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Family trust elections – June 2023

With:
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Information provided is general in nature; precise application depends on specific circumstances

Different type of trusts

- Fixed trust – where all persons have fixed entitlements to all of the income and capital of the trust (272-65 Schedule 2F ITAA 1936)
  - 'Vested' and indefeasible'
  - PCG 2016/16 provides outline of factors considered
  - Factors that can 'defeat' an interest include broad amendment powers; powers to reclassify units, receipts and appoint beneficiary interest to another person
- Non-fixed trust – any trust that is not a fixed trust (272-70 Schedule 2F ITAA 1936)
- Family trust – a trust where a family trust election is in force (272-75 Schedule 2F ITAA 1936)

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Importance of distinction

- Different rules apply to different types of trusts
- A fixed trust may have less conditions required to be met compared to a non-fixed trust
- A family trust may have less conditions required to be met compared to a non-fixed trust
- If relying on the fact that a trust is a fixed trust, note:
  - Not all unit trusts are fixed trusts
  - Not all fixed trusts are unit trusts
  - Terms of trust deeds should be read and considered in light of ATO guidelines
    - Particularly when purchasing a 'fixed trust' from an online provider (warstory)

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Why make one?

- Trust losses
- Company loss provisions
- Holding period rule for passing on franking credits
- Small business restructure rollover (328-G ITAA 1997)
- No trustee beneficiary reporting rules

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Trustee beneficiary reporting

- https://www.ato.gov.au/General/Trusts/In-detail/Closely-held-trusts/Trustee-beneficiary-reporting-rules/?page=2#Closely_held_trusts
- Trustee of closely held trust must make a 'trustee beneficiary' statement in certain circumstances
- Closely held trust includes a discretionary trust
- Trustee beneficiary statement not required if closely held trust
  - Has a valid family trust election;
  - Has a valid interposed entity election; **or**
  - Forms part of a 'family group'

Small business restructure rollover

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- Key requirement for SBRR is transaction must not have the effect of materially changing the ultimate economic ownership of the assets (and the relevant share of such ownership if multiple persons)
- Uncertainty in determining who holds ultimate economic ownership for a discretionary trust
- Special rule available for discretionary trusts (328-400 ITAA 1997) where all of the following are satisfied:
  - Either or both of the following applies:
    - Before transaction, asset was property of a non-fixed trust that had a FTE
    - After transaction, asset was property of a non-fixed trust that had a FTE
  - Every individual who before the transfer took effect, had the ultimate economic ownership of the asset was a member of the family group of the individual specified in the FTE
  - Every individual after the transfer took effect has the ultimate economic ownership of the asset is a member of the family group

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Holding period rule

- TD 2007/11
- Relates to old rules in 'Division 1A of former Part IIIAA ITAA 1936, as in force at 30 June 2002' in determining whether an entity is a qualified person in respect of franked distributions made to them after 30 June 2002.
- Qualified person rules present to ensure only 'true economic owners' of a company would be able to benefit from a credit of the tax paid by the company.
- Requires a person to hold the shares for 45 days (where franking credit entitlements are $5,000 or more).
- A discretionary trust with a FTE will satisfy the test (as a family group will be identified)

Company loss provisions

- If seeking to meet the continuity of ownership test (for a company) and a discretionary trust is the sold shareholder – difficulties arise in determining whether test is met as a trustee cannot beneficially owner shares (as well as the underlying nature of the discretionary trust) (TD 2000/27)
- FTE made by the trustee, however, can deem the shares are taken to be beneficially owned by the family trust

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Trust losses

- Tests are required to be met to access revenue losses in a trust
- Pattern of distributions test – non-fixed trust
- Control test – non-fixed trust
- 50% stake test – fixed trust and non-fixed trust
- Income injection test – family trust, fixed trust and non-fixed trust
- FTE means less tests are required to be met – doesn't mean you always need to make one provided analysis of the other tests are undertaken

