Understanding Trust Losses

Carlo Di Loreto

Tuesday, 13 May 2025

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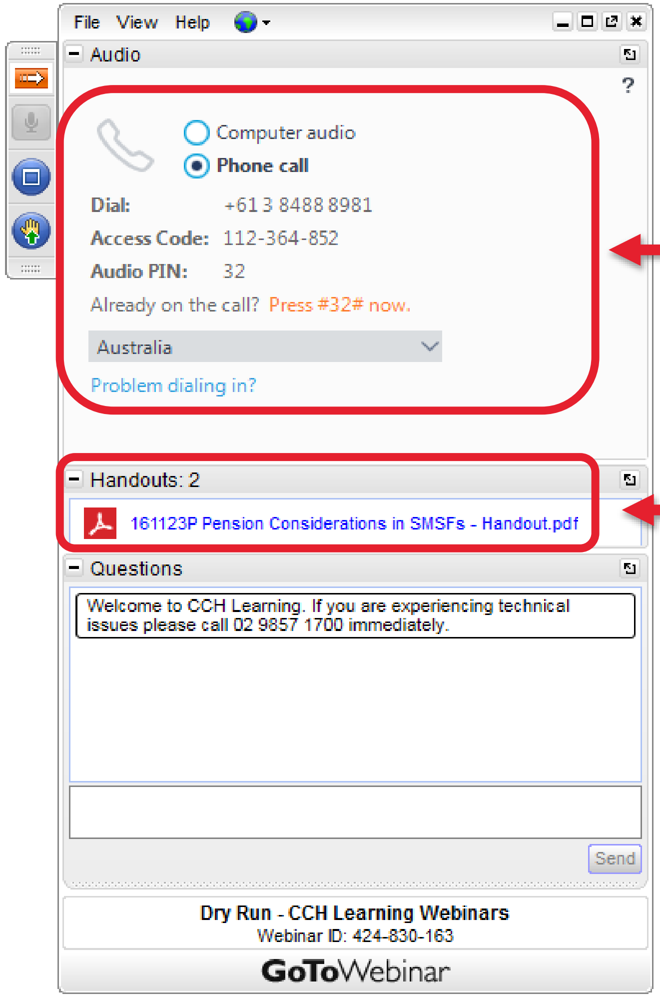

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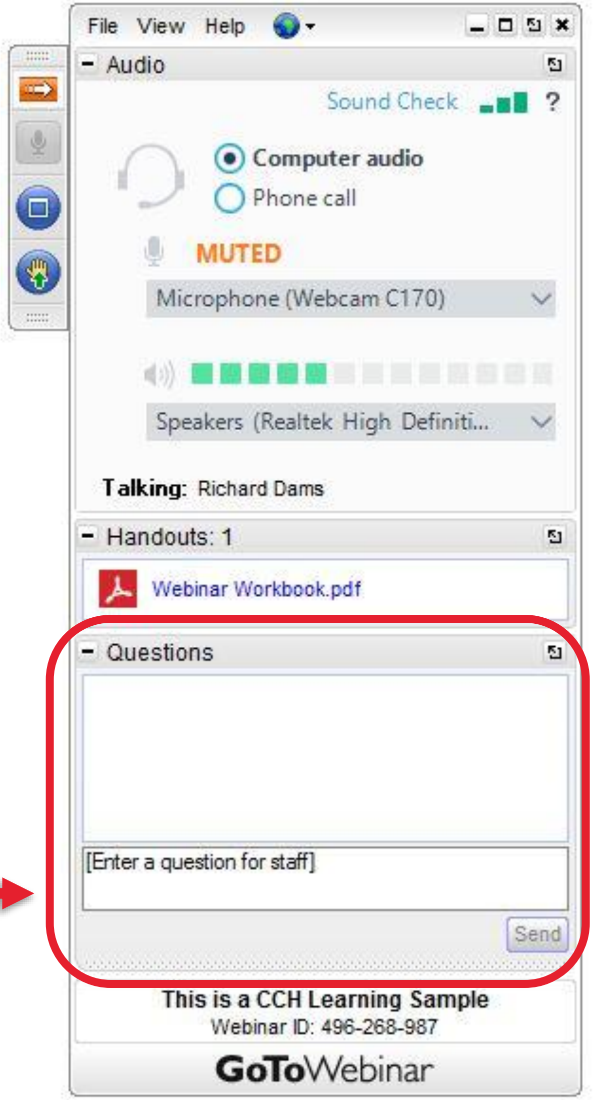

