Commissioner's view in TD 2017/20 and the potential FTDT liability should take into consideration the existing limitations to revoke an FTE and the fact that such revocation may be irreversible.

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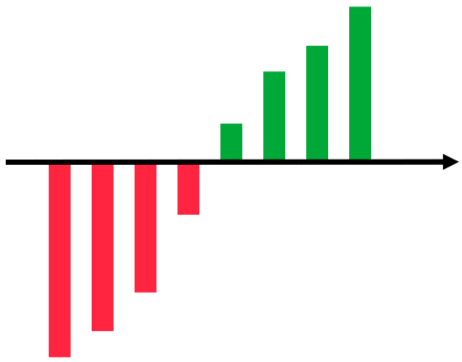
90 Ruling Compendium TD 2017/20EC, Issue 2.

5.2.2 Example: unit trust and losses

As noted above, if no income is distributed in the loss year and there is no change in control/unit holders during the test period, then the **non-fixed trust** tests will likely be passed by a unit trust.

That is, even if the unit trust is one where persons **do not** have a fixed entitlement to all the income and capital of the trust[91] and therefore the unit trust must assess the non-fixed trust loss tests, is passing those tests difficult?



Consider a scenario where over time a unit trust moves from a period of losses and then enters a period of positive net assessable income.

Assuming the fact scenario above (that is, no change in control and no prior distribution of income) then the pattern of distributions test should not prevent those prior year losses being carried forward and applied against the positive net assessable income.

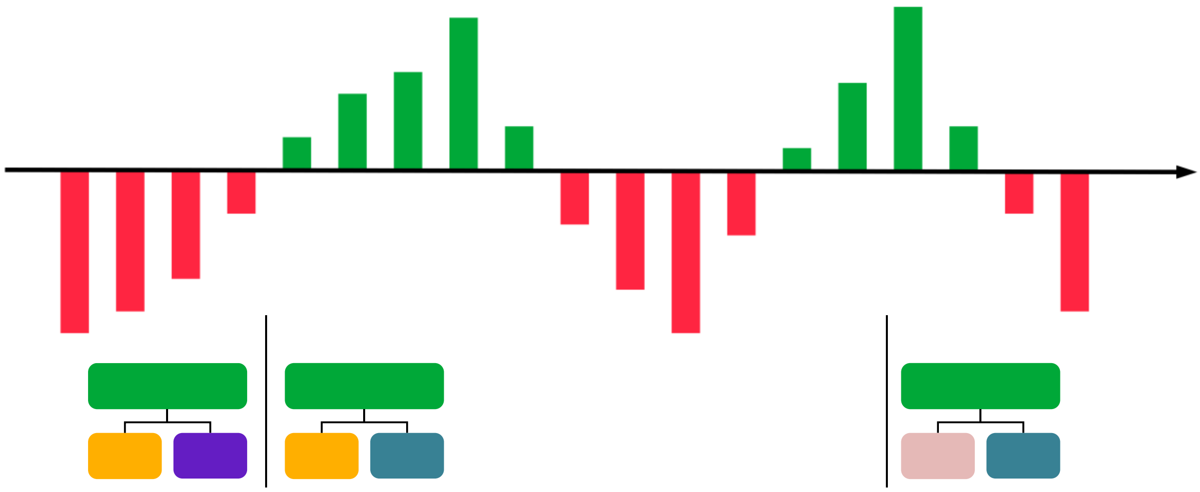
So, is the pattern of distributions test such a large problem for non-fixed unit trusts?

Alternate scenario

Let us consider an alternate scenario where:

1. the unit trust is still treated as a **non-fixed trust** due to the lack of fixed entitlements to all the income and capital of the trust;
2. there are **changes in the unit holding** over time as new investors acquire units and former unit holders sell down or exit; and
3. the unit trust does pass in and out of **periods of loss** consistent with cyclical changes impacting the business conducted by the unit trust.

[91] Section 272-65 of Schedule 2F of ITAA 36.



In that scenario the pattern of distributions test will be failed and prior year losses will not be able to be carried forward to be offset against future income.

The unit trust cannot adopt the common strategy used by discretionary trust non-fixed trusts being the making of an FTE. If the unit trust were to make an FTE to pass the pattern of distributions test it is likely that a FTDT liability (47%) will be triggered on any distributions to one of the unit holders.

That is, the making of the FTE will necessitate choosing a test individual. Then, any distributions to ‘outsiders’ of the family group of the test individual will trigger a liability to FTDT.

Consider a simple scenario of family A and family B directly or indirectly investing in a unit trust. If the unit trust makes an FTE choosing a member of family A as the test individual, then any distributions to family B (despite the unit holding providing them with the legal entitlement to that distribution) will trigger FTDT.

If, however, there were **fixed entitlements** to all the income and capital of the unit trust, then these non-fixed trusts tests, such as the pattern of distributions test, would **NOT** apply in determining the ability to access trust losses.

6. Revocation of FTEs and varying the test individual

6.1 Revocation of FTEs and IEEs

6.1.1 FTEs

Prior to TLAM4 2007[92] FTEs were irrevocable except in specific limited circumstances relating to fixed trusts.

For discretionary trusts,[93] FTEs may now be revoked *unless* tax losses have been recouped (or bad debt deductions or franking credits have been claimed) during a period (commencing at the start of the income year specified in the FTE and ending on the last day of the income year immediately prior to the income year specified in the revocation) where the recoupment or claim was only possible because of the FTE.[94]

The revocation may be made for an income year that occurs before the end of the fourth income year after the income year specified in the FTE.[95] For example, if an FTE was made in the 2021 income year, the election has to be revoked prior to 30 June 2025.[96]

The revocation of the FTE must also be made in the tax return of the trust for the income year in which the revocation is sought.[97] If the trust does not need to lodge a tax return for the relevant year then the revocation must be in writing in an approved form specifying the income year from which the revocation is to be effective and must be given to the Commissioner on or before two months after the end of the relevant income year. There is a discretion for the Commissioner to accept revocations at a later point in time.[98]

6.1.2 IEEs

Subject to the following, IEEs cannot be revoked.

