

Family Trusts; the beginning, middle and end¹

Alex Whitney, Senior Associate, West Garbutt

1 Overview

- 1.1 Family discretionary trusts, thanks to advantageous tax positions and flexibility, are probably the most common holding structure for private wealth. They are used to passively hold assets as well as conduct businesses. However, their proper use is made complex by a range of factors – stemming from, among other things, the uncomfortable marriage of equity and tax law and increasing numbers of ‘integrity measures’ driven at least in part to address a public perception of trusts as a tax avoidance vehicle.
- 1.2 This paper addresses a range of issues that ‘family trusts’ must concern themselves with. In this paper to avoid confusion, I will refer to ‘generic’ family trusts (as in any trust that is maintained for a family’s benefit, but which may not have made a family trust election) as discretionary trusts, and will only use the expression ‘family trust’ when referring to trusts that have made a family trust election (**FTE**).
- 1.3 This paper is broadly split into three sections to cover the lifecycle of discretionary trusts and family trusts. This paper is a survey of the technical issues relating to family trust elections, as well as more general issues that discretionary trusts that are being maintained for a family need to consider, including:
- the eligibility requirements for making an FTE;
 - the advantages in making an FTE;
 - making interposed entity elections (**IEEs**);
 - managing the family trust distribution tax regime;
 - varying or revoking an FTE; and
 - disposing of interests in an entity that has made an FTE or IEE.
- 1.4 In this paper, I refer to the:
- *Income Tax Assessment Act 1997* (Cth) as **ITAA97**; and
 - *Income Tax Assessment Act 1936* (Cth) as **ITAA36**.

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2 The Beginning – establishing a family trust

Establishing a discretionary trust

- 2.1 Mechanically, the process of establishing a discretionary trust has been made very simple. A trustee is chosen or registered, a document provider is paid a few hundred dollars, given a set of instructions, and a few hours later (if that) a discretionary trust deed is provided for the client to sign. This, together with the settlement sum, establishes the trust at law and equity.
- 2.2 The next steps are also made relatively easy in this day and age – either the accountant or the client applies for a TFN and/or ABN for the discretionary trust, opens a bank account, and starts using the trust. When it comes to do the first tax return for the new trust, the accountant may make a family trust election (**FTE**) as a matter of course.

Turning a discretionary trust to a family trust

- 2.3 Now to turn a discretionary trust to a family trust is also relatively simple mechanically – a form is completed and posted off to the Commissioner. However, it is worthwhile looking at the eligibility criteria that must be met to actually make a family trust election. If these criteria are not met at the end of the year in which an FTE is made, the FTE is treated as not having been made, with flow on consequences I will touch on later.
- 2.4 For a valid FTE, the requirements in section 272-80 Sch 2F ITAA36 must be met. Those requirements are:
- the election must be in writing and in the approved form;
 - the election must specify a **living**² individual to determine the family group (the **test individual**);
 - the trust must pass the 'family control test' as set out in section 272-87 Sch 2F ITAA36.
- 2.5 An FTE can be effective retrospectively provided that the family control test is passed in each prior year, and distributions have been made to the test individual's family group only³.
- 2.6 It is the ATO's view that a family trust election can only be made after the year in which it commences – because the family control test requires that the trust satisfies the test **at the end of the income year**. Further, even if the test is satisfied, it will not validate an FTE made before the end of the income year.

² ATO ID 2014/3 – while the inability to nominate a deceased person is unlikely to be an issue, doing so could potentially expand the family group, which is presumably why the ATO does not allow it.

³ 272(4A) Sch 2F ITAA36

The family control test

2.7 The key requirement for an FTE is the family control test – found in section 272-87 Sch 2F ITAA36. The purpose of the family control test is fairly intuitive. It is intended to ensure that a family trust is controlled by a singular family group. That being said, it is worth going through in some detail because despite being conceptually relatively easy to understand, the drafting is not user friendly.

2.8 It is best to start with subsection (2) of section 272 Sch 2F ITAA36, which states that if the following are met by a 'group' as identified in subsection 272(1) Sch 2F ITAA36, then the family control test is satisfied:

(2) The requirement for the purposes of subsection (1) is that:

- (a) the group has the power, by means of the exercise of a power of appointment or revocation or otherwise, to obtain beneficial enjoyment (directly or indirectly) of the capital or income of the trust; or*
- (b) the group is able (directly or indirectly) to control the application of the capital or income of the trust; or*
- (c) the group is capable, under a scheme, of gaining the beneficial enjoyment in paragraph (a) or the control in paragraph (b); or*
- (d) 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; or*
- (e) the group is able to remove or appoint the trustee of the trust; or*
- (f) the group has more than a 50% stake in the income or capital of the trust; or*
- (g) persons in the group are the only persons who, under the terms of the trust, can obtain the beneficial enjoyment of the income and capital of the trust.'*

2.9 To summarise the above, if a group can control the trustee (directly or indirectly), and/or control the trust's application of its income or capital it is likely to satisfy these requirements.

