

TAX-ACTION

Issue 2 – August 2004

FAMILY TRUST ELECTIONS - TIME IS RUNNING OUT!

Taxpayers have been provided with this wonderful opportunity to make a retrospective family trust election (“FTE”) or retrospective interposed entity election (“IEE”) in the 2004 year. As well, where these elections have previously been made, there is also an opportunity to make these existing elections apply to an earlier year than is currently the case. This has led to a high level of confusion among taxpayers and advisors alike. The following questions have been commonly been asked of us:-

- When do we need to make retrospective elections?
- What conditions must be met in order to make these retrospective elections?
- What are the time limits for making elections?
- What do I do if I am not sure an election was previously made?
- What are the implications of making these elections?
- Should we make a retrospective election just in case?
- Who can we nominate as the specified individual?
- What other problems can arise in relation to nominating a specified individual?

Each of these questions is addressed in more detail below.

When do we need to make retrospective elections?

There are four circumstances we have identified where a FTE or IEE may be required. These are:-

- *A discretionary trust has made a tax loss or incurred a bad debt deduction since 9th May 1995 and the alternative deduction recoupment tests cannot be met or it is uncertain they can be met.*

In these cases there are a variety of alternative tests that must be met including the 50% stake test, the control test, the pattern of distribution test and the income injection test before the loss or bad debt deduction is available. These tests can be met and not all of the tests will apply depending on the circumstances of each trust. Sometimes the pattern of distribution test can be contrived to be met in the deduction recoupment year.

GuSTAX Consulting Pty Ltd
ABN 16 097 171 509
(Just Tax Consulting)
PO Box 5200,
Studfield Post Office,
Wantirna Vic. 3152
Email: tony@justtax.com.au



The contents of this paper are for general information only. They are not intended as professional advice and you should consult a qualified accountant or other suitably qualified professional. Whilst all care and diligence has been exercised in the preparation of this newsletter, GuSTAX Consulting Pty Ltd expressly disclaims all liability for any loss or damage arising from reliance upon any information in this paper.

Copyright strictly reserved. No part of these Notes may be reproduced or copied in any form or by any means (graphic, electronic or mechanical, including photocopying, recording, taping, or information retrieval systems) without the written permission of

GuSTAX Consulting Pty Ltd

“Tax-action” is a registered business name in the State of Victoria

The hardest test to meet will be the income injection test. Unless the trust has recouped these deductions from its own resources without income injections, loan fund injections or any other financial assistance, then meeting the income injection test is extremely difficult.

Please note that the election was required to be made in the year of the loss and not the year of recoupment if the alternative tests could not be met.

We strongly recommend a retrospective election here unless you are absolutely satisfied that the trust can meet the alternative tests. Otherwise, should the Tax Office conduct an audit of the trust and is within the time limits for amendment, the losses or bad debt deductions will probably be forfeited.

- ***The trust is in receipt of franked dividends from shares acquired after 31st December 1997 and beneficiaries that receive distributions of those franked dividends from the trust receive in total from the trust and other sources franking credits of \$5,000 or more in an income tax year.***

The 45 day holding rule requires that shares be held at risk for more than 45 days in order for the franking credits attached to those shares to be available for the benefit of the taxpayer. Shares are held at risk where the identified owners are at risk in relation to increases and decreases in the market value of the shares during the period the shares are held. There is a “de minimis rule” where the 45 day holding rule only applies where the franking credits received by the individual taxpayer must be \$5,000 or more in an income tax year before the franking credits are forfeited. Even if the franking credits received in a trust on shares acquired after 31st December 1997 are less than \$5,000 or the distributable portion of the credits provided to a beneficiary is less than \$5,000, the 45 day holding rule can still apply where the shareholder also receives franking credits from other sources and the combined franking credits in the hands of the beneficiary are \$5,000 or more.

In a discretionary trust, it is impossible to identify who owns the shares. Whilst every eligible beneficiary is contingently entitled to the shares, until the shares are advanced out of the trust to the benefit of specific beneficiaries, it is impossible to determine the actual owners of the shares. This means that on pure technicality, the 45 day holding rule can never be met.