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Your Presenter

Carlo Di Loreto

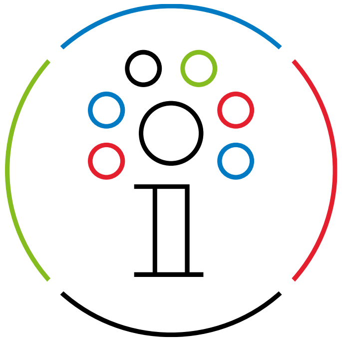
Partner - Tax Advisory

Crowe Australasia, an affiliate of Findex

Today’s session will cover

Overview

- the rules for ‘testing’ whether a trust can use a prior year tax loss are complex and they can be difficult to apply in practice
- the complexity stems from number of factors, but typically the rules involve applying a combination of various tests set-out in the legislative provisions
- the combination can differ, depending on the type of trust being tested, so this session will cover the following:
  - the trust loss rules
  - family trust & interposed entity elections
  - variation & revocation of elections
  - distribution of franking credits to beneficiaries
  - trustee beneficiary reporting rules



Overview of trust loss provisions

Types of trusts

- the trust loss provisions [Sch 2F ITAA 1936] divides trusts into 3 categories as follows:
  - fixed trusts [s 272-65];
  - non-fixed trusts [s 272-70]; and
  - excepted trusts [s 272-100] .

Types of trusts – fixed trusts

- exist where persons have fixed entitlements to all of income & capital of trust
- ‘fixed entitlement’ means ‘vested & indefeasible’:
  - present right, such as by ownership; and
  - cannot be defeated
- for unlisted trusts - requires units to be issued or redeemed at price determined on basis of net asset value according to Australian accounting principles
- most unlisted unit trusts do not meet this requirement
- unit trusts with any discretionary income / capital entitlements are not fixed trusts

Types of trusts – non fixed trusts

- a non-fixed trust is a trust which is not a fixed trust, for example:
  - discretionary trust
  - unit trust with special income units issued, or the potential to issue or redeem units at nominal value

Types of trusts – excepted trusts

- there are a number of types of excepted trusts defined in the legislation:
  - family trusts
  - complying superannuation funds
  - complying approved deposit funds
  - pooled superannuation trusts
  - deceased estates
  - fixed unit trusts held by exempt bodies
- Excepted trusts are exempt from Trust Loss rules – apart from family trusts
- Family Trusts are subject to the Income Injection Test

Trust losses - overview

- trusts may only deduct current & prior year tax losses & certain debt deductions in limited circumstances
- restrictions contained in Sch 2F ITAA 1936 & apply to:
  - tax losses [s 272-140]
  - debt deductions [bad debt & debt/equity swaps]
- tests must be satisfied during 'test period' - generally beginning of loss year to end of income year
- Sch 2F does not apply to capital losses

Tests a trust must pass to deduct a loss

- five different tests:
  - income injection test [s 270-5 to s 270-25];
  - 50% stake test [s 269-50 to s 269-55];
  - pattern of distribution test [s 269-60 – s 269-85];
  - control test [s 269-95];
  - business continuity test [s 296-100];
- different tests apply depending on type of trust
- ensure trust is correctly classified

Tests to pass

- The different tests must be satisfied by each trust:

Type of Trust	Income Injection Test	50% Stake Test	Pattern of Distributions Test	Control Test	Business Continuity Test
1. Fixed trust other than widely held unit trust	✓	✓ (1)			
2. Unlisted widely held trust	✓	✓			
3. Listed widely held trust	✓	✓			✓ (2)
4. Unlisted very widely held trust	✓	✓			
5. Wholesale widely held trust	✓	✓			
6. Non-fixed trust	✓	✓	✓ (3)	✓	
7. Family Trust	✓ (4)				
8. Excepted trust other than a family trust					

(1) An alternative test is also available in certain cases where non-fixed trusts directly or indirectly hold fixed entitlements in the fixed trust.
(2) This test can be applied if the 50% stake test is failed by a listed widely held trust.
(3) This test does not apply for current year loss purposes.
(4) This test does not apply where entities and individuals within a family group inject income into a family trust with losses.

Trust tests summary

- trusts 1 to 5 are fixed trusts - to obtain deductions for current & prior year losses need to satisfy tests as noted
- discretionary trusts are non-fixed – so need to satisfy all 4 tests to obtain deduction for prior & current year losses
- where FTE made - need to satisfy income injection test
- other excepted trusts are not affected by the provisions

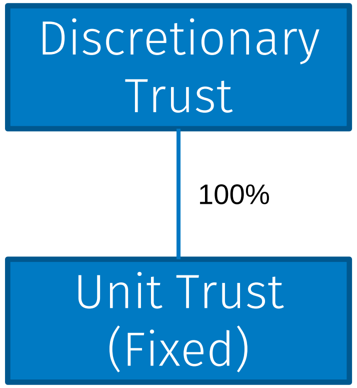
Fixed trusts (not widely held) - tests to be satisfied

50% Stake Test

- at all times during test period:
  - same individuals must have fixed entitlements > 50% of income of the trust; and
  - same individuals must have fixed entitlements > 50% of capital of the trust;
- 'look through' interposed entities to ultimate individuals
- where test failed, income year is split into two parts that are treated as separate income periods (tax loss from first part not deductible against income of second part)

