

Increasing flexibility for family trusts?

THE GOVERNMENT HAS INTRODUCED AMENDMENTS TO THE FAMILY TRUST MEASURES, BUT WHILST ANY INCREASE IN FLEXIBILITY IS A WELCOME CHANGE, THE MEASURES ARE STILL UNNECESSARILY RESTRICTIVE AND REPRESENT A MISSED OPPORTUNITY.



On the last day of Parliament before the winter recess the Government introduced the Tax Laws Amendment (2007 Measures No.4) Bill (the Bill). The Bill introduces a number of significant proposed amendments to the tax law. The natures of the changes are such that the Bill has been referred to the Senate Standing Committee on Economics. The relevant part of the Bill for the purpose of this article is Schedule 8.

The amendments made by Schedule 8 implement announcements made during the May 2006 Budget. In the Budget papers Treasury stated:

“This measure will allow family trust elections and interposed entity elections to be revoked or varied in certain limited circumstances. The definition of a family group will be broadened to include lineal descendants of family group members. In addition, trust distributions to former spouses, and to widows or widowers of family group members with new spouses, will also be exempted from family trust distribution tax.”¹

The announcements were vague but it is apparent that the amendments have been made in a very limited manner.

THE FAMILY TRUST REGIME

The family trust regime is contained in Schedule 2F of the *Income Tax Assessment Act 1936*. The measures were initially intended as a mechanism to ensure that only those persons who bore the economic loss relating to a revenue loss for tax purposes or in relation to bad debts obtained any tax benefit associated with that loss or bad debt. The regime has subsequently been extended such that it is also used in relation to the franking credit trading rules and the company loss recoupment rules.

The provisions operate by defining a family group based on an identified individual (the test individual) who alone or with others has some control in relation to operation of the trust. Entities can elect to be included within the family group of the test individual. The election in relation to the primary trust is called the “family trust election” (FTE) and the election made by a second entity to be included within the family group of the test individual is called an “interposed entity election” (IEE).

One of the consequences of making the elections is that effectively the provision of any type of benefit to someone outside the family group of the test individual triggers a liability to family trust distribution tax. Family trust distribution tax is calculated at the top marginal rate plus the Medicare levy (46.5 per cent).

REVOCAION

One of the issues with the family trust regime is that once an election is made, it is generally irrevocable save for specific limited circumstances relating to fixed trusts.

A proposed amendment made by Schedule 8 of the Bill is to introduce additional circumstances in which an election may be revoked. The circumstances are limited to those when the FTE has not been relied upon in accessing tax benefits² and where the revocation happens within a limited period of time.³

The reliance upon the FTE is important. If the taxpayer could still have accessed the relevant tax benefit without making the FTE, then the FTE is treated as not having been relied upon and therefore may be revoked.

The time period in which the FTE may be revoked is limited. Generally the period

expires at the end of the fourth income year after the income year specified in the relevant FTE. Therefore if a FTE was made specifying the 2006/07 income year, that FTE may be revoked for any income year up to the 2010/11 income year. The FTE is then only in force for the purpose of the tax legislation from the commencement period up to the end of the income year before the year in which the FTE was revoked. For example, if the FTE commenced in the 2006/07 income year and was revoked with effect from the 2009/10 income year, then that FTE will only be in force from 1 July 2006 through to 30 June 2009.

There is also a transitional rule that allows the FTE to be revoked in the period beginning at the start of the income year in which the provisions commence and at the end of the subsequent income year.⁴ The provisions commence in the year in which the Act receives Royal Assent.⁵ Assuming that the Bill is passed and receives Royal Assent this year the transitional period will commence 1 July 2007 and end 30 June 2009.

The restrictions as to when the FTE may be revoked appear to be limited to circumstances when the election was made in error and that error has been identified within the time periods allowed above. The time period restrictions seem to be unnecessarily restrictive. If the FTE has not been relied upon in accessing any tax benefits, as the first limb of the test requires, it seems unnecessary to restrict the period of time when a mistaken election may be identified and rectified.

