TRUST LOSSES

1.
CASE STUDY

CASE STUDY

- Steven Morgan, the trustee of The Johnson Investment operates a catering business. The trust also owns a number of investments. The business and investments were acquired with funds provided upon settlement of the Trust.
- Under the terms of the Trust, "income of the Trust" for a year of income is defined as income of the trust less expenses incurred in earning that income and less any income losses of prior years.
- Income and expenses for the current year are as follows:
  - Business income - $250,000
  - Dividends (franked to 100%) - $70,000
  - Business expenses – ($180,000)

CASE STUDY

- The Trust had also sustained net losses of $50,000 and $60,000 in the previous two income years, respectively. Prior to that, the Trust had always been in a net income position.
- On 14 July following the end of the CIY, Steven resolved to distribute 60% of the Trust's net income to Aaron, 30% to Barbara and the remaining 10% to Christine.
- The previous distribution of income had occurred three years previously, with 30% of the income being distributed to Aaron, 10% to Barbara and 20% to Christine. No beneficiary was presently entitled to the remaining 40%.
- The Trust has never made a capital distribution.

CASE STUDY

- The appointor (being Steven) may remove Steven as trustee under the Trust Deed. This power has featured in the Trust Deed since the Trust was first settled and has not been varied.
- There are no fixed entitlements under the Trust.
- Is The Johnson Investment Trust able to deduct the prior year losses against its net income in the CIY?

2.
BACKGROUND

BACKGROUND COMMENTS

- Division 6 ITAA 1936 deals with income generated from a trust
- No mentioned of trust losses
- Losses cannot be distributed out from the trust
- Must be carried forward and, subject to requirements being met, offset against future trust income

BACKGROUND COMMENTS

- Schedule 2F ITAA 1936
- Deals with:
  - Deductibility of loss in current year;
  - Deductibility of prior year losses;
  - Deductibility of bad debts
- Requirements differ depending on the type of trust

BACKGROUND COMMENTS

- Up to eight different types of trusts (although four of them relate to widely held trusts)
- Up to six different tests that are required for trust losses to be carried forward including:
  - Income injection test
  - Pattern of distribution test
  - Two different 50% stake tests
  - Control test
  - Same business test

DIFFERENT TYPE OF TRUSTS

- Four types of trusts to be discussed:
  - 'Ordinary fixed trust' – where beneficiaries have fixed entitlements to all the income and capital of the trust
  - Non-fixed trust – a trust which is not a fixed trust
  - Family trust – a trust that has made the election to be a family trust for the purposes of the trust loss measures
  - Excepted trust – a complying superannuation fund or approved deposit fund, certain deceased estates, and a few other particular trusts

TESTS TO ACCESS LOSSES

- Ordinary fixed trust:
  - 50% stake test; and
  - Income injection test
- Non-fixed trust:
  - Income injection test;
  - Pattern of distribution test (if applicable);
  - 50% stake test (income or capital tested separately) (if applicable; and
  - Control test
- Family trust – income injection test only
- Excepted trust (other than a family trust) - none

3.
THE TESTS

INCOME INJECTION TEST

- Relevant for majority of trusts
- Section 270-10 ITAA 1936
  - Trust must have an allowable deduction (prior-year losses can be included)
  - There is a 'scheme' where:
    - Trust derives income
    - An 'outsider' provides a benefit to the trust or beneficiary
    - The trustee (or beneficiary) must provide a benefit to the outsider
    - There is a connection between the deduction and one or more things occurring under the scheme
    - The scheme has occurred not merely incidentally

INCOME INJECTION TEST

- Whether the scheme is merely incidental will depend on the facts and circumstances surrounding the scheme
- Section 270-15 outlines the consequences of the income injection test
- In short, the test is targeting genuine ‘outsiders’ who are looking to take advantage of losses in the trust
- As such, the test doesn’t apply to ‘income injection schemes’ within a family group
- Please note section 270-25 outlines who an ‘outsider’ is in the context of family trusts and non-family trusts
- Section 270-20 also outlines what constitutes a ‘benefit’

INCOME INJECTION TEST

- In practice, if the income injection test fails, the net income of a trust is varied to ensure the income diverted into the trust does not benefit from the trust loss.

THE 50% STAKE TEST – FIXED TRUST - METHOD 1

- The basic 50% stake test – for fixed trusts – ss 266-40, 269-50.
  - Total of the same individuals have fixed entitlements, directly or indirectly, to more than 50% of the income of the trust at the relevant times, ie all times during the test period. (The test period is from the start of the income year in which the loss was incurred to the end of the income year in which the loss is sought to be recouped.); and
  - The same individuals (not necessarily the same as those that hold fixed entitlements to income) have fixed entitlements, directly or indirectly, to more than 50% of the capital of the trust at the relevant times.

