

# Family trust elections – where are we today?

**THERE HAS BEEN SIGNIFICANT UNCERTAINTY SURROUNDING THE FATE OF THE AMENDMENTS MADE TO THE FAMILY TRUST REGIME: HAS THIS UNCERTAINTY NOW BEEN RESOLVED?**



## INTRODUCTION

In 2007 there were a number of amendments made to the family trust regime in Schedule 2F of the *Income Tax Assessment Act 1936 (ITAA36)*. Amendments were made to both the procedural mechanisms associated with the making of a family trust election and the substantive provisions of the family trust regime. However, since the publication of the article titled “Increasing flexibility for family trusts” in the August 2007 edition of this journal,<sup>1</sup> the amendments to Schedule 2F of ITAA36, and particularly the amendments to the substantive provisions of the family trust regime have been subject to much uncertainty. This uncertainty continued up until September 2008 as a result of the proposal of the new Rudd Labor Government to reverse the amendments made to Schedule 2F of ITAA36 with retrospective application effective from 1 July 2008.

So as to clarify the current provisions of the family trust regime, this article will revisit the amendments made to Schedule 2F of ITAA36, consider their proposed reversal and will ultimately identify the current state of the law in respect of the family trust regime.

## FAMILY TRUST ELECTIONS

A family trust election involves defining a family group based on an individual (**test individual**). It is the election of the test individual in respect of a trust that is referred to as the “family trust election” (**FTE**). Other entities can elect to be included within the family group of the test

individual and such an election is called an “interposed entity election” (**IEE**).

A FTE may be made for a number of reasons. The most common reasons for making a FTE are to enable access to trust losses and to access franking credit benefits associated with a dividend received by a trust.

Under the trust loss provisions of Schedule 2F of ITAA36 family trusts are “excepted trusts”.<sup>2</sup> Excepted trusts are not required to satisfy a number of the threshold tests set out in Schedule 2F of ITAA36 in order to claim tax losses and certain debt deductions. However, this does not mean there are no tests to be satisfied in order for a family trust to obtain a deduction for a tax loss. For example, the income injection test may be relevant and require consideration in determining the availability of a tax deduction in respect of a loss incurred. The legislation regarding the ability to obtain a deduction for a tax loss or other debt deduction is a complex area and not within the scope of this article to consider. However, it is important to recognise that the making of a FTE in respect of a trust obtaining a deduction for tax losses, although fundamental, is just one part of the analysis to be undertaken.

In relation to the ability of a beneficiary of a trust to access franking credits, as a general rule, a beneficiary of a discretionary trust will only be entitled to the franking credit benefit associated with a dividend where the discretionary trust has made a FTE.<sup>3</sup> This results from the requirement that a taxpayer may only claim franking credits if that person is a “qualified person” in relation to the franked dividend. Again, the making of a FTE is fundamental to the ability of a trust to access franking

credits but it is not necessarily the only matter requiring consideration.

## AMENDMENTS TO THE PROCEDURAL MECHANISMS OF MAKING A FTE

Prior to the introduction of *Tax Laws Amendment (2007 Measures No. 4) Act 2007 (TLAMA2007)*, in order for an entity to fall within a family group it was potentially necessary for both a FTE and IEE to be made, and potentially more than one of each. That is, if there was more than one trust to be included in the family group it was potentially necessary for both a FTE and IEE to be made to ensure that each of the trusts were members of each of the other trust’s family group.

For example, assume there was a group of three trusts each with the same test individual. In this circumstance it would have been necessary for nine elections to be made. One FTE and two IEEs would need to be made in respect of each trust. This was necessary to ensure that each of the trusts were members of the other trusts’ family group.

However, this is no longer necessary as a result of the insertion of new s 272-90(3A) into Schedule 2F of ITAA36 by TLAMA2007. Section 272-90(3A) provides as follows:

“A trust with the same primary individual specified in its family trust election is a member of the primary individual’s family group in relation to the conferral or distribution.”

This section effectively provides that each trust which has made a FTE nominating the same test individual will automatically fall within the same family group without the need for potentially making multiple IEEs.

Arguably this amendment has achieved its original purpose of simplification of the

system by significantly reducing the reporting obligations imposed on entities in relation to the making of a FTE and eliminating what was previously seen to be multiple reporting of the same information.

## AMENDMENTS TO THE SUBSTANTIVE PROVISIONS OF THE FAMILY TRUST REGIME

The amendments to the substantive provisions of the family trust regime have been the subject of significant uncertainty, which first arose in August 2007.