As part of the 45 day holding rule provisions, a concession was allowed for discretionary trusts that made a family trust election. As soon as the election was in place, the trustee was deemed to be the individual owner of the shares thus allowing the 45 day holding rule to be met. It should be noted that there is no alternative way of meeting this 45 day holding rule for a discretionary trust. Therefore sooner or later discretionary trusts that hold shares acquired after 31st December 1997 will need to make a family trust election to protect the franking credits for the beneficiaries.

CHANGE OF EMAIL DOMAIN & ADDRESS

As a matter of convenience to our clients in pronouncing the name of our practice and remembering our email address, we have adopted the following email address:-

tony@justtax.com.au

Please alter your records to reflect this new email address.

We will continue to trade as Gustax Consulting Pty Ltd (pronounced Just Tax Consulting) and will continue to provide specialist GST advice.

However, please keep in mind that we are income tax, employment taxes and GST specialists and can provide high level tax consulting services as well as competitive tax training in all of these areas. ♦

No election is required where the trust does not receive franking credits at all or where it can easily be ascertained that none of the beneficiaries will ever exceed the \$5,000 franking credit threshold. Otherwise there is no choice but to make the election in these cases in order to safeguard the franking credits in the beneficiaries' hands.

- ***The trust has an ownership interest in a company that has incurred losses or bad debts and the company needs to take account of the trust's ownership interest in order to pass or fail the continuity of ownership ("COT) test.***

In order to recoup tax losses in a company or bad debt deductions, the company must meet the COT test. Failing the COT test, it may then meet the same business test ("SBT") in order to recoup the losses. Failure of both tests means that the losses are forfeited.

Whilst the COT test has been modified over time, the main requirement is that the company must show that more than 50% of the shareholders in the year the loss or bad debt, must also be shareholders in the year of recoupment of that deduction as well as all of the period in-between.

Where a discretionary trust owns the shares, the owners of the shares cannot be determined. If 50% or more of the owners cannot be determined, the company can neither pass nor fail the COT test. As it cannot prove it has passed or failed this test, it cannot access the SBT test and the losses and bad debt deductions are forfeited forever. SBT is only available where COT is failed!

If the discretionary trust makes a family trust election, the shareholder will be deemed to be the trustee personally and the company will now be able to identify an owner of the shares for the purpose of applying the COT test. This may enable the company to pass the test (or fail it thus providing access to the SBT test).

There are alternative tests in the carry forward loss provisions where the discretionary trust has not made family trust elections. However these alternative tests are almost impossible to understand and apply and very difficult to meet. The safest approach in almost all of these cases is to make a FTE.

Although these provisions only apply to losses and bad debts incurred in companies from 1st July 1996 onwards, unrecouped company losses and bad debts from prior to that date are also at risk without this election in place. Usually the continuous ownership test cannot be met continuously from 1st July 1996 onwards without an election in place.

- ***The trust has an interest in a fixed (unit) trust which has incurred losses or bad debts since 9th May 1995 and that fixed trust cannot pass the alternative tests to recoup those deductions and needs to count the ownership interest of the trust to pass the 50% stake test.***

In order for a fixed trust to access losses or bad debt deductions it must pass a variety of tests as well. The

About the Editor

Tony Evans is a Chartered Accountant who has extensive tax consulting experience over 20 years working in the profession including overseas experience working with VAT in the UK. The founder and Managing Director of GuSTAX Consulting Pty Ltd, he was previously a partner with a boutique tax division in one of the mid-tier accounting firms in Melbourne. Tony's diverse tax specialisation's include: -

- GST
- Employment taxes
- Corporate Taxes
- CGT
- PAYG
- Expatriate Taxation

He is also recognised as an excellent communicator and trainer and has conducted numerous technical sessions for the ICAA and members of the profession. ♦

first test is the 50% stake test. Where discretionary trusts own more than 50% of the interests in a fixed trust, the only way this test can be met is by the discretionary trusts making FTEs. This test is similar to the COT test for companies.

