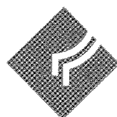

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9 July 2007

Committee Secretary
Senate Economics Committee
Department of the Senate
Parliament House
Canberra ACT 2600

By e-mail: economics.sen@aph.gov.au

Dear Sir/Ms,

Submission on Schedule 8 of the Tax Laws Amendment (2007 Measures No. 4) Bill 2007 ("the Bill")

Pitcher Partners welcomes the opportunity to provide comments on the Bill.

For the purposes of this submission Pitcher Partners comprises 5 independent firms operating in Melbourne, Adelaide, Sydney, Brisbane and Perth. Collectively we would be regarded as one of the largest accounting associations outside the (so called) 'Big Four'. Our specialisation is servicing and advising smaller public companies, large family businesses, small to medium enterprises ("SMEs") and high wealth individuals - which we refer to as "the middle market" or "our target client base" in this submission. Thus our particular focus in reviewing the Bill is on its implications for the middle market.

At the outset we would like to emphasise that whilst we welcome the amendments proposed by the Bill - and would not, thus, want to see its passage blocked - we do so only on the basis that 'something is better than nothing'. Otherwise, it is our strongly held view that the amendments proposed by the Bill represent only a small part of the changes that are necessary in this area of the tax law.

In short, we are extremely disappointed with the way in which the Government's May 2006 announcement that there would be changes in this area has been implemented.

Pitcher Partners is an association of independent firms
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What the Government said in May 2006

In a press release issued on 9 May 2006 the Treasurer announced that measures would be introduced:

allowing ***family trust elections*** *to be revoked or varied in certain limited circumstances. As there is currently no provision for family trust elections to be revoked, this will increase flexibility. The definition of the family group will be broadened to include lineal descendants, and certain changes in family circumstances will be recognised for the purposes of exempting distributions from family trust distribution tax. This measure addresses concerns raised by the Institute of Chartered Accountants in Australia relating to practical difficulties in complying with the trust losses regime and complements the changes made by the Government in the 2004-05 Budget which also increased the flexibility of family trust elections;*
(Our emphasis)

The concerns raised by the Institute of Chartered Accountants in Australia ("ICAA") were numerous - see attached Appendix - but only a small number are addressed in the Bill. Notwithstanding the amendments proposed in the Bill therefore, a (very) large number of practical difficulties will continue to be encountered by taxpayers and their advisers as they attempt to comply with the law in this area.

What we said to Treasury in a submission on an exposure draft ("ED") version of the Bill

1. Revocation of family trust elections ("FTEs")

1.1 Where a trust no longer has tax losses/the need for a FTE no longer exists

The broad objective of the trust loss rules was described in paragraph 1.4 of the Explanatory Memorandum to the *Taxation Laws Amendment (Trust Loss and Other Deductions) Act 1998* as follows:

The purpose of the trust loss measures is to restrict the recoupment of prior year and current year losses and debt deductions of trusts in order to prevent the transfer of the benefit of those losses or deductions. The tax benefit of losses is transferred when a person who did not bear the economic loss at the time it was incurred by the trust obtains a benefit from the trust being able to deduct the loss.

Given this broad objective, there is no need for the trust loss rules to continue to apply to trusts where those trusts have fully recouped their tax losses, and/or no longer have bad debt deductions, in accordance with those rules.

In other words, despite the fact that the rules have already been applied to "prevent the transfer of the benefit of those losses or deductions" the current ED will not allow a trust to revoke a FTE.

Similarly, there is no need for a FTE where franked dividends are no longer being received by a trust or a company owned by a discretionary trust has recouped all of its losses.

Submission 1

A FTE should automatically be revoked if:
- *a trust no longer has tax losses (and/or no longer has bad debt deductions); or*
- *the need for a FTE to allow access to imputation credits/company losses no longer exists.*

At the very least there should be a choice for taxpayers to revoke a FTE in these circumstances.

(Note: This submission point has not been adopted in the Bill)

1.2 Inadvertent error/change in circumstances

The time limits proposed in the ED for revoking a FTE are an unnecessary 'cap' - especially in cases of inadvertent error or a change in circumstances.

Submission 2

There should be no time limits imposed as to when a FTE can be revoked.