An IEE may be revoked where the election was made for an entity that was already included in the family group of the test individual at the election commencement time or where the entity is a member of the family group.[99] The revocation must be in respect of an income year being the later of the income year specified in the election and the beginning of the income year in which the entity became

92 *Tax Laws Amendment (2007 Measures No 4) Act 2007*.

93 The tests for fixed trusts are different and contained in subsection 272-80(6) of Schedule 2F of the ITAA 36.

94 Subsection 272-80(6A) of Schedule 2F of the ITAA 36.

95 Paragraph 272-80(6B)(a) of Schedule 2F of the ITAA 36.

96 In the case of FTEs made prior to the 2003 income year, transitional measures enabled trustees to revoke the election by 30 June 2009 (refer to paragraph 272-80(6B)(b)) of Schedule 2F of the ITAA 36.

97 Subsection 272-80(8) of Schedule 2F of the ITAA 36.

98 Subsection 272-80(7)(c)(ii) of Schedule 2F of the ITAA 36

99 Subsection 272-85(5A) of Schedule 2F of the ITAA 36.

a member of the family group, and finishing at the end of the fourth income year after commencement.[100]

An IEE is taken to be automatically revoked if the FTE to which it relates is revoked.[101]

6.2 Variation to the test individual

Amendments made by TLAM4 2007 enable a once-off variation to the test individual specified in an FTE.[102]

The variation may be made for an income year that occurs before the end of the fourth income year after the income year specified in the FTE.[103] For example, if a FTE was made in the 2019 income year, the election made has to be varied prior to 30 June 2023.

In the case of FTEs that were made prior to the 2003 income year, transitional measures enabled trustees to vary the test individual until 30 June 2009.[104]

The variation must be made in the trust's income tax return for the income year from which the variation is to be effective, or in the case of a retrospective variation, in writing and in the approved form specifying the income year from which the variation is to be effective.[105]

6.2.1 Conditions for varying an election

The variation is only allowed where the new test individual was a member of the original test individual's family at the election commencement time and where no conferrals of present entitlement to, and distributions of income or capital have been made by the trust or an interposed entity outside the new test individual's family group during the period in which the election has been in force.[106]

There are some additional circumstances in which the test individual may be varied relating to marriage breakdown. These provisions are not limited in time (as the general variation power referred to above) and do not contain qualifying restrictions regarding there being no distributions outside of the family group. The provisions only require that because of an order, agreement or award of the kind mentioned in the CGT marriage breakdown provisions the new individuals and members of the new individual's family have control of the trust.[107]

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100 Paragraph 272-85(5C)(a) of Schedule 2F of the ITAA 36. Transitional measures enabled revocations to be made by 30 June 2009 (paragraph 272-85(5C)(b) of Schedule 2F of the ITAA 36).

101 Subsection 272-85(5B) of Schedule 2F of the ITAA 36.

102 Subsection 272-80(5B) of Schedule 2F of the ITAA 36.

103 Paragraph 272-80(6B)(a) of Schedule 2F of the ITAA 36.

104 Paragraph 272-80(6B)(b) of Schedule 2F of the ITAA 36.

105 Subsection 272-80(8) of Schedule 2F of the ITAA 36.

106 Subsection 272-80(5A) of Schedule 2F of the ITAA 36.

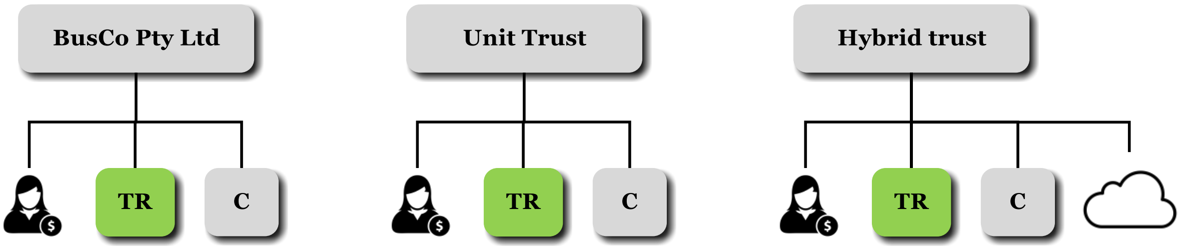
107 Refer subsection 272-80(5C) of Schedule 2F and section 95D of the ITAA 36 and paragraphs 126-5(1)(a) to (f) of the ITAA 97.

7. Entities with losses and FTEs

7.1 Multiple families – non-fixed trusts

As noted above in the discussion regarding a startup business conducted by a non-fixed trust,[108] the ability to access losses incurred in the conduct of a startup business may require careful management of the pattern of distributions test and the carrying forward of the losses to future years when the business becomes profitable before those losses may be recouped.

This presents challenges for groups where there are multiple families investing in a single structure and one family invests through a profitable trust with taxable income.



As illustrated above in green, the profitable trust will be paying tax on its taxable income whilst the entity in which it invests continues to incur losses.

Further, the unit trust and the hybrid trust (assuming they are non-fixed trusts as discussed further below) will need to satisfy the pattern of distributions test to carry the losses forward. This can be a problem if there are changes to the equity participation over time, potentially resulting in the loss of the earlier stage carried forward losses.

It is not possible for the unit trust or hybrid trust to become an excepted trust and not subject to the pattern of distributions test where there are multiple families investing given the structure of the family trust regime requiring the nomination of a single test individual and the family group then being defined by reference to that individual. The result of an FTE being made in respect of one of these multiple family investment structures will be to expose distributions to families outside of the test individual's family group to family trust distributions tax despite that distribution arising because of their equity interest.

Another complication with such structures that incur losses is the potential for ultimate business failure. In that instance, given the inability to inject income into the structure unless an FTE was made,[109] where a business completely fails, the losses may remain trapped unless the structure itself undertakes a new profitable business.