There is an alternative to the 50% stake test and that test is much harder to meet and requires detailed analysis. Whilst the need for the discretionary trusts that own interests in the fixed trust to make FTEs is removed, it is rare that this alternative test is met.

Irrespective of the above, the fixed trust must also pass an income injection test. Unless the income injection has come only from the trustee of the trust or the unit-holders, the trust must basically recoup the losses or bad debt deductions solely from its own resources. Any injection of assets, loan funds or benefits into the trust that leads to the recoupment of those losses is likely to breach the income injection test.

Unless you are totally satisfied the alternative tests have been met, a retrospective FTE is probably required. However there is little point in making elections if the income injection test is failed in any event.

What conditions must be met in order to make these retrospective elections?

The concession in PS LA 2004/1 (GA) is literally that. It is in conflict with the taxation law. Basically the Commissioner of Taxation is allowing trusts to breach the law in making these retrospective elections. In a Court of Law, it is unlikely that any retrospective elections would be considered valid and effective. For this reason, the requirements of the practice statement must be met in full to get this discretion.

Several conditions must be met to make a retrospective FTE or to treat an existing FTE as having an earlier application. These are:-

- The trust must meet the Family Control Test at all times the election is backdated to. This means that you must be able to demonstrate that the same family controlled the trust for the whole period from when the election is first applied.
- The trust cannot have made a distribution of income or capital to a person who would be considered outside the family group during the period the election is to be effective. Whilst the family group is defined in the trust loss provisions and is quite wide, an analysis of all distributions should be made to confirm that all recipients are in the family group with reference to the specified person nominated. Where distributions have been made to other trusts and companies, these entities may need to make a retrospective IEE for the same specified person and will need to meet similar tests. Choosing the correct specified person will be an essential part of this process.
- There cannot already be in place a valid FTE unless you are requesting the current FTE to have further retrospective application.

If these tests cannot be met, you will not be able to make the retrospective elections and will need to meet the alternative recoupment tests where appropriate.

What are the time limits for making elections?

The practice statement is quite specific. This one off opportunity requires the retrospective election to be made in your 2004 trust tax return but only where that tax return is required to be lodged. To be effective, we suggest that these returns are lodged within the lodgement period time limits.

If no tax return is required to be lodged for the 2004 tax year, the retrospective FTE must be lodged by 31st August 2004. This requirement will apply where the trust has no assessable income and under the gazetted regulations in relation to lodgement of returns, no tax return lodgement is required. We understand that lodging a tax return for the 2004 tax year in these circumstances will be ineffective in making the retrospective FTE. For dormant trusts, we strongly recommend that retrospective FTEs are lodged by 31st August 2004.

The ATO will soon be issuing guidelines in relation to how you make a retrospective election or how to have an existing election treated as applying from an earlier date. However and subject to the guidelines, we recommend the following approaches:-

For making retrospective elections for the first time:-

- Flag the front cover of the tax return indicating the year the election is to be valid from.
- Attach as a schedule to the return, the FTE or the IEE completed in every detail as required.
- Arrange for the return and FTE / IEE to be signed by the public officer.
- Ensure when lodging the return that a copy for the FTE / IEE election is also lodged. For ELS lodgements, the election must be attached and lodged electronically.

In relation to having a current FTE / IEE treated as applying to an earlier time, no guidelines on how to do this have been provided by the ATO. Whether you incorporate the following into the tax return or arrange the following separately, we recommend the following:-

- A separate letter is addressed to the ATO requesting that the current election has retrospective application indicating the date it is to apply from.
- A copy of the current FTE / IEE is attached.
- All documents are clearly signed by the public officer of the trust.

As guidelines on these arrangements are due out from the ATO shortly, the above comments are made subject to those guidelines.

What do I do if I am not sure an election was previously made?

This may be a real problem particularly where the records do not exist, you have picked up the client recently or there have been significant staff changes in your practice. Please keep in mind that the current ATO view is that if an election has not been physically or electronically lodged, no valid election has been made.