If the above is unacceptable then (at the very least) there should be an unfettered discretion conferred upon the ATO to accept submissions from taxpayers regarding the revocation of a FTE.

(Note: This submission point was not adopted in the Bill)

2. Revocation of interposed entity elections ("IEEs")

2.1 Where a trust no longer has tax losses/the need for the IEE no longer exists

Together with the ability to revoke a FTE where a trust no longer has tax losses or the need for the FTE no longer exists, it is sensible that IEEs made for inclusion within the family group of the test individual also be subject to revocation in those same circumstances.

Submission 3

An IEE should automatically be revoked if:

- *a trust no longer has tax losses (and/or no longer has bad debt deductions); or*
- *the need for a FTE/IEE no longer exists.*

At the very least there should be a choice for taxpayers to revoke an IEE in these circumstances.

(Note: This submission point has not been adopted in the Bill)

2.2 Where an entity is no longer part of the family group

The irrevocability of an IEE means that the trust loss rules inhibit the issue/sale of shares in a company or units in a unit trust to any entity outside of the test individual's family group.

Submission 4

Where an entity that has made an IEE leaves a test individual's family group (e.g. via a sale), there should be an automatic revocation of the IEE (or, at the very least, an ability to revoke the IEE in such a case).

(Note: This submission point has not been adopted in the Bill)

2.3 Inadvertent error/change in circumstances

The time limits proposed in the ED are an unnecessary 'cap' - especially in cases of inadvertent error or a change in circumstances.

Submission 5

There should be no time limits imposed as to when an IEE can be revoked.

If the above is unacceptable then (at the very least) there should be an unfettered discretion conferred upon the ATO to accept submissions from taxpayers regarding the revocation of an IEE.

(Note: This submission point was not adopted in the Bill)

3. Variation of test individual

As shown by a later example, problems with FTEs and IEEs can arise where the test individual is deceased. The proposed change in the ED is too narrowly confined in that a new test individual can only be specified where no distributions have been made outside the new test individual's family group since the specified year of the original election.

Submission 6

Entities that have made FTEs or IEEs in relation to a deceased test individual should be able to revoke those elections and make new FTEs and IEEs (if required) in relation to a new test individual that is not deceased. The only requirement that ought to be imposed is that the new test individual be part of the original (deceased) test individual's family group.

(Note: This submission point has not been adopted in the Bill)

We also believe that there should be flexibility to change the test individual more than once (i.e. to cater for more than one death) provided that each new test individual remains part of the original family group.

Submission 7

There should be an unlimited ability to vary the test individual when a test individual dies provided that each new test individual remains part of the original family group.

(Note: This submission point has not been adopted in the Bill)

In light of the fact that there are probably other situations where a variation should be permitted we believe there needs to be a general discretion given to the ATO to accept a variation of the test individual.

Submission 8

There should be an unfettered discretion conferred upon the ATO to accept submissions from taxpayers regarding the variation of a test individual.

(Note: Once again, this submission point has been ignored)

4. Family and family group definitions

As illustrated by way of an example later in this submission the proposed definition of 'family' is too narrow as it excludes the cousins, aunts and uncles of the test individual. Also, we query:

- whether foster children will fall within the proposed family definition; and
- why entities controlled by/the lineal descendents of a former spouse or a widow(er) are excluded from the family and family group definitions.

Submission 9

The definition of a family should be expanded to include the siblings, and their lineal descendants, of the parents of the test individual.

The definitions of a family and a family group should also include:

- *foster children (if they are not already covered); and*
- *entities controlled by/lineal descendants of a former spouse or a widow(er)*

(Note: As above, this submission has not been adopted)

5. Application date of the changes

The ED indicates that the measures will have effect from the income year in which the enabling legislation receives Royal Assent. Given that the proposed changes reflect an appreciation (by legislators, the ATO and taxpayers) that the current trust loss provisions are flawed and create unfair outcomes, the proposed changes should

come into effect retrospectively from the commencement of the trust loss provisions (or, at the least, from the time of the Budget announcement).

<u>*Submission 10*</u>

The changes should apply retrospectively from the commencement of the trust loss provisions (or, at the least, from the time of the Budget announcement).