Fixed trusts (not widely held) - alternative test

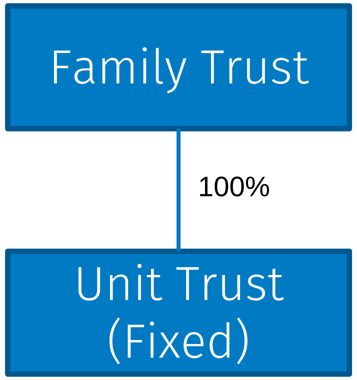
- 50% stake test cannot be passed where > 50% of entitlements held (including indirectly) by non-fixed trusts:



- alternative test available
- for each non-fixed trust entitlement holder:
  - hypothesise that non-fixed trust seeking to deduct a tax loss
  - notionally apply tests for non-fixed trust
  - each non-fixed trust entitlement holder must pass all of notionally applied tests

Fixed trust owned by family trust - deemed individual

- where family trust (FTE made) has direct/indirect fixed entitlement in an entity - deemed to hold fixed entitlement as individual for own benefit, for example:



- the unit trust can pass the 50% stake test
- the alternative test does not apply

Non-fixed trusts - tests to be satisfied

50% Stake Test

- only applies where > 50% of entitlements to income or capital are fixed
- will not apply to typical discretionary trust

Control Test

- a 'group' must not begin to control the trust during test period
- 'group' is broadly a person & associates, acting together or alone

Non-fixed trusts - tests to be satisfied

Control Test

- the control may change if:
  - new trustee appointed
  - there is a change in appointor
  - group acquires > 50% stake in income or capital
  - trustee accustomed to act in accordance with a new group
  - a group gains control of a trust under a scheme

Non-fixed trusts - tests to be satisfied

Control Test

- no change in control if person resigns directorship of corporate trustee but continues to control by other means [ATO ID 2005/276]
- death of a person will not cause test to be failed, provided does not trigger materialisation of a new group that begins to control the trust [ATO ID 2007/59]
- where test failed, income year similarly split into two parts

Non-fixed trusts - tests to be satisfied

Pattern of Distributions Test (POD)

- only required to be considered where trust has distributed income or capital:
  - within 2 months of the end of the income year (when losses are recouped); and
  - in at least one of the 6 earlier income years
- if the trust incurred tax losses or made no distributions in all 6 years prior to the income year, test does not apply
- only applies when seeking to deduct a prior year tax loss (not applicable to current year deductions)

Non-fixed trusts - tests to be satisfied

Pattern of Distributions Test

- a trust passes the POD test if it distributed more than 50% of:
  - all ‘test year’ distributions of income to same individuals; and
  - all ‘test year’ distributions of capital to same individuals (who need not be same as those above)
- ‘test year’ distributions typically comprise income distributions made in the:
  - income year (after recoupment of losses); and
  - year before loss year (noting wide definition of distributions that may also be made during intervening years)

Non-fixed trusts - tests to be satisfied

Pattern of Distributions Test

- percentage distributed for any particular beneficiary is lowest percentage of any test year distribution
- ‘look through’ interposed entities to ultimate natural people
- CGT small business relief retirement & 15-year exemptions require a significant individual [at least 20% distribution] - may cause a conflict with desire to pass POD test
- anti-avoidance measures - ensure arrangements entered into to pass POD test result in failure

Pattern of distributions test - example

- compare lowest percentage distributions:

Year	Net income	Distributed to
2021	$100,000	Bill - $80,000 (80%) Erica - $20,000 (20%)
2022	($40,000)	N/A
2023	($30,000)	N/A
2024	$110,000 (70,000) $40,000	Bill - $10,000 (25%) Erica - $30,000 (75%)

	2021	2024
Bill	25% (deemed)	25%
Erica	20%	20% (deemed)
POD Result	45%	45%

- the result is that the test is failed.

Fixed and non-fixed trusts - losses denied permanently

- where any of following tests are failed:
  - 50% stake test
  - control test
  - POD test
- losses or deductions are permanently denied

Schemes to take advantage of deductions

Income Injection Test

- applies to all types of trusts, apart from excepted trusts
- for family trusts – only income injection test applies in modified form
- if trust involved in income injection scheme to take advantage of losses & deductions - may be prevented from doing so under income injection test
- if test failed, no deduction allowable in income year against the scheme assessable income - denied losses & deductions still be available for future years

Income injection test - when applied

- trust has a deduction (including a prior year loss)
- there is a scheme:
  - trust derives assessable income
  - outsider to trust provides a benefit to trust/beneficiary [benefit can include the injected income]
  - trustee/beneficiary provides a return benefit to the outsider or an associate [return benefit can include the deduction]
- reasonable to conclude assessable income derived wholly or partly, but not merely incidentally, because of deduction