THE 50% STAKE TEST – FIXED TRUST - METHOD 2

- Alternate stake test for fixed trusts – applies to fixed trusts that are not widely held unit trusts if:
  - 50% or more of the fixed entitlements to income or capital of the trust are directly held by a non-fixed trust(s) at all times in the test period
  - individuals do not have more than a 50% stake in the income or capital of the trust at the start of the test period – s 266-45.
- There is no change in the persons directly holding fixed entitlements to shares of the income or capital of the trust nor the percentage of their shares; and
- Every non-fixed trust (ie not a family trust or other excepted trust) that holds fixed entitlements in the fixed trust, directly or indirectly, would satisfy the relevant tests that apply to non-fixed trusts if they stood in place of the loss trust.

THE 50% STAKE TEST – FOR NON-FIXED TRUST

- 50% stake test – non-fixed trust with > 50% fixed entitlements in income or capital – s 267-40(2).
- If individuals have more than a 50% stake in the income or capital of the trust at any time in the test period, then at all times in the period from that time, the same individuals must have had more than a 50% stake in the income or the capital respectively of the trust.

THE 50% STAKE TEST

- The alternate stake test is very difficult to satisfy. However, note that by making a family trust election, a non-fixed trust will be treated as if it has the fixed entitlement as an individual (see s 272-30(2)). This means that if sufficient non-fixed trusts make a family trust election, instead of having to satisfy the alternate stake test, it may be possible to only have to satisfy the basic 50% test which is not as onerous in its requirements.

THE CONTROL TEST

- A group is taken to control a trust if it:
  - has the power to obtain enjoyment of income or capital
  - Is able to control the application of income or capital
  - Is capable of going the enjoyment of the above under a scheme
  - The trustee is accustomed or under an obligation or might reasonably be expected to act in accordance with the wishes of the group
  - The group has the ability to remove or appoint the trustee
  - The group acquires greater than 50% stake in income or capital.
- Group is defined at section 269-95(5) to be a person plus one or more associates.

PATTERN OF DISTIBUTION TEST

- Applies for non-fixed trusts
- Section 267-20 provides that a non-fixed trust that can deduct in the income year a tax loss from a loss year, must satisfy a number of tests including the condition at s 267-30(2) if applicable. If they are not satisfied, the trust cannot deduct the tax loss.
- Section 267-30(2) states the condition is that the trust must pass the pattern of distributions test for the income year.
- Section 267-30(1) states that if a non-fixed trust distributed income or capital or both in the income year or within two months after its end and in at least one of the six earlier income years, it must meet the condition in s 267-30(2), ie it must pass the pattern of distributions test for the income year.

PATTERN OF DISTIBUTION TEST

- The test only applies where:
  - in the year that income is made that you want to apply losses against, there is a distribution of either income or capital (or within two months of the year end)
  - in at least one of the earlier six years there is a distribution of either income or capital.
- Section 269-60 provides that a trust passes the pattern of distributions test if:
  - the trust distributed directly or indirectly to the same individuals, for their own benefit, a greater than 50% share of all “test year distributions” of income
  - the trust distributed directly or indirectly to the same individuals (who may be different from those who received income distributions), for their own benefit, a greater than 50% share of all test year distributions of capital.

PATTERN OF DISTIBUTION TEST

- The test year distributions are all distributions made by the trust in any of the following periods:
  - the income year that the loss is to be applied plus two months after its end
  - an income year where a distribution was made that is:
    - the nearest to the loss year but before the loss year, or
    - if there is no distribution before the loss year, or the loss year commences more than 6 years before the start of the income year, then the nearest year to the loss year after the loss year that commences within the 6 year period
  - each intervening year between the above 2 years (see s 269-65).
- The test is applied separately for distributions of income and capital. If the test is failed, it appears the loss is lost.

PATTERN OF DISTIBUTION TEST

- To see if the same individuals have received greater than 50% of the test year distribution, and so if the trust has passed the pattern of distribution test, add up the lowest distribution percentage (possibly 0%) that each beneficiary received in any test year distribution. Therefore, if in the period in question a beneficiary received the following percentages of each distribution – 20%, 60%, and 8% – the percentage for that beneficiary is 8% (see s 269-70).

4.
CASE STUDY

CASE STUDY

- Type of trust?
- Tests to satisfy?
  - Income injection?
  - Control?
  - 50% stake?
  - Pattern of distribution?