The time period restriction is further enforced by the limitations that apply in effecting the revocation. The revocation must be made in the tax return of the trust for the income year in which the revocation is sought.⁶ If the trust does not need to lodge a tax return for the relevant year then the revocation must be in writing in an approved form specifying the income year from which the revocation is to be effective and must be given to the Commissioner of Taxation on or before 2 months after the end of the relevant income year. There is a discretion for the Commissioner to accept revocations at a later point in time.⁷

Similar rules apply in relation to the revocation of an IEE. Those provisions provide that an IEE is taken to be revoked if the FTE to which the IEE relates is revoked.⁸ Further, an IEE may be revoked by an entity if that entity is or becomes a member of the family group to which the IEE relates, by the operation of the new provisions outlined below.⁹ The time period limitations and notification requirements that apply for the revocation of an IEE are similar to those that apply for the revocation of a FTE.¹⁰

TEST INDIVIDUAL

Proposed amendments to the choice of the test individual also reflect an intention to allow rectification of errors rather than a genuine attempt at increasing flexibility.

The amendments provide for a once-only¹¹ opportunity to vary a FTE by choosing a new test individual.¹² To do so the new test individual must have been a member of the family of the original test individual as at the commencement time of the FTE.¹³ Further, in general terms there cannot have been an event that would have triggered a liability to family trust distribution tax by either the trust or an entity that had made an IEE in relation to the trust. That liability being determined as if the new test individual had been the test individual throughout the time that the FTE had been in force.¹⁴ The actual provisions of the legislation refer to conferrals of a present entitlement to income and capital or distributions of income or capital.

The amendments are overly restrictive as a result of the legislation taking a very specific rather than more purposeful approach which ultimately leads to inconsistencies and inequitable outcomes.

For example, if the trust had made a distribution of income and capital outside the family group of the original test individual at some point during the period in which the FTE was in force, it would have incurred a liability to family trust distribution tax. However the distribution would not have invalidated the FTE. Under the proposed amendments, if the recipient of the distribution referred to above was also outside the family group of the new test individual¹⁵ then even though the family trust distribution tax had been incurred and also paid, the fact that there had been a distribution outside the family group is enough to deny the trust the ability to elect a new test individual.

It is difficult to identify the reason for the limited scope of the variation provisions. It seems inconsistent with the initial intention of the family trust regime to ensure that only those persons who suffer the economic loss can obtain the tax benefit, to disallow the nomination of new test individuals from within that family group. If there is a concern that the family group could be shifted by such new nominations it would be possible to introduce a further variation power not based on only rectifying errors. This new variation power could be designed to deal with the death of the test individual whereby the family group could remain limited to the family group of the deceased individual but allow another individual to be chosen as the test individual for the FTE. If future trusts within control of the family could choose the same test individual and yet be limited to the family group of the deceased individual it would facilitate the addition of trusts to the family group after the death of the test individual. At present, the death of the test individual creates a significant impediment to the ability to add addition trusts to the family group.¹⁶

The time period restrictions that apply in relation to the revocation of FTEs described above also apply in relation to the variation of the test individual.¹⁷ Again, this appears to be an artificial limitation on the operation of the family trust regime. Whilst there are potential solutions to address the problem the query remains as to why this limitation is imposed in relation to the variation of the test individual.

There are some additional circumstances in which the test individual may be varied relating to marriage breakdown.¹⁸ These provisions are not limited in time and do not contain qualifying restrictions regarding there being no distributions outside the family group. The provisions only require that as a result of an order, agreement or award of the kind mentioned in the CGT marriage breakdown provisions¹⁹ the new individuals and members of the new individual's family have control of the trust.²⁰

FAMILY MEMBER AND THE DEFINITION OF FAMILY

The remaining amendments made by Schedule 8 are not as controversial and do provide for some increased flexibility or at least practical solutions to current problems with FTEs.

First, the amendments provide that trusts that have made FTEs nominating the same test individual are all within the one family group.²¹ This means that the prior practice of making numerous IEEs for trusts all nominating the same test individual can cease. Previously a group of three trusts with the same test individual would require nine elections to ensure that all of the trusts were members of each others family groups (one FTE and two IEEs in each case). Under the proposed amendments the IEEs will not be required.