Before proceeding to consider where the uncertainty has arisen, it is first necessary to briefly reiterate the amendments introduced to the family trust regime by TLAMA2007. TLAMA2007 received Royal Assent on 24 September 2007 with the amendments made having retrospective application, such that they are effective from 1 July 2007. These amendments have been considered in detail in the article titled “Increasing flexibility for family trusts”<sup>14</sup> which includes an analysis of the amendments made including whether those amendments are sufficient to achieve the intended policy reasoning behind the amendments.

Pursuant to TLAMA2007, the three substantive amendments to Schedule 2F of ITAA36 effective from 1 July 2007 were as follows:

1. the introduction of the ability to revoke a family trust election, albeit a limited right;<sup>5</sup>
2. the introduction of the once only ability to vary the test individual nominated pursuant to a FTE;<sup>6</sup> and
3. the amendment to the definition of family and family group.<sup>7</sup>

### Revocation

Prior to the amendments to Schedule 2F of the ITAA36 by TLAMA2007, once a FTE was made it was generally irrevocable save for very limited circumstances relating to fixed trusts.<sup>8</sup> Schedule 8 of the TLAMA2007 introduced additional circumstances in which a FTE or ITEE may be revoked. The circumstances are limited to those when the FTE has not been relied upon in accessing tax benefits<sup>9</sup> and where the revocation happens within the specified limited period of time.<sup>10</sup>

In relation to the issue of reliance, the question to be asked in determining

whether there has been reliance on a FTE is whether the taxpayer could have accessed the relevant tax benefit without having made the FTE. If the answer to this question is yes, then the FTE is treated as not having been relied upon and therefore may be revoked.

would have triggered a liability to family trust distributions tax by either the trust or an entity that had made an IEE in relation to the trust, if the new individual had been the test individual throughout the entire period that the FTE had been in force.<sup>18</sup>

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The time period within which the revocation of the FTE must be made is limited. Generally, a revocation pursuant to s 272-80(6A) of ITAA36 cannot be made unless the revocation is in respect of an income year that occurs during the period starting at the beginning of the income year specified in the FTE and finishing at the end of the fourth income year after the income year specified in the FTE.<sup>11</sup> TLAMA2007 also includes a transitional provision that allows a FTE to be revoked during the period beginning at the start of the income year in which the provisions commence and at the end of the subsequent income year.<sup>12</sup> Accordingly, this transitional period will end on 30 June 2009.

Although the ability to revoke a FTE is restricted, the amendment does provide an opportunity for FTEs<sup>13</sup> to be revoked, returning to the trust the ability to distribute outside the family group without incurring family trust distribution tax.<sup>14</sup> Similar provisions are also included in respect of IEEs.<sup>15</sup>

### Test individual

The introduction of the ability to vary the test individual nominated pursuant to a FTE is a once only opportunity<sup>16</sup> and is restricted by the following factors:

- the new individual must have been a member of the family of the individual originally specified in the FTE;<sup>17</sup> and
- there cannot have been any distribution or conferral of present entitlement that

Further, the timing restrictions that apply in respect of revoking a FTE also apply in respect of the ability to vary the test individual.<sup>19</sup> This includes the transitional timing provision which permits the variation of the test individual to take place during the period beginning at the start of the income year in which the provisions commenced and at the end of the subsequent income year, being 30 June 2009.<sup>20</sup>

In addition to the above ability to vary the test individual, a test individual may also be varied as a result of marriage breakdown.<sup>21</sup> In order for a test individual to be varied to a new individual in these circumstances it is necessary that there is an order, agreement or award of the kind mentioned in the capital gains tax marriage breakdown provisions<sup>22</sup> regarding the marriage breakdown and that the new individual and members of the new individual's family have control of the trust.<sup>23</sup>

### Family and family group

The definitions of family and family group were amended in two ways as a result of TLAMA2007.

The first amendment is the insertion of new ss 272-90(2A)(a) – (c) of ITAA36. This amendment provides that former spouses, widows/widowers and step-children 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 second amendment is the extension of the definition of the family of a test individual. The definition lineal descendants now includes the nephew, niece or child of the test individual.<sup>24</sup> Further, adopted children, step-children and ex-nuptial children are to be considered in determining the lineal descendants of a member of the family.<sup>25</sup> Finally, a person will not cease to be a member of the family as a result of the death of another member of the family.<sup>26</sup>

The diagram below illustrates the persons who will fall within the definition of “family group” as a result of these amendments, with the changes as a result of TLAMA2007 being highlighted.

**Proposed reversal of amendments by the Rudd Labor Government and Tax Laws Amendments (2008 Measures No 4) Bill 2008**

On 13 August 2007 the Australian Labor Party (ALP), being in opposition to the government at that time, announced for the first time its intention to reverse the changes to the family trust regime introduced by the *Tax Laws Amendment (2007 Measures No. 4) Bill 2007*. At this time, Royal Assent in respect of the *Tax Laws Amendment (2007 Measures No. 4) Bill 2007* was yet to be received. The announcement by the ALP provided no details as to the extent of the proposed reversal of the amendments.