(Note: This submission point has not been followed)

6. There should be no requirement to lodge FTEs and/or IEEs with the ATO

We question why FTEs and/or IEEs need to be lodged with the ATO - surely the current method of indicating on a tax return that an election has been made is sufficient.

<u>*Submission 11*</u>

FTE and/or IEE elections should not need to lodged with the ATO. The current method of merely indicating on a tax return that an election has been made should be allowed to continue.

(Note: This submission point has been ignored - in the (very) limited cases where a FTE and/or an IEE can be varied or revoked, an election to do so must be lodged with the ATO)

7. Changes to the definition of an 'outsider'

Whilst we welcome the proposed change to the definition of an 'outsider to the trust' in section 270-25, we query why this particular amendment is not retrospective to the commencement of the trust loss rules - it can surely never have been the intention of Parliament that trusts which had made FTEs with the same test individual would be regarded as 'outsiders' of each other.

<u>*Submission 12*</u>

The changes to section 270-25 should apply retrospectively from the commencement of the trust loss provisions.

(Note: This submission point has not been adopted)

8. 'Mismatch' between the CGT marriage breakdown rollover rules and the proposed subsection 272-80(5C)

We query why there is a 'mismatch' between the CGT marriage breakdown rollover rules and the proposed subsection 272-80(5C). For example, why does the latter only deal with court orders whereas the CGT rules allow a rollover under a maintenance agreement?

<u>*Submission 13*</u>

Subsection 272-80(5C) should apply to any court order, maintenance agreement, financial agreement etc that is covered by section 126-5 of the 1997 Tax Act.

(Note: This submission point has been adopted)

9. Subsection 272-80(6B)

If time limits are to be imposed (contrary to our earlier submissions on this point) then to avoid any possible confusion the proposed subsection 272-80(6B) should make it clear that a variation/revocation can be made before the later of the two periods it mentions. There should also be an ATO discretion to accept a variation outside these periods.

<u>*Submission 14*</u>

Subsection 272-80(6B) should be amended to make it clear that a variation/revocation should be made before the later of the periods mentioned in paragraphs (a) and (b).

The ATO should also be provided with a discretion to accept a variation outside these periods.

(Note: This submission point was not adopted)

10. Allowing revocations and variations to be effective from a date during an income year

To prevent a liability to Family Trust Distributions Tax ("FTDT") from (inadvertently) arising where, for example, the control of a trust is changed part way through an income year under a court order and distributions have already been made prior to that time, subsection 272-80(8)(b) should allow a revocation or variation to be effective from a date during a specified income year.

<u>*Submission 15*</u>

Subsection 272-80(8)(b) should allow a revocation or variation to be effective from either a date during a specified income year or the start of that year.

(Note: This submission point has been ignored)

11. IEE to be varied/revoked in the same cases as a FTE

Whilst we welcome the proposed changes to section 272-85, we believe that an IEE should also be allowed to be revoked or varied in circumstances that 'mirror' those in which a FTE can be revoked or varied.

Submission 16

Section 272-85 should also be amended to allow an IEE to be revoked or varied in the same circumstances in which a FTE can be revoked or varied.

(Note: This submission point has not been adopted)

12. Broaden the definition of a family

As stated in Submission 9, we believe that the definition of a family should be wider. The case of aunts and uncles is demonstrated by the following example.

Example: Individuals A, B and C are brothers and sisters. The individuals run a business through the XYZ Trust. The child of Individual B (Child D) manages the day to day business of the XYZ Trust but administers it on behalf of the three Individuals A, B and C. The trust chooses Child D as the test individual. Under the proposed definition of the "family group", individuals A and C cannot be part of Child D's family group.

We also query why there is a distinction between current and former family members - the definition of 'family', for example, could simply refer to the individual's spouse or former spouse(s).

(Note: This submission point has been ignored)

13. Variation of test individual (death of an individual)

The death of a test individual means that future trusts and interposed entities cannot currently make an election to treat the same individual (the deceased) as the test individual. As per Submission 7, we are of the view that there should be an exception to the once only test where there is a death of a test individual. Refer to the following example.

Example: Individual A is the test individual of Trust X but subsequently dies. Subsection 272-80(5A) is used to change the test individual to Individual B. The following year, Individual B passes away. Trust X wishes to change the nominated person to the daughter of Individual B. Why is this subsequent change restricted?