7.2 Multiple families – partnership of trusts

A partnership of discretionary trusts may facilitate both:

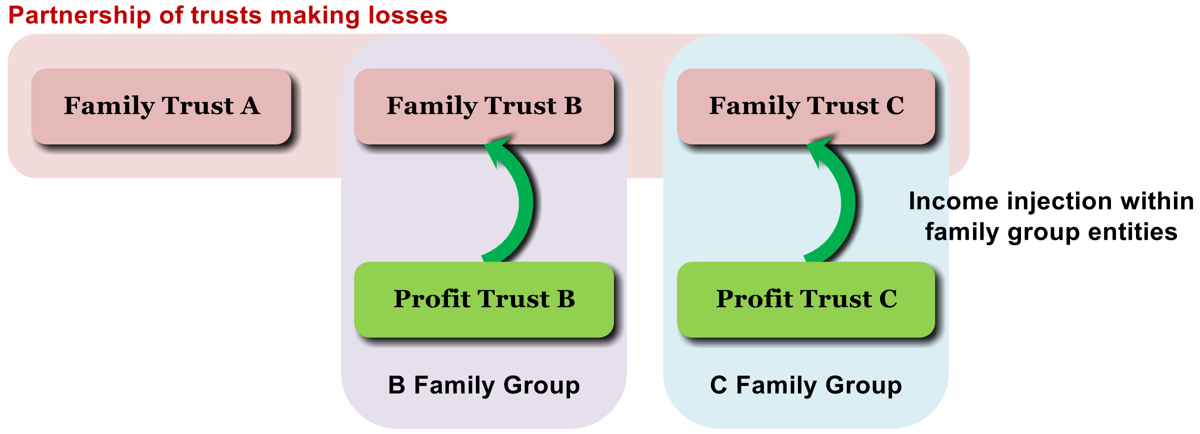
[108] See Part 4.6.1 of this paper.

[109] Or the entity was a fixed trust for the purposes of Schedule 2F of the ITAA 36.

1. access to losses incurred during the start-up phase of the business; and

2. access to losses incurred should the business fail;

as each trust may make its own FTE so that it becomes an excepted trust for the purposes of the trust loss rules. This enables the carry forward of losses incurred without concern for the pattern of distributions test. It also enables profitable trusts within the individual family groups to inject income into the loss-making trust to offset against those losses.



There are several other complexities involved with a partnership of discretionary trusts that are beyond the scope of this paper, but the illustration of the way such a structure may effectively address losses incurred during the startup phase of a business indicates one of its significant advantages.

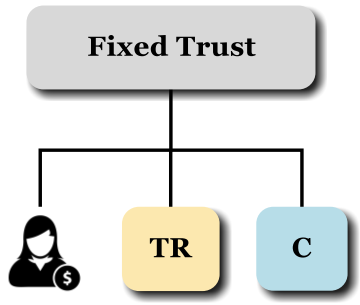
7.3 Fixed trusts

Fixed trusts are divided into ordinary fixed trusts and widely held fixed trusts (unlisted or listed).

7.3.1 Ordinary fixed trusts

A trust is a fixed trust if persons have a fixed entitlement to all the income and capital of the trust.[110]

A person has a "*fixed entitlement to a share of the income or capital*" of a trust if they have a vested and indefeasible interest in the share of the income or capital of the trust.[111] In relation to unit trusts in which units are redeemable or further units may be issued, an interest in the income or capital of the trust will not be defeasible where:[112]



1. if the units are listed for quotation in the official list of an approved stock exchange - the units held by the person will be redeemed, or any further units will be issued, for the price at

110 Section 272-65 of Schedule 2F of the ITAA 36.

111 Subsection 272-5(1) of Schedule 2F of the ITAA 36.

112 Subsection 272-5(2) of Schedule 2F of the ITAA 36.

which other units of the same kind in the unit trust are offered for sale on the approved stock exchange at the time of the redemption or issue; and

2. if the units are not listed - the units held by the person will be redeemed, or any further units will be issued, for a price determined on the basis of the net asset value, according to Australian accounting principles, of the unit trust at the time of the redemption or issue.

The decisions in *Colonial First State Investments Ltd v COT*[113] and *Kafataris v DCT*[114], and the ATO Decision Impact Statements published in respect of those decisions,[115] mean that it is almost impossible to meet the definition of fixed entitlement for the purposes of section 272-5 of Schedule 2F of the ITAA 36.

The difficulty in meeting the legislative test of a "*fixed trust*" arises because of the notion of "*fixed entitlement*" in section 272-5. A trust is a fixed trust if persons have fixed entitlements to all the income and capital of the trust.[116] Subsection 272-5(1) provides that:

> **272-5(1) If**, under a trust instrument, a beneficiary has **a vested and indefeasible interest** in a share of income of the trust that the trust derives from time to time, or of the capital of the trust, the beneficiary has a *fixed entitlement* to that share of the income or capital.
>
> [Emphasis added]

While subsection 272-5(2) further clarifies the test (see above) to provide that the mere fact that the units are redeemable or that further units are able to be issued does not result in the interest being defeasible if those units may only be redeemed or further units issued "*for a price determined on the basis of the net asset value, according to Australian accounting principles, of the unit trust at the time of the redemption or issue*".

However, this concession is still not sufficient to satisfy the ATO that an express private unit trust drafted to achieve fixed trust status necessarily complies with the legislative test of fixed entitlement. The current ATO view in relation to the provisions is expressed in the *Decision Impact Statement* in respect of *Colonial First State Investments Ltd v COT* as follows:

> ***Whether the Wholesale Fund is a fixed trust for the purposes of section 272-65 in Schedule 2F (the fixed entitlement issue)?***
>
> The Court found that the Wholesale Fund was not a 'fixed trust' for the purposes of section 272-65 of Schedule 2F as the interests of unitholders in income and capital of the trust were defeasible.
>
> The Commissioner submitted that clause 43 of the constitution (which permitted the Responsible Entity to make any modification, addition or deletion to the constitution) was capable of being used to defeat any interests in the income and capital of the Wholesale Fund which the unitholders may enjoy.
>
> The Court noted that the Commissioner's position failed to take account of paragraph 601GC(1)(b) of the Corporations Act 2001 which permits a Responsible Entity to change its constitution only if they consider the change will not adversely affect members' rights. However, the Court left open the question of whether there was any circumstance in which the Responsible Entity could terminate, invalidate or annul Colonial's

113 [2011] FCA 16.