The position of the ALP was again reiterated in a costing request made on 21 November 2007 (ALP148) in which the ALP requested Treasury to provide a costing on the ALP’s policy to “reverse the changes to Family Trusts introduced by the Government in *Tax Laws Amendment (2007 Measures No 4) Bill 2007*”.

The costing request noted 1 July 2008 as the intended date for implementation of the change although the extent of the proposed reversal was still not specified.

It was at this time that the first sign of uncertainty and concern arose.

The effect of this announcement being that the new provisions of Schedule 2F of ITAA36 could not be relied upon with any certainty if they were to be reversed in totality effective from 1 July 2008.

Consistent with the ALP’s media release, the ALP introduced *Tax Laws Amendments (2008 Measures No 4) Bill 2008 (TLAMB2008)* to the House of Representatives on 26 June 2008.

“...all amendments to Schedule 2F of ITAA36 as a result of TLAMA2007 remain in force with no amendment effective from 1 July 2007.”<sup>34</sup>

The position of the ALP in relation to the reversal of TLAMA2007 was confirmed in a media release of 13 May 2008.<sup>27</sup> The media release contained details of the proposed reversal and the extent of the proposal reversal of the amendments made by TLAMA2007. The proposed amendments to ITAA36 were to reverse the introduction of the following:

1. the extension of the definition of family to limit lineal descendants to children and grandchildren of the test individual and the test individual’s spouse effective from 1 July 2008; and
2. the once only ability to vary the test individual of a FTE in limited circumstances effective from the 2007-08 income year.

Both of these proposed amendments to ITAA36, being a reversal of part of the provisions introduced by TLAMA2007, were justified by the ALP on the basis that the aim of the reversal of these provisions was “to improve the integrity of the tax system and to achieve cost savings to help fund more urgent priorities”<sup>28</sup> and to “... reduce the scope for family trusts to utilise tax losses to lower income tax, delivering on the Government’s commitment to disciplined budget management.”<sup>29</sup>

TLAMB2008 included provisions to effect the reversal in part of the amendments made to the family trust regime by TLAMA2007. TLAMB2008 also made it clear that these proposed amendments were not to have effect in the 2007-08 income year. Although commentators and tax experts continued to have concerns regarding the amendments, there was some relief that such amendments would not have retrospective application<sup>30</sup> as had been previously indicated in respect of the reversal of the ability to vary the test individual.<sup>31</sup>

Significant criticism was received by the ALP for the position taken in respect of the reversal, in part, of the amendments made to Schedule 2F of ITAA36 by TLAMA2007. There were a number of grounds for such criticism including the following:

- there were queries regarding the costs savings to be achieved by the amendment and a view that the burden imposed on business as a result of the reversal of the amendments would far outweigh any gain in tax receipts;<sup>32</sup> and
- the amendments made by TLAMA2007 did not have the purpose of facilitating tax benefits but instead aimed to avoid

	Grandparent	Grandparent	
	Parent	Parent	
Brother/Sister	Primary individual	Spouse	Brother/Sister
Child	Child	Child	Child
All lineal descendants	All lineal descendants	All lineal descendants	All lineal descendants
And spouses, former spouses, widows, widowers and step-children of all above parties			

inequities and unfairness arising from a restricted definition of family and family group.<sup>33</sup>

On 26 August 2008 the Senate Standing Committee on Economics considered the amendments proposed to the family trust regime by Schedule 2 of TLAMB2008 in light of the comments made by a number of taxation experts and bodies including the Taxation Institute of Australia. Arguments included reference to the policy behind the original amendments made to Schedule 2F by TLAMA2007 together with the insignificant costs savings to be achieved by TLAMB2008. Ultimately, the Senate Standing Committee on Economics indicated that the proposed amendments still achieved the outlined objectives of the ALP, including costs savings, however large they may be.

## FINAL POSITION

Regardless of the comments made by the Senate Standing Committee on Economics in relation to the TLAMB2008, when TLAMB2008 came before the Senate it was passed subject to the deletion of Schedule 2, being the provision of TLAMB2008 which sought to reverse the amendments made to the family trust regime. The amended TLAMB2008 was subsequently accepted by the House of Representatives. TLAMB2008 was passed by both houses on 17 September 2008 and received Royal Assent on 3 October 2008.