CASE STUDY

- No information in relation to income injection test, but presumably can be identified when reviewing trust accounts for the financial year (i.e. unexplained receipts by the trust)
- No change in control
- As no beneficiary has any fixed entitlement under the trust, the 50% stake test does not apply (only applies if beneficiaries had a greater than 50% stake in the trust)
- CIY - 60% of the income to Aaron, 30% to Barbara and the remaining 10% to Christine.
- PIY - 30% of the income to Aaron, 10% to Barbara and 20% to Christine. No beneficiary was presently entitled to the remaining 40% (it was accumulated).
- Pattern of distribution test failed as, taking the lower of each distribution, Aaron received 30%, Barbara received 10% and Christine received 10% which does not equal > 50%.

5.
FIXED TRUSTS

‘FIXED TRUST’

- More than being a unit trust
- Note different legislation use the term ‘fixed trust’
- ATO has issued *Practical Compliance Guideline PCG 2016/16* outlining factors that may result in a unit trust being fixed for the purposes of the trust loss rules
- Not legally binding, only a guide
- Idea on trying to ensure unitholders have a ‘fixed entitlement’ to all income and capital of the trust

PCG 2016/16

- Factors that may suggest a unit trust not qualifying as a fixed trust:
  - Circumstances in which the interest is capable of not vesting or being defeated
  - The likelihood of the interest not vesting or being defeated
  - The nature of the trust
- Comment unit trust provisions reflecting a non-fixed trust:
  - If trust deed can be amended without the unanimous consent of all unitholders
  - The trustee can issue new units or redeem existing units other than at market value
  - The trustee can make gifts
  - The deed allows for different classes of units
  - The trustee can transfer assets of the trust to another trust with similar beneficiaries
  - There are partly paid units

PCG 2016/16

- Some safe harbours identified in PCG 2016/16 (per safe harbour 6)
  - All units on issue must have the same rights to income and capital
  - No discretionary units which give the trustee the discretionary power to distribute income or capital have been issued
  - Trustee does not have a discretion in relation to the distribution of income or capital between the unitholders
  - Trustee has never exercised any discretion to distribute income or capital, power to gift any assets or power to hold the assets of the trust on the terms of another trust

WHAT TO DO

- Don’t just make a fixed trust or vary a unit trust into a fixed trust for trust loss reasons
- Although the reduced tests required to be met, as well as other advantages (such as the ability to pass on franking credits to unitholders and application of CGT event E4) may be attractive, consider the downside
- It is truly a fixed trust which means the trustee has no discretion to accept or refuse a unit holder’s request for their units to be redeemed or transfer of units
- As with most things in tax, you need to look at the bigger picture as well

6.
FAMILY TRUSTS

‘FAMILY TRUST’

- A family trust isn’t your ordinary ‘discretionary trust’
- For the purposes of the trust loss provisions a family trust is a trust in respect of which a family trust election (FTE) has been made (section 272-75)
- It is as simple as picking a ‘main individual’ for the family to revolve around (the test individual) and making an election by completing a form
- Once making the election, however, distributions from the trust must remain within the family around the test individual
- The nominated test individual cannot also be reversed
- The Trust must also pass the ‘family control test’ per section 272-87

'FAMILY TRUST'

	Grandparent	Grandparent	
	Parent	Parent	
Brother/Sister	**Test Individual**	Spouse	Brother/Sister
Child	Child	Child	Child
Lineal descendants	Lineal descendants	Lineal descendants	Lineal descendants
And spouses, former spouses, widows, widowers and step-children of all above parties			

‘FAMILY TRUST’

- Note the family tree on the previous slide does not involve other entities
- It does not mean a family trust cannot distribute to other entities
- A family trust can still distribute to another entity if that entity makes an interposed entity election (this election is generally irrevocable), or interests in that entity 100% is within the family group

FAMILY CONTROL TEST

- As mentioned previously, a trust must pass the family control test in section 272-87 at the end of the particular income year
- A trust passes the test if a group:
  - Has the power to obtain, or is capable under a scheme of gaining, beneficial enjoyment of the capital or income of the trust
  - Is able to, or is capable under a scheme of gaining, control of the application of the capital or the income of the trust;
  - 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
  - Has more than a 50% stake in the income or capital of the trust; and
  - Includes the only persons who under the terms of the trust can obtain the beneficial enjoyment of the income and capital of the trust

WHAT TO DO?

- Just as mentioned with fixed trusts, whether you jump into a family trust election needs to be carefully considered as making such elections may not be in the best interest of the trust
- While having such an election reduces the tests required for utilising trust losses as well as other benefits (such as accessing franking credits), it also does impose a layer of complications on who is able to benefit from the trust
- As you saw the beneficiary class is reduced from a tax perspective (although under trust law, you could still distribute to other persons who fall outside the family group but falls inside the beneficiary definition)
- Distributing outside this family group results in a tax liability (the family trust distribution tax)

CREDITS

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THANKS!

ANY QUESTIONS?

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