2.10 In determining the group, we need to return to subsection 272(1) Sch 2F ITAA36. That subsection is extracted below (original emphasis):

- (1) *A trust in respect of which a family trust election or an interposed entity election is proposed to be made **passes the family control test** if:*
- (a) *the requirement in any of the paragraphs of subsection (2) is satisfied in relation to a group consisting of:*
 - (i) *the individual (the **primary individual**) who is to be specified in the family trust election or, in the case of an interposed entity election, who is specified in the family trust election to which the interposed entity election will relate; or*
 - (ii) *one or more members of the primary individual's family (see section 272- 95); or*
 - (iii) *the primary individual and one or more members of the primary individual's family; or*
 - (b) *the requirement in any of paragraphs (a) to (e) of subsection (2) is satisfied in relation to a group consisting of a person or persons covered by subparagraph (a)(i), (ii) or (iii) of this subsection and one or more legal or financial advisers to the primary individual or to a member of the primary individual's family; or*
 - (c) *the requirement in paragraph (f) of subsection (2) is satisfied in relation to a group consisting of:*
 - (i) *the trustees of one or more family trusts, provided the primary individual is specified in the family trust election of each of those family trusts; or*
 - (ii) *such trustees and a person or persons covered by subparagraph (a)(i), (ii) or (iii).'*

2.11 Subsections (a), (b) and (c) essentially identify three categories of 'groups' that are capable of satisfying the requirements in subsection (2) in order for the trust to pass the family trust control test. Subsection (a) essentially refers to the test individual, their family members, or the test individual **and** their family members. Subsection (b) allows for the possibility that a financial or legal advisor may be involved in the control of the trust (which is not uncommon, especially for testamentary trusts), without causing the trust to fail the family control test. Subsection (c) is the odd one out in that it allows trusts with fixed interests to satisfy the

family control test if it is controlled by one or more family trusts – however in practice this is unlikely to every be useful.

Example 1:

The Slipnir Trust is a discretionary trust. It is controlled by Mr Odin and Mr Thor, who are the primary beneficiaries, appointors and directors of Slipnir Trustee Pty Ltd. Mr Odin and Mr Thor are (obviously) father and son and are a group under section 272(1)(a)(iii) (extracted above). The group of Mr Thor and Mr Odin are capable of indirectly controlling the application of income or capital of the Slipnir Trust, and Slipnir Trustee Co is accustomed or reasonably expected to act according to their wishes. The Slipnir Trust will satisfy the family control test and a family trust election could be made.

2.12 So, assuming the family control test can be satisfied, the trust can make an FTE and become a family trust. This begs the question – what are the advantages and disadvantages in doing so? This neatly takes us to the ‘middle’ part of the trust lifecycle – actually using a trust in a tax effective way.

3 The middle – using a discretionary trust or family trust effectively

3.1 So, the trust has been established, and we are now to consider whether the trust should make an FTE and become a family trust.

3.2 Making an FTE and turning a discretionary trust into a family trust confers a number of advantages and one major disadvantage onto a trust. Briefly summarised, a family trust:

- has easier access to its own carry forward losses and bad debt deductions;
- allows for easier access to prior year company losses and bad debt deductions;
- allows for franking credits to flow through the trust; and
- allows for easier access to the small business restructure rollover.

3.3 The major disadvantage is that when an FTE is made, the family trust is limited to making distributions to members of the test individual’s family group. A distribution to an entity not within that group incurs family trust distribution tax – a penalty tax levied on the trustee. I discuss the family trust distribution tax in greater detail below.

Advantages of a family trust

Carry forward losses and bad debt deductions - trusts

3.4 As noted above, a family trust can more easily access prior year losses and bad debt deductions for both its own losses and companies in which it holds shares.