114 [2008] FCA 1454.

115 Refer to https://www.ato.gov.au/law/view/document?Docid=LIT/ICD/NSD1190of2009/00001 (*Colonial First State*) and https://www.ato.gov.au/law/view/document?docid=LIT/ICD/2510-9/2007/00001 (*Kafataris*).

116 Section 272-65 of Schedule 2F of the ITAA 36.

entitlement to a share of the income or capital of the Wholesale Fund and reasonably consider that the change would not affect members' rights. [paragraphs 99-100]

Ultimately the Court held that the interests of unitholders in income and capital of the Wholesale Fund could be defeated by the unitholders exercising the powers granted to them under paragraph 601GC(1)(a) of the Corporations Act 2001 to modify, replace or repeal the constitution by special resolution. [paragraphs 103-106]

…

Fixed entitlement issue

The decision confirms the ATO view that very few trusts satisfy the definition of 'fixed trust' in section 272-65 of Schedule 2F in the absence of the exercise of the Commissioner's discretion (essentially because beneficiary entitlements to income or capital are generally liable to be defeated by the exercise of a power in the deed or by a statutory power).

…

Fixed entitlement issue

The ATO has previously considered issuing a public ruling about the fixed entitlement test in the trust loss provisions in Schedule 2F. The ATO has previously concluded that, even on a purposive and contextual interpretation of the actual words used in the legislation, an interpretative position could not be reached that aligned with industry expectations. The indefeasibility requirement was significant in that respect.

7.3.2 Self-assessment relief

Practical Compliance Guideline PCG 2016/16 provides assistance as to when the Commissioner will exercise his discretion and circumstances where a safe harbour applies to treat a trust as a fixed trust, as if the Commissioner had exercised his discretion.

PCG 2016/16 has application for the meaning of fixed entitlements and fixed trusts as outlined in Schedule 2F of the ITAA 36 However, despite submissions to the contrary, the final PCG does not address the meaning of those terms for the purpose of the 'non-arm's length income' rules (the ATO position is still that Taxation Ruling TR 2006/7 applies) or for former subsection 160APHL(14) of the ITAA 36 (the holding period rule for streaming franking credits).

The concept of fixed entitlements and ATO view

A trust is a fixed trust if persons have fixed entitlements to all the income and capital of the trust. A beneficiary will be considered to have fixed entitlements to income or capital of a trust if their interest is vested and indefeasible.

Regarding what constitutes a vested interest, PCG 2016/16 asserts that:

> "…an interest is 'vested' if it is vested in interest or vested in possession'. An interest is vested in possession when it gives its holder a right of present enjoyment, whereas an interest is vested in interest if it gives its holder a present right to future enjoyment".[117]

[117] PCG 2016/16 at paragraph 13.

PCG 2016/16 confirms that the mere object of a discretionary trust does not have a vested interest in, and therefore does not have a fixed entitlement to, either the income or capital of the trust. This is consistent with the understanding that the entitlement to income or capital by a beneficiary of a discretionary trust does not arise under a trust instrument, but pursuant to an exercise of the power of the trustee of that trust.

PCG 2016/16 also includes the Commissioner's view on the concept of 'indefeasible interests' as being an interest that "*can be defeated by the actions of one or more persons or by the occurrence of one or more subsequent events*."[118]

PCG 2016/16 lists the following powers as powers which cause a beneficiary's interest to be defeasible:[119]

1. power to amend the trust deed;
2. power to issue or redeem units;
3. power to issue units of different classes or to reclassify units;
4. power to classify receipts as being on income or capital account where the units that have been issued do not all have equal rights to receive the income and capital of the trust;
5. power to appoint a beneficiary's interest in the income or capital of the trust to another beneficiary;
6. power to settle or appoint any part of the corpus of the trust to a new trust with different beneficiaries; and
7. power to enforce the forfeiture or cancellation of partly paid units due to the non-payment of a call except where such partly paid units would be void *ab initio*.

Satisfaction of the 'savings rule' in subsection 272-5(2)

Under subsection 272-5(2) of Schedule 2F of the ITAA 36, there is a 'savings rule' provision, which states that the mere fact that a trustee has a power to redeem units in a unit trust, or issue further units, does not mean that unit holders' interests in the income or capital of the unit trust are defeasible, provided that the requirements of subsection 272-5(2) are satisfied.

PCG 2016/16 lists a series of situations where the savings rule has application.[120] Overall, the rule applies where further units are issued, or existing units redeemed, for a price based on a market value of the assets and liabilities of the relevant trust.

[118] PCG 2016/16 at paragraph 15.
[119] PCG 2016/16 at paragraph 16.
[120] PCG 2016/16 at paragraphs 18 to 22.

Safe harbour

PCG 2016/16 also outlines a safe harbour.[121] If the safe harbour applies, the trustee of a trust is allowed to manage the trust's tax affairs as if the Commissioner had exercised the discretion to treat the beneficiaries as having fixed entitlements to the income and capital of the trust.

Attachment B to PCG 2016/16 outlines the conditions that must be satisfied to qualify for access to a safe harbour. Those conditions differ depending upon how the relevant trust is categorised. Attachment B outlines six categories of trusts:

1. listed trusts;
2. registered managed investment schemes that are trusts;
3. certain widely held trusts that satisfy licensing requirements;
4. unregistered managed investment schemes that satisfy licensing requirements;
5. specific singles interest holder trusts; and
6. other trusts.