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Pattern of distribution test

- Passes test if trust distributed directly or indirectly a greater than 50% share of the income and 50% share of the capital to the same individuals
- Considers distributions of income and capital separately
- Effectively requiring an analysis of historical year distributions and ensuring they remain largely with the same group of individuals
- Issues arise where:
  - Distributions made to an entity with discretionary entitlements or whose shareholder/unitholder is a discretionary entity (i.e. a bucket company with a discretionary trust shareholder).
  - Concept of distribution is broad an includes distributions by way of loan and allowing a beneficiary to use trust property or releasing a debt

Control test

- Passes test where the same group controls the trust directly or indirectly.
- Test failed if there has been a change of control.
- Group includes a person; and/or their associates (per 318 ITAA 1936)
- Considers if the group has the power to dictate distributions/impact who can benefit or control the trust

50% stake test

- Requires same individuals to hold more than 50% of the stake in the income and capital of the trust (easy to prove with a fixed trust)
- Other trusts holding units in a unit trust will need to make a FTE
- Where non-fixed trust holds units in a unit trust without a FTE, then the other tests will need to be met

Income injection test

- Test failed if:
  - Trustee derives income
  - 'Outsider' provide a benefit to the trustee or an associate
  - Trustee provides a benefit to the outsider or associate
  - There is a scheme that can be identified
- Note that benefit is broadly defined
- If the trust is not a family trust, then an 'outsider' is a person other than the trustee or a person with fixed entitlement to a share of the income or capital of the trust
- If the trust is a family trust, then an outsider is a person other than:
  - The trustee of the trust/a person with fixed entitlements
  - Test individual and family members of the FTE
  - Related entities to the family group

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Family trust elections

- Family trust election must nominate an individual (known as the **test individual**) as the individual whose family group is to be taken into account in relation to the FTE
- Family group includes:
  - Test individual
  - Spouse
  - Parent and grandparent of the test individual and spouse
  - Lineal descendants of test individual and spouse
  - Siblings of test individual and spouse
  - Lineal descendants of siblings of test individual and spouse
- Spouse include same sex couples
- Children includes adopted, step children and ex-nuptial children

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Family trust elections

- Family trust election must nominate an individual (known as the **test individual**) as the individual whose family group is to be taken into account in relation to the FTE – only one FTE per trust
- Family group includes:
  - Test individual
  - Spouse
  - Parent and grandparent of the test individual and spouse
  - Lineal descendants of test individual and spouse
  - Siblings of test individual and spouse
  - Lineal descendants of siblings of test individual and spouse
- Spouse include same sex couples
- Children includes adopted, step children and ex-nuptial children

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Family trust elections

- Test individual must be living and the trust must pass the family control test (at the time at the end of the income year)
  - Note that advisors could potentially be involved in the control without causing the trust to fail the test
- FTE can be retrospective provided:
  - the family control test is passed in each prior year until the start date;
  - Distributions have been made to the test individual's family group only
- Revocable in certain circumstances within 4 years from the effective date
- Variable provided distributions are not made outside the family group
- Only one variation allowed
- Interposed entity elections may also be revoked/varied

Family group

- Other non-individuals can form part of the family group
  - The trust that made the FTE
  - Trusts with FTE with same test individual
  - Companies, partnerships, trusts with interposed entity elections
  - Companies, partnerships, trusts in which **family group members have fixed entitlements directly or indirectly** to all of the income and capital
  - Deductible gift recipients
  - Certain entities whose income is exempt under certain sections
  - Deceased estates of family members

Interposed entity elections

- Election by entity that allows entity to become part of a family group
- Consider if required – e.g. examples where company solely owned by test individual
- IEEs can also be retrospective provided the entity has not distributed outside the family group
  - Requires family control test to be met
  - Distributions only been made to members of the test individual's family group
- Family trust distribution tax applies to IEEs as well
- IEEs can also be revoked in limited circumstances
- IEE cannot be made for multiple trusts unless test individual is the same