- 3.5 Readers may be familiar with the trust loss provisions in Schedule 2F of the ITAA 36. An in-depth discussion of those provisions is outside the scope of this paper but a brief discussion will be helpful nonetheless.
- 3.6 Broadly speaking, for a trust to utilise prior year losses or claim bad debt deductions to reduce its taxable income, it must pass certain tests. Which tests to apply is based on whether the trust is a fixed trust, or a non-fixed trust.
- 3.7 Fixed trusts are trusts where the beneficiaries have a fixed entitlement to the income and capital of the trust⁴. In this context, a fixed entitlement is defined to be a '*vested and indefeasible*' interest in the trust⁵. Most trusts, including most unit trusts will not meet this definition. The Commissioner of Taxation does have a discretion to treat a non-fixed trust as a fixed trust, and there is a practical compliance guideline that sets out when he will do so⁶. Under those guidelines, many unit trusts will be treated as fixed trusts provided certain limitations on the issue, redemption and variation powers of the trustee are included.
- 3.8 Non-fixed trusts are, as the name suggests, any trust which is not a fixed trust (or treated as a fixed trust under the Commissioner's discretion). All discretionary trusts and hybrid trusts will fall into this category.
- 3.9 Very briefly, the tests for a non-fixed trust are:
- **the pattern of distributions test**⁷ – this requires that 50% of distributions of income or capital are made to the same individuals in each test year. 'Distribution' in this context has the expanding meaning in section 272-60 Sch 2F ITAA36, which is discussed further below;
 - **the 50% stake test**⁸ – this test is satisfied if individuals have a 50% or more fixed entitlement in the income or capital of the trust and those individuals maintain their fixed entitlement to 50% or more of the income or capital of the trust. This is unlikely to occur given the difficulties in establishing that fixed entitlements exist and that non-fixed trusts are unlikely to have discrete percentage interests;
 - **the control test**⁹ – this requires that no group of persons comes to control the trust during the relevant time periods; and
 - **the income injection test**¹⁰ – the income injection test is an integrity measure that can prevent a trust from accessing part or all of its carry forward losses if a benefit

⁴ Section 272-65 Sch 2F ITAA36

⁵ Section 272-5(1) Sch 2F ITAA36

⁶ PCG 2016/16

⁷ Section 267-30 Sch 2F ITAA36

⁸ Section 267-40 Sch 2F ITAA36

⁹ Section 267-45 Sch 2F ITAA36

¹⁰ See Division 270 Sch 2F ITAA36

has been conferred on the trustee, beneficiary or associate of the trustee or beneficiary by an outsider to the trust. In this context, an outsider is a person other than the trustee or a person with a fixed entitlement to income or capital of the trust.

- 3.10 Family trusts seeking to access prior year losses or bad debt deductions face an easier time as a family trust does not need to satisfy any of the tests other than a modified income injection test. This immediately removes some of the administrative burden in determining whether a family trust can access prior year losses.
- 3.11 For family trusts, the injection test is modified such that the definition of outsider is modified to be a person other than the trustee, a person with a fixed entitlement to the income or capital of the trust, or the test individual, members of the test individual's family, a family trust with the same test individual and any entity that has made an IEE¹¹.
- 3.12 The consequence of this changed definition means that the income injection test is much more difficult to fail. Normal intra-group transactions where the parties are family members or entities with an IEE will not cause the family trust to fail the income injection test.

Example 2:

Slipnir Trust is a non-fixed trust that has significant carry forward losses from a failed property development. Huginn Trust is another non-fixed trust that has made significant income in the current year as a result of successful trading. The controller of both trusts, Mr Odin, wishes to cause the Huginn Trust to distribute income to the Slipnir Trust to utilise its losses.

If either or both the Slipnir Trust and Huginn Trust have not made an FTE nominating Mr Odin as the test individual, then the distribution of income from the Huginn Trust to the Slipnir Trust will cause the Slipnir Trust to fail the income injection test, meaning the losses will not reduce its assessable income. This is because the Huginn Trust is an outsider to the Slipnir Trust (as it is not the trustee or an entity with a fixed entitlement to the Huginn Trust's income or capital), and it has conferred a benefit on the Slipnir Trust by distributing income to it.

If **both** the Slipnir Trust and Huginn Trust have made an FTE nominating Mr Odin as the test individual, the Huginn Trust will not be an outsider to the Slipnir Trust. The distribution of income to the Slipnir Trust will not cause the income injection test to be failed.

- 3.13 Overall, a family trust has a far easier time accessing prior year losses or bad debt deductions – and in particular, family trusts will find it easier to distribute income within a private group to take advantage of prior year losses wherever they might be available.

¹¹ Section 270-25 Sch 2F ITAA36

Carry forward losses and bad debt deductions – companies

- 3.14 As with trusts, there are particular tests that must be satisfied for a company to access its own prior year losses or bad debt deductions. Put briefly, a company must satisfy either the continuity of ownership¹² test or the same or similar business test¹³.
- 3.15 The same business test is infamous for being exceptionally difficult to pass. Thankfully, in March 2019, legislation was finally passed to introduce a companion 'similar' business test that is easier to satisfy. That being said, testing a business to determine whether the similar or same business test are satisfied can be an onerous task and does not provide certainty of tax outcomes without a private ruling – for this reason many advisors want to rely on the continuity of ownership test wherever possible.
- 3.16 To pass the continuity of ownership test, the same persons must **beneficially** own 50% or more of the shares of the company from the beginning of the loss years to the year in which the losses are recouped.
- 3.17 The issue here for a trust shareholder is that the trustee does not beneficially own the shares in the company – and no particular persons beneficially own the shares. The ATO has confirmed that their view is that where a discretionary trust holds shares in a company it cannot hold those shares beneficially – see TD 2000/27. This means that if discretionary trusts hold 50% or more of the shares in a company, the company **cannot** satisfy the continuity of ownership test and prior year losses will not be available to reduce current year taxable income.
- 3.18 However, if a trust has made an FTE, the trust is considered to beneficially own shares in a company for the purposes of the continuity of ownership test¹⁴. This can allow the company to satisfy the tests and use its prior year losses or bad debt deductions.