Income injection test - issues of note

- ‘scheme’ has same meaning Part IVA ITAA 1936
- scheme defined broadly to include most arrangements & can include a single transaction
- benefit defined broadly to include rights, property & services, provided directly or indirectly
- ‘injected’ income can include:
  - trust distribution
  - management fees
  - interest

Income injection test - outsider

- outsider to a trust is a person other than:
    - trustee of the trust
    - beneficiary with fixed entitlement to income or capital of trust
- beneficiary of a discretionary trust is an outsider

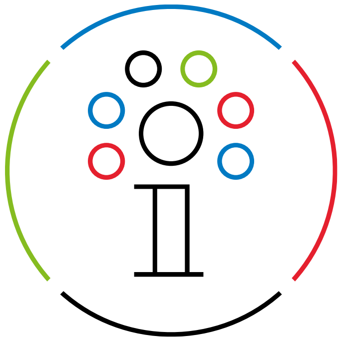
Income injection test - family trusts

- only test applicable to family trusts
- modified definition of 'outsider' is a person other than:
  - trustee
  - person with fixed entitlement
  - TI & members of TI's family
  - family trust with same TI
  - an entity that has made an IEE
  - an entity wholly owned by TI, his/her family & other family trusts with same TI

Poll Question 1

A unit trust will be a non-fixed trust under the Trust Loss rules if:

a) Income units have been issued
b) Units can be issued for nominal value
c) Units can be redeemed for nominal value
d) All of the above
e) None of the above



Family trust & interposed entity elections

Family trusts & family trust elections

- family trust [s 272-75] - where trustee has made a family trust election (FTE)
- any distributions outside family group assessed at highest marginal rate of tax for individuals plus Medicare levy - family trust distribution tax
- can be a fixed trust or a non-fixed trust
- election must specify an individual (the ‘test individual’ [s 272-80(3)]) & must pass family control test [s 272-80(4)]

Relevance of FTE's & IEE's

- deducting tax losses
- ability to use imputation credits
- company losses

Family control test

- a trust cannot make an FTE unless it satisfies family control test (FCT) under s 272-87
- FCT satisfied if trust is controlled by a controlling group consisting of the following:
  - the ‘test individual’ (TI) and/or one or more members of TI's family; or
  - the above people & a financial or legal adviser to family; or
  - the trustees of one or more family trusts with same TI, or such trustees & any of the persons listed in the first point

Family trust election - family group

- family group defined ‘in relation to’ a distribution by a trust [it is specific to a particular trust]
- where family trust makes distribution to someone who is not a member of the family group, family trust distributions tax is triggered
- definition of ‘family group’ contains following categories:

Family group - the TI's family

- The family group [s 272-90] comprises:
  - the TI's family [s 272-95]
    - (a) the TI
    - (b) parent, grandparent or sibling of the TI or the TI's spouse
    - (c) nephew/niece or child of the TI or the TI's spouse
      - any lineal descendant of the above nephew/niece or child
      - the spouse of anyone in (a) – (c) above
  - spouse includes de-facto spouse

Family group - the TI's family

Note:

- the provisions stipulate that certain people continue as family members:
  - a person does not cease to be a family member merely because of the death of another family member
  - an adopted/step/ex-nuptial child is taken to be a lineal descendant

Family group - certain former family members

- the definition of family group contains a category of ‘certain former family members’ [s 272-90(2A)] including:
  - ex-spouse of TI or a member of TI's family due to marriage breakdown
  - widow/widower of TI or member of TI's family now spouse of someone else who is not a member of TI's family
  - a step-child of TI or a member of TI's family before a marriage breakdown

Family group - family trust with same TI

- a family group category includes a ‘trust with same test individual’ [s 272-90(3A)]
- result is that the above family trusts are automatically members of each other's family group
- this means that no interposed entity elections (IEE’s) required

Family group - exclusions

- family group exclusions:
  - relatives of TI's ex-spouse (ex-spouse remains in family group)
  - uncles/aunts
  - cousins
  - great-grandparents

Interposed entity election (IEE)

- a company, trust or partnership can make IEE [s 272-85] to be included in TI's family group in relation to a family trust
- an IEE generally relevant where members of family group plus other family trusts with same TI do not have fixed entitlements to all income & capital of entity
- if those people/entities have fixed entitlements – entity automatically part of family group & IEE not required

Interposed entity election

- an IEE can be made for an income year later than year in which FTE made
- an IEE can not be made if entity does not pass family control test
- multiple IEE's can be made but only in relation to family trusts with same TI [revoked IEE's ignored]
- where an entity that has made an IEE makes a distribution [including dividend, partnership distribution] to someone who is not a member of the family group, family trust distribution tax triggered

Family trust distribution tax [Sch 2F 271-5 – 271-105]

- levied at highest marginal rate of tax for individuals plus Medicare levy [currently 47%]
- applies if an entity has made an FTE or IEE
- entity makes a distribution outside family group
- if distribution made by a family trust:
  - liability to FTDT is on trustee
  - if trustee is a company, liability imposed on the directors