Whilst PCG 2016 addresses a range of different trust structures as outlined above, most SME and private business taxpayers will be interested in the sixth safe harbour provided in Attachment B. To satisfy the conditions applicable to this category of "*other trusts*":

1. the trust must have a trust instrument;
2. all beneficial interests in the income and capital of the trust are vested;
3. all beneficial interests have the same rights to receive the income and capital of the trust;
4. all beneficial interests in the income and capital of the trust can be expressed as a percentage of the total income and capital of the trust;
5. the trust is not a discretionary trust or a trust with default income or capital beneficiaries;
6. a trustee or manager has never exercised a power capable of defeating a beneficiary's interest to defeat a beneficiary's interest in the income or capital of the trust, and
7. an arrangement has not been entered which would result in section 272-35 of Schedule 2F of the ITAA 36 having application, in the trafficking of the tax benefit of a tax loss, bad debt deduction or debt/equity swap deduction, or in fraud or evasion.

Importantly, PCG 2016/16 states that a safe harbour only has application during the period in which the conditions are satisfied. Therefore, if a taxpayer requires certainty in relation to the fixed entitlement issue for a future time, it will still need to seek the exercise of the Commissioner's discretion through a private ruling application. The requirement to have a fixed entitlement before, during and immediately after an exchange of units under a scrip-for-scrip roll-over under Subdivision 124-M of the ITAA 97 is provided as an example of a situation where a taxpayer requires certainty at a future time (the "*immediately after*" requirement) and therefore could not use the safe harbour approach.

[121] PCG 2016/16 at paragraph3 23 to 24 and Attachment B.

Commissioner's discretion to treat an interest as fixed entitlement

PCG 2016/16 asserts that where the beneficiaries' interests in the trust are not fixed entitlements, and the trust does not satisfy the requirements for a 'safe harbour', the trustee may request that the Commissioner exercise his discretion to treat beneficiaries' interests as being vested and indefeasible.

PCG 2016/16 contains a list of factors which are favourable to the exercise of the discretion.[122] The list includes circumstances where all beneficiaries have equal rights to receive the income and capital of the trust, and unanimous approval by all beneficiaries are required to amend a trust instrument.

The list of factors adverse to the exercise of the Commissioner's discretion include:

1. a trustee or manager exercises a power to defeat beneficiaries' interests in the income or capital of the trust;
2. there are significantly different beneficiaries of the trust in an income year for which an entity seeks to have a fixed entitlement, than the beneficiaries of the trust in the income year(s) in which the trust made a tax loss, or incurred a bad debt deduction or debt/equity swap deduction;
3. an arrangement has been entered which would result in section 272-35 of Schedule 2F of the ITAA 36 having application, in the trafficking of the tax benefit of a tax loss, bad debt deduction or debt/equity swap deduction, or in fraud or evasion.

The application of PCG 2016/16 is complex and professional assistance is essential to ensure that the taxpayer's circumstances can benefit from the savings rule and / or safe harbour, or whether the Commissioner's discretion should be requested.

[122] PCG 2016/16 at Attachment C.

8. Entities with losses and extended family ownership

Changes to the FTE regime have highlighted issues that may arise for family groups with multiple trust structures. In particular, the inability to nominate a deceased person as the test individual for an FTE[123] is a potential limitation to the future flexibility of family groups as the business continues to grow and evolve and where the family may wish to establish new trusts and include those trusts within an existing family group.

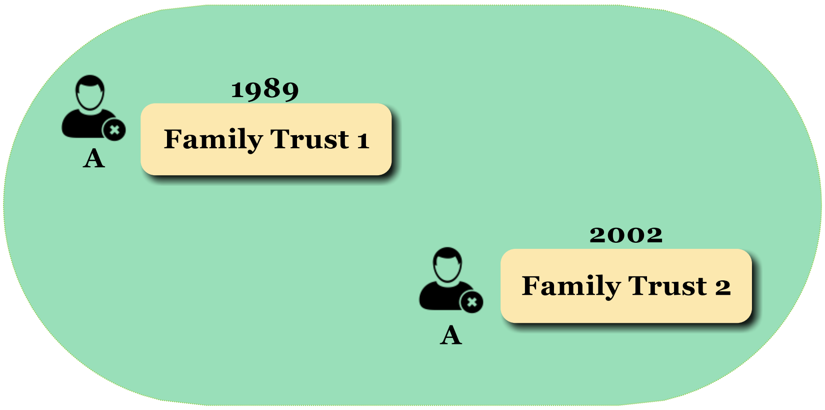
The FTE regime presents challenges for succession planning where a family group comprises multiple trusts and the test individual for the relevant FTE dies. These challenges include:

1. elections are generally irrevocable;
2. it is difficult to change the test individual for the purpose of the family group;
3. revocations and variations that are allowed are generally restricted to a four-year window consistent with the policy intent of only permitting rectification of mistakes rather than introducing a level of flexibility;
4. death is not a trigger for allowing the change of a test individual;
5. it is not possible to choose a deceased person as the test individual for an FTE;[124] and
6. each trust may only make one FTE.[125]

8.1 Potential solution using IEEs

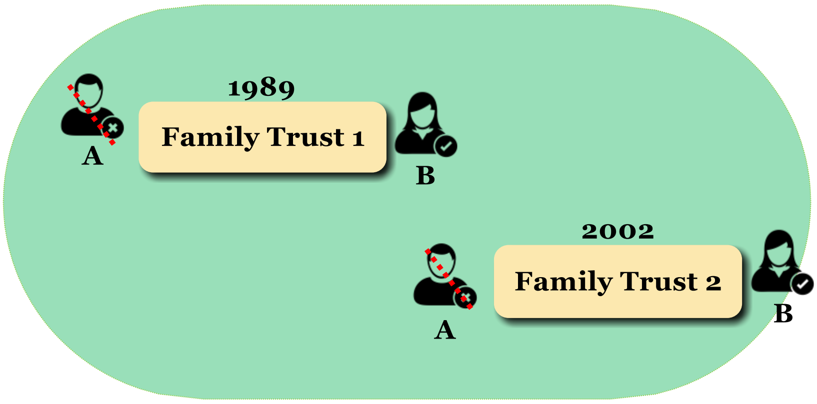
Consider the scenario where a family operates two trusts:

1. Family Trust 1 settled in 1989 with Individual A chosen as the test individual; and
2. Family Trust 2 was settled in 2002 with Individual A chosen as the test individual.