(Note: This submission point has not been adopted)

14. Variation of test individual (connected IEE elections)

Confirmation is required that IEEs are automatically varied when a new test individual is appointed. Refer to the following example.

Example: Individual A is the test individual of Trust X. Company B has made an IEE in respect of Individual A and Trust X. The test individual of Trust X is changed to Individual B. Confirmation is required that this change in the test individual automatically 'flows through' to the IEE made regarding Trust X.

(Note: This submission point has been ignored)

Further details/clarification

If you would like further details on any aspect of this submission and/or would like a particular issued clarified please contact either Mark Northeast on (03) 8610 5204 or me on (03) 8610 5110.

Yours sincerely,

John Brazzale
Tax Partner/Executive Director

APPENDIX - EXTRACT FROM ICAA SUBMISSION ON DEFICIENCIES AND INAPPROPRIATE CONSEQUENCES ARISING FROM FAMILY TRUST ELECTIONS AND INTERPOSED ENTITY ELECTIONS

1 Revocation of FTEs

FTEs are generally irrevocable under subsection 272-80(5) of the 1936 Act unless the trust that made the election is a fixed trust and satisfies all the other conditions set out in subsections 272-80(6) – (8) (essentially there must also have been a change in control of the trust).

We consider that the ability to revoke FTEs is too limited for the following reasons:

- The definition of a "fixed trust" in the trust loss rules is extremely narrow and is practically very difficult to satisfy.
- There is no discretion on the part of the Commissioner to allow revocation of an FTE where a genuine error has been made in completing the election.

1.1 Restrictive definition of "fixed trust"

A "fixed trust" is defined in section 272-65 as one where "persons have fixed entitlements to all of the income and capital of the trust".

Subsection 272-5(1) sets out the circumstances in which there will be a fixed entitlement to income or capital of a trust. This provision reads:

"If, under a trust instrument, a beneficiary has a vested and indefeasible interest in a share of income of the trust that the trust derives from time to time, or of the capital of the trust, the beneficiary has a fixed entitlement to that share of the income or capital."

The term "vested and indefeasible" is critical to the determination of whether there is a fixed entitlement to income or capital of a trust. This term is not defined in the 1936 Act or the 1997 Act and the ATO has issued no guidance material that clarifies the term. There is, however, some discussion at paragraphs 13.4 to 13.9 of the explanatory memorandum to the *Taxation Laws Amendment (Trust Loss and Other Deductions) Act 1998*.

Of relevance here is subsection 272-5(2), which provides that the mere fact that units in a unit trust are redeemable, or that further units may be issued, does not mean that a unit holder's interest in the income or capital of the trust is defeasible provided, where the units are not listed for quotation in the official list of an approved stock exchange, the units will be redeemed or issued for a price determined on the basis of the net asset value, according to
Australian accounting principles, of the unit trust at the time of the redemption or issue.

The implication arising from subsection 272-5(2) is units in a unit trust will not confer on unit holders a vested and indefeasible interest in the income or capital of the unit trust if the trust deed allows the trustee to issue or redeem units for a price determined other than on the basis of net asset value. Such a unit trust would therefore be a non-fixed trust.

Care also needs to be taken where a unit trust deed empowers the trustee to issue special units. The ATO issued an interpretative decision, ATO ID 2002/750, that held that a superannuation fund that held 100% of the issued units in a unit trust did not have a vested and indefeasible interest in the unit trust because the trustee had the power to issue special units at whatever price the trustee thought fit. The unit trust was therefore a non-fixed trust for the purposes of the trust loss rules.

Finally, there is also an argument to the effect that if a trust deed confers upon a trustee the power to accumulate income, then the beneficiaries of that trust have no interest in the income of the trust.

In light of the above, our experience has been that virtually all unit trusts, which are conventionally viewed as fixed trusts for other commercial purposes, are in fact non-fixed trusts under the trust loss rules. Most unit trust deeds provide trustees with an unfettered power to issue units at any price determined by the trustee (with or without the consent of existing unit holders), the power to issue special units or the power to compulsorily redeem units. This means that the interests of existing units holders in such a trust are defeasible.