Further, proposed amendments also now provide that former spouses,²² widows/widowers,²³ and step children²⁴ will remain members of the family group despite changes in the nature of the relationship between the parties, for example by marriage breakdown or remarriage.

The definition of the "family" of a test individual has also been extended. It now includes lineal descendants of the nephew, niece or child of the test individual.²⁵ Further, adopted children, step-children and ex-nuptial children are to be considered in determining the lineal descendants of a member of the family.²⁶ Finally, amendments provide that a person does not cease to be a member of the family as a result of the death of another member of the family.²⁷

The extension to the definition of the family still excludes some individuals who may ordinarily be considered to be family members. For example, cousins, uncles and aunts of the test individual are not members of the test individual's family group.²⁸

CONCLUSION

Whilst any increase in flexibility in the operation of the family trust regime is welcomed it is disappointing that the opportunity to introduce sensible and practical amendments to ensure that the measures operate fairly and equitably has been missed.

The family trust regime is an example of an area of the tax law where open and genuine consultation between all stakeholders could result in a much better system. Whilst there were a number of very good submissions made in relation to exposure draft material²⁹, it is unknown why those submissions have not been accepted and why consultations in relation to this legislation were conducted privately. It is hoped that in the future there may be some open debate as to the purpose of the

family trust regime, resulting in legislation being drafted to satisfy that purpose whilst still remaining fair and equitable.

If the Bill is enacted and receives Royal Assent, taxpayers will need to carefully review existing FTEs and IEEs to determine whether they can and should take advantage of the short transitional period to vary the test individual or revoke an existing FTE or IEE.

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Reference notes

- 1 Commonwealth Government, *Budget Measures 2006-07*, Budget Paper 2, Part 1, page 18.
- 2 Tax Laws Amendment (2007 Measures No.4) Bill, Schedule 8, Item 3, proposed s 272-80(6A).
- 3 *Ibid*, item 3, proposed s 272-80(6B).
- 4 *Ibid*, item 3, proposed s 272-80(6B).
- 5 *Ibid*, item 14.
- 6 *Ibid*, item 4, proposed s 272-80(8).
- 7 *Ibid*, item 4, proposed s 272-80(8)(c)(iii).
- 8 *Ibid*, item 6, proposed s 272-85(5B).
- 9 *Ibid*, item 6, proposed s 272-85(5A).
- 10 *Ibid*, item 6, proposed s 272-85(5C) & (6).
- 11 *Ibid*, item 2, proposed s 272-80(5B).
- 12 *Ibid*, item 2, proposed s 272-80(5A).
- 13 *Ibid*, item 2, proposed s 272-80(5A)(a). The Explanatory Memorandum to the Bill states that this requires the new test individual to have been alive at the election commencement time (para 8.32).
- 14 *Ibid*, item 2, proposed s 272-80(5A)(b) and (c).
- 15 A likely result if the recipient was an unrelated arms length third party.
- 16 See Monahan, J, "Trust elections – different primary individuals", *Taxation In Australia* 40(3) September 2005, page 150.
- 17 Tax Laws Amendment (2007 Measures No.4) Bill, item 3, proposed s 272-80(5A), (6B) and item 4, proposed s 272-80(7).
- 18 *Ibid*, item 2, proposed s 272-80(5C).
- 19 Specifically, *Income Tax Assessment Act 1997*, s 126-5(1)(a) to (f).
- 20 Tax Laws Amendment (2007 Measures No.4) Bill, item 2, proposed s 272-80(5C) read with proposed s 272-80(5D).
- 21 *Ibid*, item 9, s 272-90(3A).
- 22 *Ibid*, item 8, s 272-90(2A)(a).
- 23 *Ibid*, item 8, s 272-90(2A)(b).
- 24 *Ibid*, item 8, s 272-90(2A)(c).
- 25 *Ibid*, item 10, s 272-95(1)(c).
- 26 *Ibid*, item 10, s 272-95(3).
- 27 *Ibid*, item 10, s 272-95(2).
- 28 Brazzale, J (Pitcher Partners), *Submission on Schedule 8 of Tax Laws Amendment (2007 Measures No.4) Bill to the Senate Economic Committee*, 9 July 2007, page 5.
- 29 *Ibid*