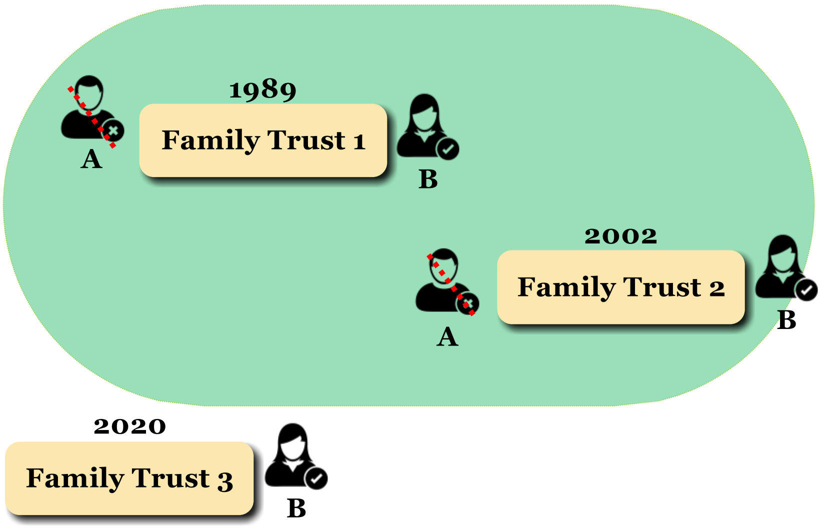


[123] Refer to subsection 272-80(3) of Schedule 2F of the ITAA 36 and ATO Interpretative Decision ATO ID 2014/3.
[124] Refer to subsection 272-80(3) of Schedule 2F of the ITAA 36 and ATO Interpretative Decision ATO ID 2014/3.
[125] Subsection 272-80(11) of Schedule 2F of the ITAA 36.

Individual A then dies leaving his daughter (Individual B) in control of the group.

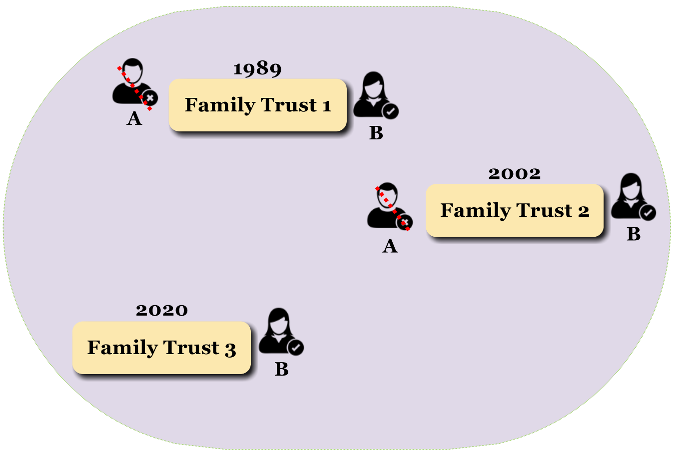


In 2020 Individual B decides to establish a new business (which could be related to the existing business). The business will be conducted through a new discretionary trust – Family Trust 3. As the new business is likely to make tax losses in its first years of operation and the activities of Family Trust 1 and Family Trust 2 are likely to be profitable, Individual B wishes to include Family Trust 3 within the same family group as Family Trust 1 and Family Trust 2.



As Individual A has died it is no longer possible to make an FTE nominating Individual A as the test individual. Further, it is not possible to elect Individual B as the test individual for Family Trust 1 and Family Trust 2 unless those FTEs were made within the past four years.

If Individual B had been chosen as the test individual for the FTEs at the outset, then simply electing Individual B as the test individual for an FTE for Family Trust 3 would have automatically included Family Trust 3 within the family group comprising Family Trust 1 and Family Trust 2.

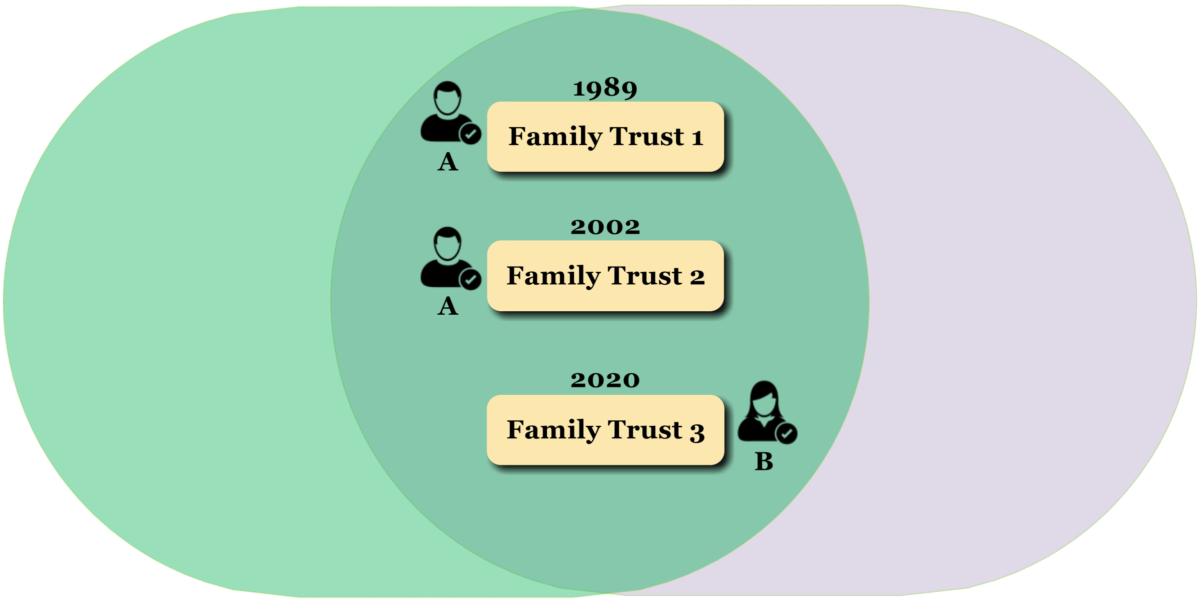


8.2 IEEs

It may still be possible to include Family Trust 3 within the family group of Family Trust 1 and Family Trust 2 by making an IEE.