Many tax agents arranged for elections to be signed and held but may not have validly lodged them. Indicating that an election was made on the front cover of a tax return is not sufficient. The schedule of the election had to be completed and lodged as well. It had to be tagged correctly on the software as being lodged with the tax return.

TAX TRAINING FOR YOUR PRACTICE

With the complexity of taxation laws, it is now essential that you and your staff undertake regular taxation training. Gustax Consulting offers significant benefits in providing training including:-

- **Highly reputable trainer in Tony Evans, our in-house tax specialist. You get a trainer that provides tax consulting advice to tax practitioners and is not just a training presenter.**
- **Best value for money in town – starting from \$675 plus GST per two hour session in Suburban Melbourne. This includes both a tax update and a special topic each month. The composition is up to you!**
- **Practical based sessions that tell you what is relevant for your practice. We ask you what you want and tailor accordingly!**
- **Guaranteed to get the same highly skilled trainer each session resulting in continuity and consistency in your training.**
- **Comprehensive Tax Update notes each month provided electronically in advance of the session so you can read them before hand.**
- **Extensive list of special topics to choose from with detailed papers – and you get to choose when you want the topic!**
- **Training is provided at your premises to all of your staff at a mutual time of convenience – No need for you to travel.**
- **Over three years track record of high quality service.**
- **Groups of up to 20 people allowed in sessions and you can share costs with others by putting groups of firms together.**

If monthly sessions don't suit – talk to us. We can provide flexible solutions to meet your practice's needs. Don't pay anymore than you need for high quality tax training - Contact Tony Evans to find out more on: -

Telephone	9884 1187
Facsimile	9887 5325
Email	tony@justtax.com.au
Mobile	0402 035 767

For the 1998 year, some tax agents may have completed elections after they lodged the returns. Unless these were posted into the ATO, the ATO is unlikely to have registered that a valid election has been made.

It is possible to do a Freedom of Information request to the ATO to establish whether an election was made or not. We strongly recommend you do this where there is some uncertainty as to whether a valid election has been made. If you take this approach, please ensure that you request a copy of the lodged election be supplied. Without this, you will not know who the specified person is. This information will be crucial if other FTEs or IEEs are required to be made for associated entities.

What are the implications of making these elections?

Once a valid election has been made, the trust or other entity will be subject to Family Trust Distribution Tax at 48.5% on any distributions made outside the family group. These restrictions apply to income and capital distributions. It will not matter what the trust deed allows, the pool of beneficiaries will be restricted to the following to avoid the imposition of this tax on the trustee:-

- The specified individual
- Family members of the specified individual.
 - The specified individual's spouse (but not their ex-spouse)
 - A child, child of a child, parent, grandparent, brother, sister, nephew or niece of the specified individual or of his/her spouse
 - The spouse of any of the above
- The discretionary trust the family trust election relates to.
- Interposed entities that have elected to be such in relation to the family group.
- Certain 100% owned family entities that do not need to make an interposed entity election.
- The deceased estates of the specified individual or family members of the specified individual upon their death.
- Certain persons who hold interests in SMEs that have made interposed entity elections.
- Certain charities, gift deductible recipients and tax exempt bodies.

The proviso on the above is that any entity making an IEE must also nominate the same specified individual to be part of the same family group.

Should we make a retrospective election just in case?

If there is no need to make a FTE election, it probably should not be made. The problem in the past is that too few people actually understood these provisions and neglected to make elections when they should have.

If none of the four circumstances set out earlier apply to the trust then no election is required. In three out of the four circumstances, it may still be possible to access losses under alternative tests and this should be established before any elections are made. However if one or more of the four circumstances apply and there is doubt that the alternative tests can be met, an election will be required to preserve the losses, deductions or franking credits.

In relation to investment trusts that hold and are adding to share portfolios, sooner or later they will need to make an election as sooner or later the franking credits received in the hands of a beneficiary will exceed \$5,000.

Please be aware that where a retrospective election should have been made and the taxpayer failed to take advantage of this option, the ATO is unlikely to show any mercy on the taxpayer later on in an audit situation.