Accordingly, there are no fixed entitlements to all of the income and capital of that trust and it constitutes a non-fixed trust for the purposes of the trust loss rules.

In conclusion, the power to revoke FTEs in section 272-80 is never exercised because there are simply no or very few trusts that fall within the definition of a "fixed trust" for the purposes of the trust loss rules.

Recommendation (i)

We recommend that the definition of "fixed trust" be reviewed and modified to include trusts such as unit trusts that are traditionally considered to be synonymous with fixed trusts. One possibility would be to amend the definition of "fixed trust" to include any trust to which CGT event E4 would apply and/or that has historically distributed to the same unit holders in proportion to their unit holdings.

<u>1.2 No discretion to allow revocation</u>

Since the introduction of these rules, we have encountered numerous examples of errors that have been made by taxpayers and tax practitioners in the preparation of FTEs including the specification of incorrect test individuals and the making of FTEs that were not required.

These errors were largely attributable to the excessive complexity of the trust loss rules.

This complexity has been exacerbated by the application of FTEs in other areas of the income tax legislation as follows:

- to allow the tracing for the purposes of applying the continuity of ownership test in Division 165 and 166 of the 1997 Act to be satisfied for the purposes of recouping losses in companies ("the company loss recoupment measures"); and
- to allow franking credits attached to dividends received by a trust to be passed through to beneficiaries of the trust under Division 1A of Part IIIAA of the 1936 Act ("the holding period rules").

Taxpayers that make such errors are subject to harsh and unforgiving consequences such as:

- Payment of family trust distribution tax ("FTDT") at a rate of 48.5% on distributions outside the test individual's family group.

  In one case of which we are aware, a tax practitioner prepared and lodged FTEs for those of his clients that were trusts and had received franked dividends. The purpose of the FTEs was to allow those trusts to pass franking credits attached to those dividends to beneficiaries under the holding period rules in Division 1A of Part IIIAA of the 1936 Act ("holding period rules"). For each trust, the practitioner selected the youngest member of the family group as the test individual with a view to deferring the vesting of the trust. However, by doing so, the practitioner unwittingly excluded uncles, aunts and cousins from each test individual's family group, many of them individuals that had previously received distributions from the trusts in question. The consequence of this was that many future distributions were subject to FTDT.

- There have also been cases of taxpayers that have made FTEs were these were not necessary. This has the effect of unnecessarily restricting distributions made by those trusts to members of the test individuals' family groups. This is a particularly harsh outcome given the broad meaning of distribution under the trust loss rules, which, in addition to the conventional understanding of a distribution from a trust, includes loans, transfers or use of property, other dealings with money or property and the forgiveness of debts.

Recommendation (ii)

We recommend that consideration be given to the possibility of amending section 272-80 to provide the Commissioner with discretion to allow certain terms of a FTE to be changed when an inadvertent error (such as specification of an incorrect test individual) has been made, or revocation of a FTE that was clearly made when it was not required, e.g. where an error in interpretation of the trust loss rules has arisen. Such discretion would only be exercised where it could be demonstrated in writing that an error was made or that a FTE was made when not required.

2 Revocation of IEEs

Where a trust has made a FTE, distributions by that trust are effectively confined to the family group of the test individual that is specified in the FTE. This is because distributions outside of that family group will attract FTDT of 48.5%. To avoid FTDT on distributions, other trusts, companies or partnerships may make IEEs to be included in the family group of the test individual specified in the FTE. However, entities that have made an IEE must also restrict any distributions to the family group of the test individual otherwise FTDT will be imposed.

Pursuant to subsection 272-85(5), IEEs cannot be revoked in any circumstances. However, there are a number of situations in which we consider that revocation of IEEs should be permitted.

2.1 Sale of an IEE outside a family group

A significant consequence of the non-revocability of IEEs is that the trust loss rules currently inhibit the sale of shares in a company, or interests in another entity, that has made an IEE, outside a test individual's family group. This is because any dividends or distributions made by the company or the entity to the new shareholders or holders of interests in the entity will be subject to FTDT. In these situations, it is only possible to sell the underlying assets of an entity that has made an IEE.