Subsection 272-85(1) of Schedule 2F of the ITAA 36 allows the trustee of a trust to make an election to be included within the family group of an individual specified in the FTE of a particular trust. Further, the restriction in subsection 272-85(7) of Schedule 2F of the ITAA 36 on the making of multiple elections does not apply where the individual specified in each of the FTEs to which the trust is making the IEE is the same.

Therefore, Individual B could ensure that the trustee of Family Trust 3 makes an IEE to be included within the family group of each of Family Trust 1 and Family Trust 2 even though it may have otherwise made its own FTE nominating Individual B as the test individual. Similarly, the trustees of Family Trust 1 and Family Trust 2 will need to make IEEs in respect of Family Trust 3.



This issue was addressed in [ATO Interpretative Decision ATO ID 2005/174][126] (now withdrawn) in which the Commissioner confirmed that a trustee of a trust which had made a FTE (Trust 1) could make an IEE that enabled Trust 1 to be included in the family group of another trust (Trust 2) that had a different test individual to the individual elected in the FTE for Trust 1. This was possible as the test individuals were brothers, resulting in the family control test being passed in relation to Trust 1 and Trust 2. The ATO withdrew ATO ID 2005/174 on 19 March 2010 but only on the basis that it is "*a straight application of the law and does not contain an interpretative decision*"[127].

There are several critical issues to be considered and addressed prior to adopting this course of action.

1. It is critical that any IEEs that are redundant as a result of the recent amendments are revoked as they will by necessity nominate the same test individual that is already in the FTE therefore not

[126] See also Monahan, J. A Matter of Trusts: Trust elections – different primary individuals, *Taxation In Australia,* Vol 40, No.3 p.150.

[127] ATO Interpretative Decision ID 2005/174 (Withdrawn).

allowing an IEE in respect of a different test individual due to the restrictions on multiple elections described above.

2. It is essential that the family control test[128] is carefully considered as the making of FTEs and IEEs is only possible if the family control test has been satisfied.

3. Families need to be acutely aware of which family members and related entities are within the family groups of both any applicable FTEs and IEEs. A distribution outside of the family group of either one will result in a FTDT liability (see above).

[128] Passing the family control test has the meaning given by section 272-87 of Schedule 2F of the ITAA 36.

9. Death, relationship breakdowns, or business sales

This paper has already discussed aspects of Schedule 2F as it applies to death, relationship breakdowns, or business sales. We provide a summary of those points with some further observations below.

9.1 Death and deceased estates

FTEs, IEE, death, and deceased estates:

1. the death of the test individual does not terminate the FTE;
2. death is not a trigger for allowing the change of a test individual; [129]
3. a person does not cease to a 'family' member **merely** because of the death of any other family member; [130]
4. the family group, but not the family, includes a person who was the spouse of the test individual or of a member of the test individual's 'family' immediately before the death of the test individual or member of the test individual's 'family', and is now the spouse of a person who is not a member of the test individual's 'family'; [131]
5. if the test individual and <u>all</u> the members of their 'family' are deceased, the deceased estates of the test individual and the members of the test individual's 'family' are members of the test individual's family group;[132]
6. subsection 269-95(2) of Schedule 2F of the ITAA 36 details circumstances in which a change in control due to death will not breach the control test for trust losses;
7. it is not possible to choose a deceased person as the test individual for an FTE;[133] and
8. the death of test individual does not prevent any other trust, company, or partnership from making an IEE to be included in the test individual's family group.[134]

Difficulties can arise where (say) a deceased estate receives a distribution from a trust that made an FTE with a deceased as the test individual, or the deceased estate wants to pass on the benefit of franking credits. This will require the executors of the deceased estate to consider whether they can (or should) make an IEE with respect to the family trust or an FTE with an individual other than the deceased.

129 See section 272-80 of Schedule 2F to the ITAA 36.

130 See subsection 272-95(2) of Schedule 2F to the ITAA 36. Note, the word 'merely'. Other factors may cause the person not to be a member of the family (see private ruling 1051629761894).

131 See subsection 272-90(2A) of Schedule 2F to the ITAA 36.

132 See subsection 272-90(9) of Schedule 2F to the ITAA 36.

133 See subsection 272-90(9) of Schedule 2F to the ITAA 36.

134 See ATO Interpretative Decision ATO ID 2008/73 and subsection 272-80(11) of Schedule 2F to the ITAA 36.

A common strategy, particularly when the test individual is elderly is, before death, establish several ‘dormant’ discretionary trusts and make the FTEs with the test individual. This allows these trusts to acquire assets post-death and be part of the family group of the (now) deceased.

What if a person’s spouse dies and does not remarry, or remarries and divorces, is the person a member of the family or family group of the deceased spouse? The answer is not clear.

9.2 Relationship breakdowns

FTEs, IEE, and relationship breakdowns:

1. the family group, but not the family, includes a person who was a spouse of either the test individual or of a member of the test individual’s ‘family’ before a “*breakdown in the marriage or relationship*”;[135]

2. the family group, but not the family, includes a person who was a child of the spouse of either the test individual or of a member of the test individual’s ‘family’ before a “*breakdown in the marriage or relationship*” of the test individual or the member of the test individual’s ‘family’; [136]

3. section 272-140 of Schedule 2F of the ITAA 36 defines “breakdown in the marriage or relationship of an individual” as, “*if the individual is living with another individual on a genuine domestic basis in a relationship as a couple (whether the individuals are the same sex or different sexes and whether legally married or not) and ceases to do so*”;

4. subsection 269-95(2) of Schedule 2F of the ITAA 36 details circumstances in which a change in control due relationship breakdown will not breach the control test for trust losses; and

5. there are some circumstances in which the test individual may be varied relating to marriage breakdown. These provisions are not limited in time (as the general variation power referred to above) and do not contain qualifying restrictions regarding there being no distributions outside of the family group. The provisions only require that because of an order, agreement or award of the kind mentioned in the CGT marriage breakdown provisions the new individuals and members of the new individual’s family have control of the trust.[137]

Although an individual does not cease to be a member of the family group because of a relationship breakdown, there may still be issues in distributing to certain members of the spouse’s ‘new’ family.