Some practices are making these elections for all trust clients irrespective of the need. Provided the client is made aware that making the election may place financial restrictions on future distributions made by the trust, this may be a reasonable approach. However, the restrictions on distributions include:-

- A trust cannot distribute to an ex-spouse of a specified person. Once they are divorced, they are no longer part of the family group. This may cause enormous problems and liabilities in a divorce settlement. Had the specified person been the common child of the divorcing couple, this problem will be avoided. However the child will have the same problem in the future, i.e. should they marry and divorce their ex-spouse will no longer be part of the family group at that time.
- A trust will not be able to distribute to another trust with a different specified person. Where two brothers establish their own trusts and nominate themselves as the specified person of their own trust, family trust distributions tax will be payable if one trust subsequently distributes to the other trust. If both trusts had nominated the same person (like the father of both sons), this problem would have been avoided.

Where a trust is only ever likely to make distributions to persons in the family group and not to entities controlled by relatives of the family group (other than those with the same specified person under an IEE), there is probably little risk in making the elections even if they are not required. However this is a decision the public officer of the trust should make with full information provided. As well, the permanent file should then be clearly updated to identify who are eligible beneficiaries and who are no longer suggested beneficiaries as Family Trust Distributions Tax will be payable.

Who can we nominate as the specified individual?

It is preferable to nominate the main or default beneficiary of a trust in most cases as the specified person when making a family trust election as usually this will mean that the members of the family group for trust loss purposes mimics closely the members of the class of general beneficiaries under

most trust deeds. However each case must be determined on its own merits after consulting the deed and the parties to the trust.

From our earlier comments, there may be good reason to nominate another person to avoid problems in case of divorce or where there are lots of trusts controlled by different family members.

There are some views in relation to who is eligible to be nominated as a specified individual. For example, the current view is that the specified individual must be alive at the commencement time of the FTE for which they are specified otherwise they are technically not an individual and cannot be nominated. They can subsequently die which leads to the interesting dilemma. Can you nominate retrospectively a specified individual who was alive at the time the FTE takes effect but is not alive when the election is retrospectively made? The ATO has not provided a view on this matter yet.

Interestingly enough, for the purpose of making an IEE, the view is that the specified person no longer needs to be alive when this election is made as long as they were alive when the FTE was made for the associated person. This is because the IEE is made in respect of a specified individual already nominated under an associated trust.

The next point to make is that it is unlikely that you can nominate a person now as the specified individual in a retrospective FTE if they had not yet been born when the original election should have been made. Again the ATO has not given an opinion on this matter.

Clearly the choice of the specified person must be made very carefully taking into account all relevant factors. Advisors should explain the implications of the choice before allowing their clients to make the decision on who to nominate.

What other problems can arise in relation to nominating a specified individual?

Once a specified individual dies, it would appear that they can no longer be nominated as the specified individual for a new FTE. However they can be nominated as a specified person for an IEE. Where new discretionary trusts are established after the death of the specified person, they will not be able to make FTEs for the same group. At this time there does not appear to be a view from the ATO on this issue and how they will apply the law.

Discretionary trusts may need to make both a FTE and an IEE in certain circumstances. Making a family trust election for the same specified person as another discretionary trust in the same family group may not be technically sufficient. In order to receive a distribution from another nominated family trust (Trust A), the second trust (Trust B) will technically need to make an IEE. The original trust (Trust A) may also need to make an IEE before it can receive distributions from the second trust (Trust B). If this technical interpretation is applied every family trust should prudently make both a FTE and an IEE. Again, at this time there does not appear to be a view from the ATO on this issue and how they will apply the law

In conclusion, taxpayers and advisors should act very carefully before taking advantage of this practice statement concession to make retrospective elections. Considerable research may be required and all taxpayers should fully understand all of the implications before proceeding with elections. Whilst these notes are reasonably comprehensive, they provide information only (and are not advice) in relation to the issues and cannot be relied upon. We strongly recommend that independent advice is obtained before proceeding with any retrospective elections. However please do not miss this opportunity due to a lack of understanding of these provisions.