Variation & revocation of elections

Family trust election - variation & revocation

- an FTE election can be varied or revoked but only if certain conditions are satisfied
- under s 272-80(5A) - trustee of family trust can vary an FTE so that different individual becomes TI (‘new TI’)

Family trust election - variation

- following conditions must be satisfied [s 272-80(5A)]:
  - new TI must have been a member of original TI's family when FTE came into force
  - any conferrals of present entitlement to, or distributions of, income or capital by family trust or entity that has made IEE during period in which FTE has been in force were made to:
    - new TI; or
    - persons who would have been members of new TI's family group at time of conferral/distribution

Family trust election - variation

- variation can only be made once & ability to nominate new TI intended for where wrong person chosen as TI [s 272-80(5B)]
- but family trust effectively must have acted in the past as if proposed new TI had always been TI from beginning [new TI must have been alive at time FTE came into force]
- variation to nominate new TI can also be made where control of trust changes due to family law obligation arising from a marriage breakdown [conferral/distribution & once-only limitations do not apply]

Family trust election - revocation

- trustee of a family trust can revoke an FTE [s 272-80(6)]
- the FTE can not be revoked when:
  - the family trust, or another entity, has recouped tax losses while FTE was in force & family trust/another entity had to rely on FTE to recoup the tax loss [does not include capital loss]
  - the family trust/another entity has claimed a bad debt deduction & had to rely on FTE in order to claim it
  - family trust distributed a franked distribution & FTE relied upon for beneficiary to use franking credit

Family trust election - time limit to vary or revoke

- FTE can only be varied or revoked within specified time limit
- variation/revocation must be **for an income year that occurs before end of the 4th income year after income year specified in FTE** [s 272-80(6B)]

Example

- a trust made an FTE in its 2020/21 tax return
- the latest year in respect of which a variation/revocation can be made is 2024/25

Example

- a trust made an FTE in its 2016/17 tax return & its 2020/21 tax return has already been lodged
- a variation/revocation can not be made

Family trust election - how to vary or revoke

- variation/revocation must be made in tax return for income year from which it is to be effective [s 272-80(7)]
- if trust not required to lodge a return - variation/revocation must:
  - be in writing & in approved form;
  - specify income year in respect of which variation/revocation is to be effective; and
  - be given to Commissioner within 2 months of end of income year, or a later day as the Commissioner allows

Interposed entity elections - revocation

- entities that have made an IEE is one of categories within definition of family group
- an entity makes an IEE to become a member of family group of a TI in relation to an elected family trust
- IEE's can be revoked under certain circumstances
- IEE can be revoked if entity was, at commencement of election, or later became, a member of the family group [s 272-85(5A)]

Interposed entity elections - revocation

- but entity must have been, or become, a member of family group by one of two ways:
  - being wholly owned between TI, his/her family & family trusts with same TI; or
  - due to this category within the definition of family group, being another family trust with the same TI
- if a family trust revokes its FTE, an IEE made by an entity in relation to that family trust is automatically revoked at the same time [s 272-85(5B)]

Interposed entity elections - time limit to revoke

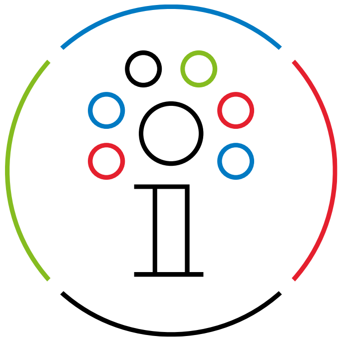
- IEE must be revoked within 4 years after year specified in IEE [s 275-85(5C)]
- alternatively, if entity becomes member of family group in a later year - revocation can be made within 4 income years after that later date
- a revocation must be made in tax return for income year from which it is to be effective
- if return not required - revocation must be given to Commissioner in writing within 2 months of year end in approved form, specifying year effective

Poll Question 2

Do the family members of an ex-spouse continue to be a member of the Family Group?

a) Yes

b) No



Distributions & franking credits

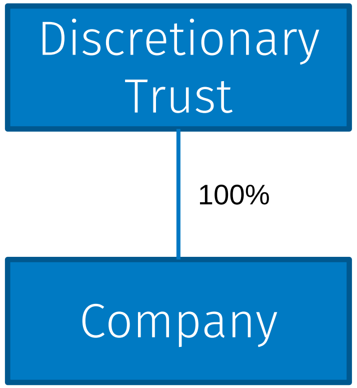
Distribution of franking credits to beneficiaries

- ’45-day holding period rule’ - cannot claim imputation credits in relation to franked dividends unless held the shares for at least 45 days [former s 160APHC & s 160APHU ITAA 1936]
- a modified version of the 45-day holding period applies to beneficiaries of a trust
- a beneficiary needs to be exposed to 30% of risks & opportunities of trust's shareholding before they can satisfy 45-day rule & claim imputation credits on dividends distributed to them