Holding period rules for dividends

- 3.19 Family trust elections can also be crucial if a trust is a shareholder expecting dividends, due to the application of the holding period rule.
- 3.20 The holding period rule broadly prevents a shareholder from using franking credits attaching to a dividend if they have not held the shares at risk for a particular period (normally 45 days).

¹² See Division 165 ITAA97

¹³ See Subdivision 165-E ITAA97

¹⁴ Section 165-207 ITAA97

3.21 Discretionary trusts are specifically excluded from being able to satisfy the holding period rule, unless it is a family trust (or if it owned the shares since pre-1997). Accordingly, FTEs should be made where a trust is expecting to receive dividends.

Small business restructure rollover

3.22 There is one other circumstance where making an FTE can allow access to tax concessions – the small business restructure rollover (found in Subdivision 328-G ITAA97).

3.23 There have been many papers on this rollover - it is a rollover that can be difficult to apply in all but the most vanilla circumstances, and a full discussion of the rollover is outside the scope of this paper.

3.24 Where family trusts become relevant in this context is determining who has ultimate economic ownership of the assets that are to be subject to the rollover.

3.25 For the restructure rollover to apply, there must be (among other things) no changes to the 'ultimate economic ownership' of the assets. In situations where there are no discretionary trusts involved in the structure, this can be very easy to determine. However because a discretionary trust has no ultimate economic owner (because the beneficial interests will change from year to year at the trustee's whim), if the assets are transferred to or from a structure that involves a discretionary trust, it is impossible to satisfy the requirement that the ultimate economic ownership does not change.

3.26 To address this issue, there is a specific provision for family trusts¹⁵. Provided that every individual who had ultimate economic ownership of the asset prior to the transfer is a member of the family group (determined by reference to the test individual nominated in the FTE) relating the transferee, then the ultimate economic ownership is deemed not to have changed.

Example 3:

Mr Odin is the sole shareholder of Mjølknir Co, a proprietary limited company. Mjølknir wishes to transfer its assets to Gungnir Co, another proprietary limited company. The sole shareholder of Gungnir Co is the Slipnir Trust. The Slipnir Trust has made a family trust election nominating Mr Odin as the test individual.

In these circumstances, the ultimate economic ownership of the assets of Mjølknir Co has not changed following its transfer to Gungnir Co – because Mr Odin is the ultimate economic owner of the assets before the transfer and is a member of the family group in relation to Slipnir Trust. Assuming the

¹⁵ Section 328-440 ITAA97

other requirements for the rollover are met, the small business restructure rollover can apply to defer the capital gains tax on the transfer of the assets from Mjólnir Co to Gungnir Co.

Effectively using a family trust

3.27 The advantages to making an FTE summarised above are a powerful incentive to making an FTE and turning a trust into a family trust. However there are a number of issues that must be navigated to ensure that the resulting family trust is used in a tax effective way.

3.28 The first and main issue in effectively using a family trust is managing its distributions so as not to fall afoul of the main disadvantage of an FTE – family trust distribution tax.

Family trust distribution tax

3.29 Family trust distribution tax is a penalty tax that applies where a family trust distributes its income or capital to a person that is not part of the test individual's 'family group'.

Family group

3.30 The 'family group' is defined in section 272-90 Sch 2F ITAA36. As a starting position, it includes the family members of the test individual. The family members are defined in section 272-95(1) Sch 2F ITAA36 to be:

- parents, grandparents, siblings of the test individual or the test individual's spouse;
- nieces, nephews or children of the test individual or the test individual's spouse;
- lineal descendants of a nephew, niece or child of the test individual or the test individual's spouse; and
- the spouse of the test individual or the spouse of any other member of the family group.

3.31 The death of any person does not cause any other person to cease being a member of the family group, and lineal descendants includes adopted children, step-children and ex-nuptial children¹⁶.