Family trust distribution tax

- Top marginal rate
- Trigger if trust confers a present entitlement or **distributes** income or capital to someone outside the family group
- Tax is due and payable:
  - If distribution made prior to election made – 21 days after date of election
  - Otherwise – 21 days after making the distribution
- Individual trustee liable
- Company trustee liable along with each person who was a director of the company at the time of distribution (all jointly and severally)

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Tax law v trust law

- The reason why family trust distribution tax is possible is because the making of a FTE does not always automatically reduce the beneficiary class in a discretionary trust
- That is, under trust law, the trust may still distribute to beneficiaries who fall outside the family group
- Consider if trust deeds should be amended to reduce the beneficiary class to reduce the risk of the family trust distribution tax
- Consider if amendment should be by varying the beneficiary provisions or a general restriction of distribution provision

Blanket FTE and IEEs?

- Do you need to make a FTE?
- Blanket making trading entities enter into a FTE/IEE:
  - What if the shares/units in the trading entity are later sold to another third party?
  - Third party will be outside the family group and FTDT will apply
- Are IEEs required?
  - If 'linking' a trust – is it simpler to make another FTE with the same test individual?
  - If 'linking' a company – is it simpler that the shares are held by the family group?

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Making FTEs now?

- If not required, may prove problematic from a succession context
- Eg.:
  - Smith Family Trust with FTE (John as test individual)
  - John has two sons – Adam and Bob
  - If John were to pass away, difficulty for Adam and Bob to establish a corporate trustee post death to receive distributions from Smith Family Trust
  - Corporate trustee would need to have:
    - Individual family members as shareholder; or
    - A trust which already made a FTE that had John as a test individual
  - A new shareholding trust cannot be created to hold the shares in the corporate trustee as John cannot be nominated as a test individual for the FTE (as John has already passed away)

General considerations

- FTE now – kick can down road (regarding the succession issue – if you can call it a succession issue)
- FTE later – more work to confirm whether FTE can be made retrospectively

Example

- Stark Family Trust holds ~$1.5m in revenue losses incurred between 2007 and 2011 from share trading
- Ned passed away in 2011 and the trust has been dormant since
- It is proposed for the Stark Family Trust to receive distributions from the Arryn Family Trust which has made profits as a result of property development work
- Winter is Coming Pty Ltd acts as trustee for the Stark Family Trust and the directorship for the company was as follows:
  - Ned (up until his death)
  - Kate (from Ned's death until 2015) – Ned's wife
  - Sansa and Arya (from 2015 until 2022) – Ned's daughters
  - Robb (from 2022 onwards) – Ned's son

Example

- Ned was the Appointor for the Stark Family Trust up until his death
- The terms of the trust deed stated that Ned's executors became the Appointor following his death.
- Ned's executor for his Will was Kate (Ned's wife).
- Nothing further has been transacted with the Stark Family Trust
- Robb controls the Arryn Family Trust
- Can a FTE be made?
  - Can it be effective from 2005?
  - Who should be the test individual?
  - What else is required to be undertaken to satisfy the trust loss rules?

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Example

- Robb should be nominated as the test individual for the income year 2007
- All previously mentioned persons would fall within Robb' family group (father, mother and sisters)
- Therefore the control of the Stark Family Trust would have remained within Robb's family group and the 'control' test would be met at the time of making the FTE (including for income years since the losses were made)
- It is important that no 'distributions' (or benefits) were made outside Robb's family group since 2007 as well.
- Robb should also be nominated as the test individual for the Arryn Family Trust so that this trust is not considered an outside for the income injection test to access the trust losses.

Example

- Consider practical difficulty to review documentation from 15+ years ago
- Better if FTE made in 'real-time'?
- Issue with income injection test instead as deceased could not be appointed a test individual of the profit making trust?

Contact details

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