Distribution of franking credits to beneficiaries

- for beneficiary to be able to claim imputation credits - they need to have a fixed interest in corpus of trust before they can satisfy the 45-day rule
- however, beneficiaries of discretionary trust do not have fixed entitlement to corpus of trust
- means they cannot be exposed to at least 30% of risks & opportunities of trust's shareholding – means the 45-day holding rule cannot be satisfied

Example



Distribution of franking credits to beneficiaries

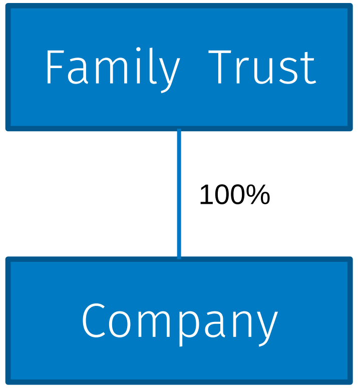
Rule

- generally - beneficiary of discretionary trust unable to claim imputation credits of dividends distributed by them by trustee of discretionary trust
- 2 exceptions to rule:
  - 45-day rule must only be satisfied to shares acquired on or after 31 December 1997
  - a beneficiary is entitled to claim imputation credits where they satisfy small shareholder exemption i.e. beneficiary's total imputation credits from all sources < $5,000

Distribution of franking credits to beneficiaries

- separate exception applies where shares owned by discretionary trust that has made a FTE
- means a beneficiary of a family trust:
  - will be entitled to claim imputation credits on dividends received by the trust
  - provided the trustee (and not the beneficiary) satisfies the 45-day holding rule

Example



Trustee beneficiary reporting rules

Trustee beneficiary reporting rules

- main purpose - to ensure trustees of closely held trusts advise Commissioner of certain information used to check that trustee beneficiary's (TB's):
  - assessable income includes correct share of trust's net income; and
  - net assets reflect receipt of the tax-preferred amounts.
- a trust is a 'closely held trust' where:
  - up to 20 individuals have between them, fixed entitlement to at lease 75% share of income or capital of the trust (known as 20/75 test); or
  - is a discretionary trust; and
  - it is not an excluded trust.

Trustee beneficiary reporting rules

- 'Excluded trusts' are:
  - complying superannuation funds, complying approved deposit funds & pooled superannuation trusts;
  - deceased estates up to end of income year in which 5th anniversary of death occurs;
  - fixed trust where income tax exempt bodies have fixed entitlements to all of income & capital of trust;
  - trusts covered by a FTE, or trusts wholly owned by members of family group or trusts that have made an IEE; or
  - unit trust whose units are listed on the ASX.

Trustee beneficiary reporting rules

- a trustee of a closely held trust must complete and lodge a correct TB statement for a year of income if:
  - a share of the net income of the closely held trust is included in the assessable income of a TB under s 97 ITAA 1936 & the share comprises or includes an untaxed part; or
  - the TB is presently entitled to a share of a tax-preferred amount of the closely held trust.
- a TB is a person (or a company) that is a beneficiary of a trust in its capacity as trustee of another trust
- in some instances - Commissioner may exempt trustee from the reporting requirements

Trustee beneficiary reporting rules

- the 'untaxed part' of a share of net income of a closely held trust is the net income of the closely held trust less any part of the share of net income that has been taxed:
  - where the TB who is a non-resident at year end has a share of net income attributable to Australian sources and the trustee has been assessed [s 98(4) ITAA 1936];
  - where the share is attributable to the net income of a part of another trust estate in respect of which, the trustee of the other trust estate is assessed [s 98(4) ITAA 1936];
  - the share is represented by an amount from which an entity was required to withhold an amount under these rules [Schedule 1, Subdivision 12-H of the TAA]; or
  - where the share is attributable to a part of the net income of another trust estate in respect of which the trustee of the other trust estate was liable to pay trustee beneficiary non-disclosure tax.
- the 'tax preferred amount' is income of the trust that is not included in its assessable income in working out its net income or capital of the trust

Trustee beneficiary reporting rules: Lodgment of TB Statements

- a correct TB statement is required to be lodged (generally with annual ITR) no later than the date by which the trust return is required to be lodged & must include:
- for resident TBs:
  - the name and TFN of each resident TB
  - the amount of the untaxed part of their share; and/or
  - the amount of their share of the tax-preferred amount.
- for non-resident TBs:
  - the name and address of each non-resident TB
  - the amount of the untaxed part of their share and/or
  - the amount of their share of the tax-preferred amount