3.32 The following entities are also included in the family group¹⁷:

- the family trust that has made the election;
- other family trusts that have made an election with the same test individual;
- entities that have made interposed entity elections;

¹⁶ Section 272-95(2) and (3) Sch 2F ITAA36

¹⁷ Section 272-90 Sch 2F ITAA36

- entities where the test individual, the test individual's family or the family trust have fixed entitlements to all the income and capital of that entity¹⁸;
- funds, authorities or institutions that are mentioned in item 1 or 2 of section 30-15 ITAA 97, provided a deduction would be available for a gift to these entities;
- particular other income tax exempt entities, including some religious institutions; and
- deceased estates of family members.

3.33 The family group can be very broad when it comes to individuals – anyone related to the test individual will normally be part of the group, but it is more restricted when it comes to entities.

3.34 The inclusion of income tax exempt charities in the family group means that even with the broad definition of 'distributes' (discussed further below), gifts to charities will not incur family trust distribution tax – as long as they properly meet the requirements to be in the group. Other donations, such as to political parties or other groups where there is no deduction may well incur family trust distribution tax.

Interposed entity elections

3.35 An interposed entity election is an election by a company, trust or partnership that essentially allows the entity to become part of a family trust (if it would not already be included).

3.36 The conditions that must be met in order for an entity to make an IEE are broadly the same as a trust making an FTE:

- the election must be in writing and in the approved form; and
- the entity must satisfy the family control test (discussed above).

3.37 As with FTEs, an IEE can be backdated provided that the entity has not distributed outside the family group in each prior year for which the IEE will apply.

3.38 If an IEE makes a distribution to a person or entity outside the relevant family group, it will also trigger the family trust distribution tax.

¹⁸ Noting the difficulty in satisfying the definition of fixed entitlement, this will normally only include companies and some partnerships. For trusts, an IEE is the best way of ensuring it is a member of the family group.

Example 4:

The Slipnir Trust holds all the issued units in the Baldur Unit Trust that operates a trading business. The Slipnir Trust has made an FTE. In the early years of the business, Slipnir Trust distributed capital to the Baldur Unit Trust. In order to avoid triggering family trust distribution tax, the Baldur Trust at that point in time made an IEE.

The Baldur Trust employs a general manager, Ms Freya who exceeds in her role. In order to allow her to participate in the profits of the Baldur Trust, Ms Freya was issued special units that confer a discretionary entitlement to income and capital.

The Baldur Trust later sells the business and makes a one-off distribution of capital to Ms Freya on her special units. In doing so, it has distributed capital to a person outside the relevant family group, triggering family trust distribution tax.

Possible solution:

It may be arguable that the amount paid to Ms Freya is equal to the consideration paid by her (in terms of labour) in her employment by the Baldur Trust, in which case family trust distribution tax should not be incurred. This will depend on the precise circumstances, and in circumstances where the parties are not dealing with each other at arms' length, it may be difficult to convince the ATO to accept this position.

What is the family trust distribution tax rate?

- 3.39 The rate of tax for the family trust distribution tax is 47%¹⁹ - demonstrating the intent that this is a punitive tax designed to ensure that value is not moved out of a family group where an FTE has been made.
- 3.40 Where family trust distribution tax is incurred, it must be paid within 21 days of the distribution being made²⁰. A failure to do so will incur general interest charge. Where family trust distribution tax has been paid, the assessable income the beneficiary reports in its tax return is reduced by the amount of tax paid – to prevent double taxation.

Who is liable for family trust distribution tax?

- 3.41 If the trustee is an individual, the trustee is liable to pay the family trust distribution tax on the value of the distribution made outside the family group. If the trustee is a company, the trustee **together with its directors** are jointly and severally liable to pay the family trust

¹⁹ Section 4 *Family Trust Distribution Tax (Primary Liability) Act 1998* (Cth)

²⁰ Where the distribution triggering family trust distribution tax occurs before the FTE is made (because the FTE is backdated), the tax is payable within 21 days of the FTE being made.

distribution tax²¹. This represents one of the few ways that tax can pierce the corporate veil and make directors personally liable to the tax debts of a company.

- 3.42 Family trust distribution tax can also apply to distributions made by a trust, partnership or company that has made an IEE. In the event a company or partnership incurs family trust distribution tax, each of the directors (in the case of a company) or each of the partners (in the case of a partnership) are jointly and severally liable²².
- 3.43 If a director did not participate in the decision to make a distribution that triggers family trust distribution tax, or voted against such a distribution, they are not liable for the tax²³.
- 3.44 There is no limitation on review period for family trust distribution tax because the debt is automatic²⁴ – it does not require the Commissioner to issue a notice of assessment (although the Commissioner may, including at a taxpayer's request, issue a notice of liability)²⁵.
- 3.45 A taxpayer can object to a notice of liability²⁶. It should be noted that because the tax debt automatically comes into existence under the family trust distribution tax, there is no objection pathway (because there is no decision of the Commissioner to object to) unless a notice of liability is issued. Taxpayers in circumstances where it is uncertain whether family trust distribution tax will arise should seek a private ruling – but thanks to the operation of the provisions, if the transaction potentially giving rise to family trust distribution tax has already occurred, the taxpayer may need to urgently (to prevent excess interest) require a notice of liability from the Commissioner so objections can be lodged.
- 3.46 Family trust distribution tax represents the main disadvantage to an FTE, because it can severely limit the flexibility offered by a discretionary trust. As can be seen from the comments above – the concept of 'distribution' repeats throughout the family trust provisions and an understanding of it is critical to understand when family trust distribution tax may apply. Unfortunately, it is not straightforward and is an evolving area of law.