The consequence of TLAMB2008 being passed subject to amendment by both houses of Parliament is that all amendments to Schedule 2F of ITAA36 as a result of TLAMA2007 remain in force with no amendment effective from 1 July 2007.<sup>34</sup>

## CONCLUSION

The extended period during which the fate of the amendments made to Schedule 2F of ITAA36 by TLAMA2007 was unknown has resulted in uncertainty and difficulties for businesses in respect of not only applying the family trust regime but also in determining the state of the law. This uncertainty has continued past the date of the TLAMB2008 receiving Royal Assent arguably because of the protracted period during which the state of the law was uncertain.

Since the passing of the amended TLAMB2008 in September 2008, tax advisors and businesses can confidently rely on the provisions contained in Schedule 2F of ITAA36 as amended by TLAMA2007 as the current law.

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### Reference notes:

- 1 D Smedley, "Increasing flexibility for family trusts", *Taxation in Australia*, Vol 42 No. 2, August 2007 at 99.
- 2 Section 272-100 of *Income Tax Assessment Act 1936*.
- 3 Subject to the entitlement of beneficiaries who are natural persons to claim a total franking rebate for the relevant income year not exceeding \$5,000 where there is no FTE (former s 160APHT of the *Income Tax Assessment Act 1936*).
- 4 D Smedley, "Increasing flexibility for family trusts", *Taxation in Australia*, Vol 42 No. 2, August 2007 at 99.
- 5 *Tax Laws Amendment (2007 Measures No. 4) Act 2007*, Schedule 8, item 3.
- 6 *Tax Laws Amendment (2007 Measures No. 4) Act 2007*, Schedule 8, item 2.
- 7 *Tax Laws Amendment (2007 Measures No. 4) Act 2007*, Schedule 8, items 8 and 10.
- 8 Section 272-80(5) of the *Income Tax Assessment Act 1936*.
- 9 Section 272-80(6A) of the *Income Tax Assessment Act 1936*.
- 10 Section 272-80(6B) of the *Income Tax Assessment Act 1936*.
- 11 Section 272-80(6B)(a) of the *Income Tax Assessment Act 1936*.
- 12 Section 272-80(6B)(b) of the *Income Tax Assessment Act 1936*.
- 13 Particularly those FTE's made in error, as the FTE is unlikely to have been relied upon.
- 14 Section 271-15 of the *Income Tax Assessment Act 1936*.
- 15 Section 272-85(5A) and s 272-85(5B) of the *Income Tax Assessment Act 1936*.
- 16 Section 272-80(5B) of the *Income Tax Assessment Act 1936*.
- 17 Section 272-80(5A)(a) of the *Income Tax Assessment Act 1936*.
- 18 Section 272-80(5A)(b) and 272-80(5A)(b) of the *Income Tax Assessment Act 1936*.
- 19 Section 272-80(6B) of the *Income Tax Assessment Act 1936*.
- 20 Section 272-80(6B)(b) of the *Income Tax Assessment Act 1936*.
- 21 Section 272-80(5C) of the *Income Tax Assessment Act 1936*.
- 22 Sections 126-5(1)(a) – (f) of the *Income Tax Assessment Act 1997*.
- 23 Sections 272-80(5C) and 95D of the *Income Tax Assessment Act 1936*.
- 24 Section 272-95(1)(c) of the *Income Tax Assessment Act 1936*.
- 25 Section 272-95(3) of the *Income Tax Assessment Act 1936*.
- 26 Section 272-95(2) of the *Income Tax Assessment Act 1936*.
- 27 *Family Trusts – Savings Measure*, Assistant Treasurer, Media Release of 13/05/2008 No.34.
- 28 *Ibid.*
- 29 *Ibid.*
- 30 Sue Williamson, *Taxation Institute welcomes the Family Trust decision*, Media Release Taxation Institute of Australia, 27 June 2008.
- 31 *Family Trusts – Savings Measure*, Assistant Treasurer, Media Release of 13/05/2008 No.34.
- 32 D Crowe, "Trust law changes to bring savings of only \$1m", *Australian Financial Review*, 13 August 2008, pg 5; M Liebler, Arnold Bloch Liebler correspondence to Senate Standing Committee on Economics dated 8 August 2008; B Pulle, "Tax Laws Amendment (2008 Measures No. 4) Bill 2008", *Bills Digest No 10 2008-2009*, 28 August 2008.

33 P Riley, "ALP tax policy will have a wide-reaching effect on family trusts", *Contact Pitcher Partners*, Issue 62 2008, pp 1-2.

34 Mr Chris Bowen, being the Assistant Treasurer for the ALP, during the consideration of the amended TLAMB2008 by the House of Representatives on 17 September 2008 confirmed the ALP's reluctant agreement to the amendment of TLAMB2008 to remove Schedule 2.