Trustee beneficiary reporting rules: Non-disclosure tax

- trustee liable to pay 'Trustee Beneficiary Non-Disclosure Tax' (TBNT) at top marginal rate if they do not provide Commissioner correct TB statement when required
- if trustee has a TBNT liability, trustee must pay tax within 21 days of due date for lodgment of trust return, unless Commissioner allows further time
- if TBNT is outstanding for 60 days after due date for payment – GIC will be payable
- trustees of closely held trusts can sue trustee beneficiaries to recover the TBNT (and any GIC) paid by them where the TB has received the full distribution

ATO audit and reviews

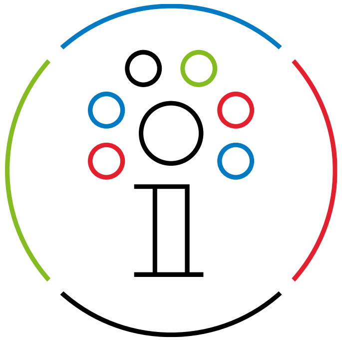
ATO audit approach to FTE and IEE

- ATO is cracking down on distributions made to beneficiaries outside the family group – unlimited amendment period allows ATO to go back to 1998 assessments
- ATO has assessed the trustees of some of Australia's wealthiest private groups for FTDT
- Arises during the conduct of Top 500 and Next 5,000 private groups performance program reviews
- Focus on tax risks associated with succession planning - all such reviews will contain questions regarding FTEs and IIEs
- FTDT assessments also have given rise to large interest charges levied on trustees

Note

- Once triggered, the Commissioner has no discretion to reduce or disregard the FTDT liability
- Fortunately – ATO adopts an administrative practice whereby they limit their review to 4 years unless there has been fraud or evasion

Key Takeaways from today's session

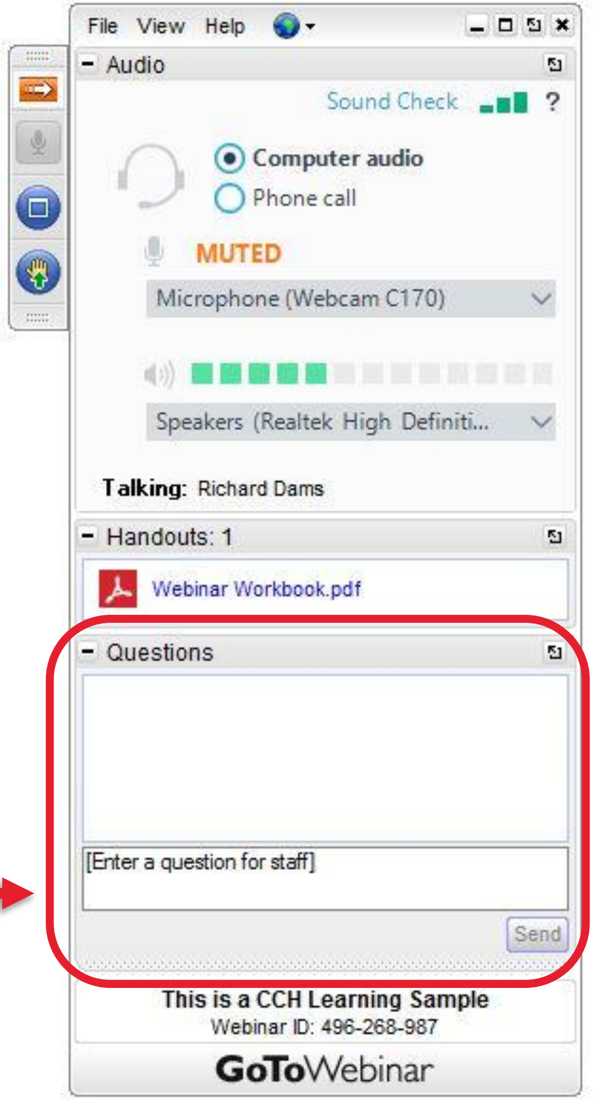


- Trust Loss rules apply differently, depending on the type of trust with losses
- Carefully categorise your trust
- Determine all necessary tests that apply
- Note that many unit trusts are non-fixed trusts
- FTEs and IIEs are a good way of accessing tax losses and franking credits
- FTE means that only the Income Injection Test needs to be considered
- FTDT of 47% can apply to distributions outside the family group where an FTE or IEE has been made – exercise caution with all distributions

Questions?