What is a distribution?

- 3.47 Distribution in this context is defined in Subdivision 272-B Sch 2F ITAA36. A trust will be considered to have made a distribution where:
- it pays or credits income or capital in the form of money to a person in their capacity as beneficiary;

²¹ Section 271-15(2) Sch 2F ITAA36

²² Section 271-25 and section 271-30 Sch 2F ITAA36

²³ Section 271-40 Sch 2F ITAA36

²⁴ Section 271-75 Sch 2F ITAA36

²⁵ Section 271-90 and section 271-95 Sch 2F ITAA36

²⁶ Section 271-90(6) Sch 2F ITAA36

- transfers income or capital in the form of property to a person in their capacity as beneficiary;
- reinvests or otherwise deals with income or capital on behalf of a person or at that persons direction in their capacity as beneficiary; or
- applies the income or capital to the benefit of a person in their capacity as beneficiary.

3.48 For companies and partnerships, the meaning of distribute can be found in section 272-50 Sch 2F ITAA36 and 272-55 Sch 2F ITAA36 respectively.

3.49 The meaning of distribute is then expanded for trusts, companies and partnerships in section 272-60 Sch 2F ITAA36, which I have relevantly extracted below (original emphasis):

- (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.*

Limit on distributions

- (2) However, subsection (1) only applies if, and to the extent that:*
- (a) the amount paid, credited, reinvested or applied, the value of the property transferred, or the value of the other thing done;*
exceeds:
 - (b) the amount or value of any consideration given in return.'*

3.50 This section has become something of a contested issue in recent years. From 2012 to 2017, it was the ATO's position in ATO ID 2012/12 that the extended definition of distribute in section 272-60 Sch 2F ITAA36 was still limited to distributions to a beneficiary of a trust – i.e. that even under that section, a trust could only legally make a distribution to a beneficiary.

Any payment, transfer of property etc. to a person who was not a beneficiary could not be a distribution.

3.51 ATO ID 2012/12 was concerned with the write off of bad debts, but it clearly stated that:

'Section 272-60 of Schedule 2F to the ITAA 1936 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) of the ITAA 1936 to the extent that they arise in a person's capacity as a beneficiary of the trust.'

3.52 This position was then **reversed** in TD 2017/20. In TD2017/20, the ATO stated its position was now that a distribution could be made to a person who was not a beneficiary of the relevant trust under the extended meaning of the word 'distribute' in section 272-60 Sch 2F ITAA36.

3.53 TD2017/20 does not explain why the ATO changed its mind. The alarming consequence of this change of mind can be found in example 2 of the TD, extracted below:

'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'.'

3.54 Under the ATO's interpretation, allowing a friend to stay in a family home results in a distribution to that friend, which in turns triggers a family trust distribution tax liability equal to 47% of the value of the 'distribution'. This seems an inappropriate outcome and creates a tax liability where there is no mischief.

3.55 Any use of trust property by any person who is not a member of the family group, and who does not pay full market value will trigger family trust distribution tax.

Example 5:

The Slipnir Trust has made an FTE and owns property that is used by Varyag Co, a company in which Mr Odin owns a third of the issued shares. As the remaining shares are owned by other families, Varyag Co does not wish to make an IEE. Varyag Co is not a beneficiary of Slipnir Trust.

The Slipnir Trust owns commercial premises that it allows Varyag Co to use for less than market value rent.

As Varyag Co is not a member of the family group, under the interpretation in TD2017/20, the Slipnir Trust has made a distribution to Varyag Co (by allowing use of the premises) and has triggered family trust distribution tax.

Possible solution:

To manage possible family trust distribution tax, it may be preferable to lease the premises to Mr Odin personally (or another member of his family group), for him to sub-lease to Varyag. In this way, the distribution is made to Mr Odin, rather than an entity (Varyag) that is outside the family group.

3.56 The ATO's justification for this interpretation of the law can be summarised as follows:

- because of the overlap between section 272-60 Sch 2F ITAA36 and sections 272-45 to section 272-55 Sch 2F ITAA36, section 272-60 Sch 2F ITAA36 creates redundancy;
- the section should be read in a way to give the section a meaning that is not redundant;
- the extended meaning of distribute makes no mention to the capacity of the person receiving the distribution; and
- putting that together, by reading the section as allowing distributions to non-beneficiaries of a trust, a non-redundant purpose is given to the section.