The former spouse, and a child of the former spouse, of the test individual would be included in the family group of the test individual. However, if the former spouse remarries, any children, siblings, etc of the new spouse would not form part of the family or family group of the test individual.

If trust makes an FTE with (say) a husband as the test individual and the couple divorce, and the wife remarries but controls that trust post-divorce, a variation of the FTE can be critical.

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[135] See subsection 272-90(2A) of Schedule 2F to the ITAA 36.

[136] See subsection 272-90(2A) of Schedule 2F to the ITAA 36.

[137] Refer subsection 272-80(5C) of Schedule 2F and section 95D of the ITAA 36 and subsections 126-5(1)(a) to (f) of the ITAA 97.

9.3 Business sales

The main issue that can arise with business sales is where a company or unit trust has made an IEE,[138] and the owner(s) of the shares or units in the company or trust wishes to sell those shares or units.

1. if the sale of the shares or units is for less than market value then it could be a distribution under section 272-60 of Schedule 2F of the ITAA 36 that would be liable for FTDT; and
2. even if the sale were for market value, for an outside purchaser, future distributions by the company or trust would be liable for FTDT for being a distribution outside the family group of the vendor.

For vendors, the second point means that purchasers will typically not buy the shares or units in a company of trust that has made an IEE.[139] This would necessitate a business sale, rather than an entity sale, and the loss of the CGT discount if the entity is a company.

The same applies for a partial sale of shares or units to an outsider.

The business could be transferred to a new company using a rollover then, post-rollover, shares sold, or new shares issued, in that company. Moving forward, when the company pays dividends, for the dividends paid to the member of the family group that originally owned the business, they need to ensure that there are not income injection issues under Division 260 of Scheule 2F of the ITAA 36.

[138] With a unit trust, the relevant election could also be an FTE.
[139] With a unit trust, the relevant election could also be an FTE.

10. When things go wrong

When liability for FTDT arises, the amount can be significant due to:

1. the liability arising by 'stealth' 21 days after a distribution many years earlier;
2. GIC being imposed 60 days later;
3. there being no amendment period; and
4. the complexity of many private groups, their distributions, and elections, means that if a liability for FTDT arises in one year, there may be liabilities in other years.

With respect to the last point, FTDT issues are often caused by:

1. making FTEs and, particularly, IEEs that did not need to be made (or not revoking in time); and
2. where an entity has made an FTE with one test individual and an IEE with respect to another test individual.

If an FTDT liability arises, then there is no 'one size fits all' strategy to deal with the problem. Complicating dealing with the problem is the Commissioner's general administrative power and the Commissioner's remedial power included in income tax, goods and services tax, and fringe benefits tax legislation to do not appear to apply to FTDT.

Instead, to deal with FTDT problems, there are several 'tools' that taxpayers can look to use depending on the circumstances. These include:

1. making retrospective FTEs or IEEs, although:
    1. can the requirements to make the election – family control test and pattern of distributions test – be met; and
    2. take care to ensure a retrospective election in one year does not create its own FTDT issues in later years;
2. can the FTE or IEEs be revoked or varied and, if so, does that create its own problems;
3. reviewing all existing FTEs and IEEs to ensure they were validly made, although saying an election was not validly made may create its own issues such as loss of franking credits or carry forward of losses;
4. review the trust deed to determine if the conferral or distribution was to a person that was not a beneficiary, that is it was an invalid distribution under the trust deed, and argue that the Commissioner's views (see above) on TD 2017/20 on section 272-60 of Schedule 2F of the ITAA 36 are incorrect, although:
    1. practically, you would have to go to court for the Commissioner to accept this argument; and
    2. if the distribution were invalid, what other tax consequences outside of FTDT would arise because of the invalidity;
5. request under section 271-90 of Schedule 2F of the ITAA 36 that the Commissioner issue a notice and object under Part IVC of the TAA 53 to that notice:

1. what if you are out of time to request, will the Commissioner issue and out-of-time notice; and

2. what does it mean by liability of a person or persons to FTDT and the due date for payment of the tax "*are not dependent on, or in any way affected by, the giving of a notice in respect of the amount*.";[140]

6. apply for remission of the GIC under the section 8AAG of the TAA 53; and

7. request that the Commissioner compromise the debt represented by the FTDT.[141]

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[140] See subsection 271-90(4) of Schedule 2F of the ITAA 26.

[141] There is not an express power under any of the taxation laws which empowers the Commissioner to compromise undisputed taxation debts. Section 8 of the ITAA 36 and equivalent provisions in other tax statutes confer upon the Commissioner responsibility for the general administration of the relevant legislation. However, *the Family Trust Distribution Tax (Primary Liability) Act 1998* does not incorporate section 8. Sections 44 and 47 of *the Financial Management and Accountability Act 1997* (Cth) impliedly invest in the Commissioner a power to enter into an agreement that includes an undertaking not to pursue part of a tax debt owing to the Commonwealth, as part of a financially prudent bargain. Similarly, section 15 of the *Public Governance, Performance and Accountability Act 2013* (Cth) invests in the Commissioner a power to enter into an agreement that includes an undertaking not to pursue part of a taxation debt owing to the Commonwealth, as part of a financially prudent bargain.

11. Conclusion

FTEs and IEES are often made with an eye to the taxation benefits they can provide.

While the taxpayer may think making an election puts them on a ‘stairway to heaven’, if wrong elections are made, the wrong test individual chosen, or not being aware of who is, or is not, in the family group, then, in many cases the election could prove to be a ‘highway to hell’.

Look before you leap.

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