Alison Wood
CCH Learning Moderator

Type your question and click Send



Upcoming Webinars

- 14 May - Ethical Challenges in Managing Uncertain Tax Positions
- 15 May – Building a Highly Engaged Team
- 15 May – Aged Care Reforms 1 July 2025
- 20 May – Generational Difference in the Workplace – How to Understand and Leverage
- 21 May – Chat GPT for Client Communication
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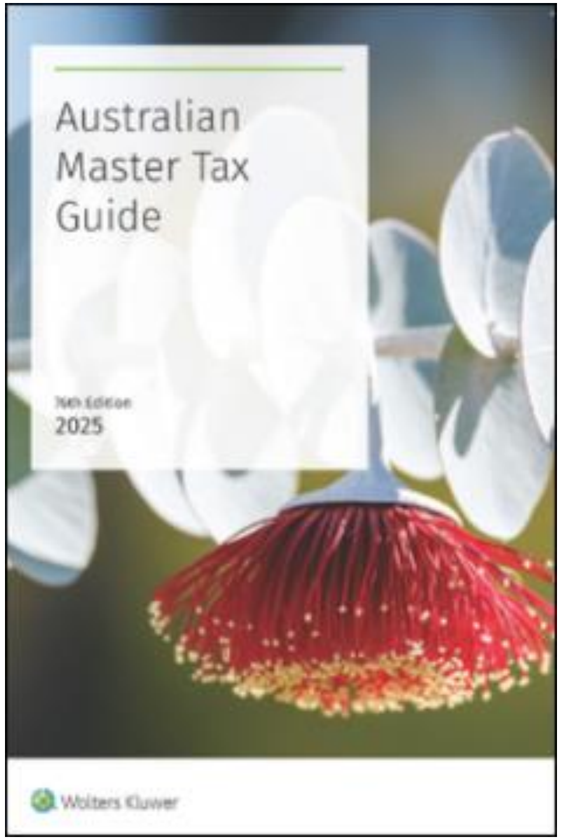

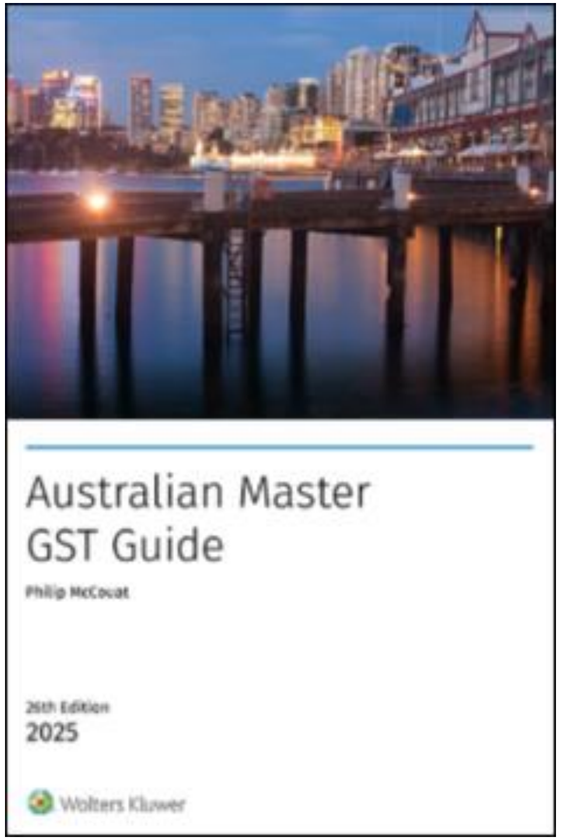

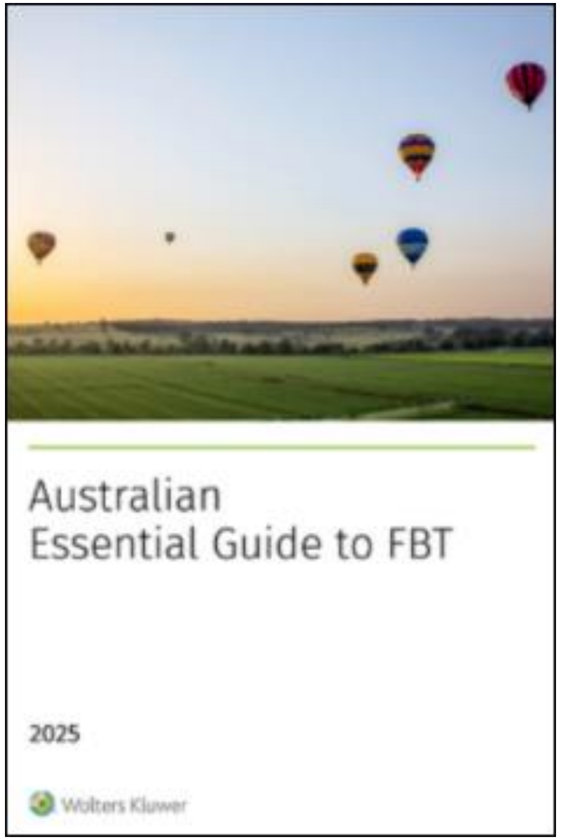

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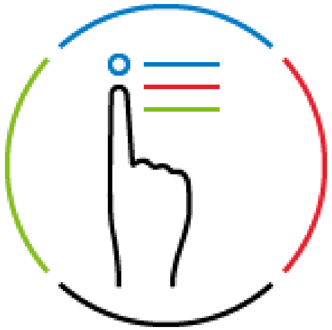

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