3.57 John Balazs, of Balazs Lazanas and Welch LLP, wrote in his article for the Weekly Tax Bulletin²⁷ that the sole judicial testing (so far) of the ATO's view resulted in the ATO reversing its position part way and the Court ordering the taxpayer's objection to be allowed in full.

3.58 That case was *Mashed Potato Pty Ltd v FCT*²⁸. It is an unreported judgment and no reasons have been published due to the somewhat unusual way it concluded. As a brief summary of the relevant facts:

- a trust was established with an explicit power to provide a residence to its beneficiaries;
- the trust made an FTE nominating Mrs H as the test individual;
- the trust acquired property and made it available to Mrs H and her family;
- immediately after the release of TD 2017/20, Mrs H allowed some friends to use the property for no consideration;
- the ATO issued a notice of liability for family trust distribution tax;

²⁷ Published 19 June 2019, at [862]

²⁸ NSD 1757/2018

- after a disallowed objection, the taxpayer appealed to the Federal Court.
- 3.59 The Court ultimately ordered that the objection decision be put aside and the taxpayer's objection allowed in full. Costs were awarded to the taxpayer. In John's article, he cites the Court stating that family trust distribution tax was not intended to "*be imposed in situations where, at the invitation of Mrs H, she invites friends to stay for the weekend*".
- 3.60 No reasons were published as the ATO chose to reverse its position and withdraw from proceedings at the Court's invitation following the taxpayer's submissions. The taxpayer submitted that:
- family trust distribution tax could only be imposed if the distribution is to a beneficiary (i.e. section 272-60 Sch 2F ITAA36 does not extend to non-beneficiaries);
 - alternatively, if the ATO's view in TD2017/20 is correct, any distribution made was to Mrs H (the test individual) and not to her friends;
 - as a further alternative, on the basis that the trust had resolved to distribute all its income, and the capital of the trust had not diminished over the financial year, no amount could be taxed.
- 3.61 These arguments neatly capture my view of TD 2017/20. In my view, in interpreting section 272-60, it is inappropriate to completely disregard the ordinary meaning of distribute in the context of trusts. A trust, in equity, can only distribute to a beneficiary – any other transfer of value to a non-beneficiary must by definition be something else.
- 3.62 Further, it is relatively clear to me that section 272-60 is a catch all provision – designed to ensure that a broad range of transactions are captured as distributions. It incorporates, and expands, the meaning of distribute for companies, partnerships and trusts. In doing so, it could not sensibly be worded to include a specific reference to the capacity in which the recipient of the distribution receives that distribution.
- 3.63 We do not know why the ATO reversed its position during the proceedings – there has been no public ATO comments on the case. It is not unreasonable to conclude that the ATO reversed its position because it believed it would not succeed in that litigation and continuing to contest it would result in an unfavourable precedent. This is of course disappointing as it deprives the public of a binding precedent.
- 3.64 What this means practically is that if your client is in a similar position to the case, and is reviewed by the ATO, then there should be prospects of success at trial. However, you will likely have to go so far as to appeal to the AAT or the Courts as the ATO's own decision makers will be bound to follow the public ruling. This is concerning and unacceptable state of play. The ATO should reconsider its position or at least provide some explanation for its

reversal in public position in 2017, and its decision to reverse its position in the Mashed Potatoes case. Alternatively, the matter needs to be urgently tested in the courts so there is clarity regarding the law.

Varying a family trust election

- 3.65 If for some reason an existing FTE is causing difficulties (perhaps because it causes entities to fall outside the family group), it is possible to vary an FTE if the conditions in section 272-80(5A) Sch 2F ITAA36 are met. A variation to an FTE must be made within four years of the FTE being made²⁹.
- 3.66 The varied FTE must nominate a test individual that was a member of the original family group, and any distributions or present entitlements to income or capital of the trust or any entity with an IEE in the group must have been made only to members of the 'new' family group.
- 3.67 The variation to the FTE itself must be in writing and in the approved form and must also be given to the ATO within 2 months of the relevant financial year ending, or some later time that the Commissioner allows³⁰. An FTE can only be varied once³¹.

4 The end – ending a family trust

- 4.1 Having now discussed in some detail the issues surrounding the ongoing use of family trusts, it is worthwhile to consider some of the issues that may present themselves at the end of a family trust's shelf life, including the possibility of revoking elections and the issues surrounding the disposal of entities which have made elections.

Revoking a family trust election

- 4.2 In very limited circumstances, it is possible to revoke FTEs. It may be desirable to do so when the limitations imposed on the entity as a result of family trust distribution tax becomes an impediment in the operation of the entity.
- 4.3 The trustee of a non-fixed trust **cannot** revoke an FTE if³²:
- the trust or another entity had incurred a tax loss and the trust or the other entity could not have reduced its assessable income as a result of that loss but for the FTE;

²⁹ Section 272-80(6B) Sch 2F ITAA36

³⁰ Section 272-80(7) Sch 2F ITAA36

³¹ Section 272-80(5B) Sch 2F ITAA36

³² Section 272-80(6A) Sch 2F ITAA36

- the trust or another entity had claimed a bad debt deduction and the trust or the other entity could not have reduced its assessable income as a result of that bad debt deduction but for the FTE; or
- a beneficiary of the trust received a franked distribution and the franking credit would have been disallowed but for the FTE.

4.4 In other words, if the trust or another entity has relied on an FTE being made, it cannot later be revoked.

4.5 Trustees of fixed family trusts may revoke an FTE if the family group continues to hold fixed entitlements to the income and capital of the trust³³.

4.6 The revocation must be made in the tax return for the year in which the FTE is revoked – i.e. it is not possible to backdate a revocation³⁴ - there are further rules that apply if the trust is not required to lodge an income tax return. I understand that it is the ATO's view that a prior income tax return cannot be amended to revoke an FTE.

4.7 If an FTE is revoked, the trust cannot later make another FTE – in other words the revocation is itself irrevocable³⁵.

Example 6:

The Midgard Trust is a discretionary trust controlled by Mr Regin. It operates a successful business and has never had carry forward losses or bad debt deductions. It does not own shares. On advice, Mr Regin caused the trustee to make an FTE in its first year of existence, with Mr Regin as the test individual.

Mr Regin made a donation to a political group last financial year and would like donate again this financial year. The organisation is not a member of Mr Regin's family group (including under the provisions for income tax exempt entities).

The trustee of the Midgard Trust will have incurred family trust distribution tax on the prior year's donation. However, it can revoke its FTE in the current year to prevent family trust distribution tax from triggering in this financial year. Doing so will impair its ability to claim losses or bad debt deductions in future years if the business suffers a downturn.

Revoking an interposed entity election

4.8 Similar to FTEs, it is possible to revoke an IEE, but in even more limited circumstances. If the company, trust or partnership that made an IEE becomes a member of the family group of

³³ Section 272-80(6) Sch 2F ITAA36

³⁴ Section 272-80(8) Sch 2F ITAA36

³⁵ ATO ID 2008/73

the related FTE's test individual (for example, because it becomes wholly owned by family members), then it is able to revoke its IEE³⁶. An IEE will also be automatically revoked if its related FTE is revoked³⁷.

- 4.9 An IEE can only be revoked within four years of it being made³⁸.

Issues surrounding disposals of interposed entities

- 4.10 Because of the difficulty in revoking IEEs and FTEs, there can be significant issues if the entity is disposed of to an unrelated third party.
- 4.11 A new owner of an entity that has made an IEE may find itself unable to extract value from the company. There are no provisions that deal with circumstances where an entity that has made an election is no longer owned by the parties that were eligible to make the election.

Example 7:

Slipnir Trust owns all the issued shares in Fenris Co and has received franked dividends from Fenris Co. Slipnir Trust has made an FTE and Fenris Co has made an IEE. In the subsequent year Slipnir Trust sells all the issued shares in Fenris Co to an unrelated third party.

The new owners of Fenris Co declare a dividend to themselves. This is a distribution that will incur family trust distribution tax as the new owners are not members of the family group of the test individual for the FTE for Slipnir Trust.

Presumably, the new owners of Fenris Co will make a substantial warranty claim against Slipnir Trust. This is an issue that must be identified as part of tax due diligence.

5 Conclusion

- 5.1 Family trusts are a very common structure for Australians holding wealth. They are unfortunately also a structure that allows taxpayers to sleepwalk into significant tax issues due to the restrictions that apply to family trusts – in particular the family trust distribution tax.
- 5.2 It is absolutely critical for this reason that advisors have a robust technical understanding of the rules governing family trusts to ensure that taxpayers don't trap themselves in adverse tax scenarios.

³⁶ Section 272-85(5A) Sch 2F ITAA36

³⁷ Section 272-85(5B) Sch 2F ITAA36

³⁸ Section 272-85(5C) Sch 2F ITAA36

- 5.3 While many of the legal issues relating to family trusts are conceptually relatively simple, the actual technical application can be complex, and appropriate care should be taken before making FTEs or IEEs.

The opinions in this paper are of the author and not of West Garbutt or Legalwise. This paper is for general information only and does not constitute legal advice. Readers should seek specific legal advice on the issues in this paper before taking action on any of the issues in this paper.