The broad objective of the trust loss rules was described in paragraph 1.4 of the Explanatory Memorandum to the *Taxation Laws Amendment (Trust Loss and Other Deductions) Act 1998* as follows:

"The purpose of the trust loss measures is to restrict the recoupment of prior year and current year losses and debt deductions of trusts in order to prevent the transfer of the tax benefit of those losses or deductions. The tax benefit of losses is transferred when a person who did not bear the economic loss at the time it was incurred by the trust obtains a benefit from the trust being able to deduct the loss. The measures are intended to prevent a significant leakage of revenue that has resulted from the transfer of the tax benefit of trust losses."

If an entity that has made an IEE "leaves" a test individual's family group, there is no reason to continue to confine distributions made by the entity to that family group. We do not consider that this would in any way defeat or compromise the policy intent described above.

2.2 FTE is revoked if family trust ceases to exist

If a trust that has made an FTE revokes that FTE or the trust ceases to exist (i.e. vests), there is no longer any need for IEEs made by entities to be included in the test individual's family group. In this regard, we refer to ATO Interpretative Decision 2003/236, which held that an IEE remained in force even after the vesting of the trust in respect of which the FTE was made. This appears to be an unintended outcome of the trust loss rules.

2.3 Unnecessary IEEs

As with FTEs, there have also been some instances where IEEs have been made where they were not required. A test individual's family group in section 272-90 automatically include entities that are wholly owned by family members of the test individual (refer subsection 272-90(5)). However, in some cases, IEEs have inadvertently been made for such entities thereby unnecessarily confining distributions to the test individual's family group and preventing the sale of interests in the IEE outside of the family group.

Recommendation (iii)

For the reasons discussed above, we recommend that trustees of trusts that have made IEEs should have a choice to revoke those IEEs in the following circumstances:

- The IEE leaves the family group, e.g. shares in a company, or interests in an entity, that has made an IEE is sold outside of the family group. There is no policy rationale for the IEE to have continued application in these circumstances.
- A trustee of family trust in relation to which the IEE has been made revokes the FTE. In this regard, we also reiterate our earlier recommendation that the circumstances in which an FTE can be revoked be extended.
- An IEE was unnecessarily made.

3 Choice to revoke elections after utilisation of losses or debt deductions

We refer to the broad objective of the trust loss rules described at section 2.1 of this submission. If the objective of the trust loss rules is to ensure that only those who economically suffer a loss benefit from the eventual recoupment of the loss, then there is no need for the rules to continue to apply to trusts that have made FTEs where the losses have already been fully recouped or that no longer incur any debt deductions. Once there are no losses or debt deductions in a trust, there is no policy reason to continue to confine distributions to members of the test individual's family group.

Recommendation (iv)

Our recommendation in this regard is that there should be a choice for taxpayers to revoke a FTE if a trust no longer has losses or debt deductions. This will ensure that, as long as there are losses or debt deductions in a trust, distributions by the trust cannot be made outside the group without attracting FTDT and that the same persons, being the members of the test individual's family group, bear the economic loss and also obtain the benefit of the losses or debt deductions. After those losses have been fully recouped or the debt deductions fully offset against assessable income, there is no requirement for a FTE and the trustee should then have the option to revoke the election. We stress that the purpose of the trust loss rules would not be defeated if this recommendation were adopted.

Note that the FTE would not automatically lapse after any losses or debt deductions are fully utilised. This is because an FTE may be made for other reasons namely for the purposes of the company loss recoupment measures and the holding period rules (briefly described at section 1.2 of this submission). Revocation would only be a choice available to the trustee of the trust that made the IEE.

In conjunction with any choice made by a trustee of a family trust to revoke a FTE, we also consider that any entities that have made IEEs to be included in the family group of the test individual should also be given the choice to revoke the IEEs.

4 Discretion to extend time to lodge FTEs and IEEs

We note the Commissioner is able to allow an extension of time for a trust to lodge a FTE where the trustee is not required to lodge a return under subsection 272-80(2). That provision reads:

"The election must be made in the trust's return of income for the specified income year. If the trustee is not required to furnish a return for the income year, the election must:

(a) be in writing in a form approved by the Commissioner; and

(b) be given to the Commissioner before the end of:
(i) 2 months after the end of the income year specified; or
(ii) such later day as the Commissioner allows."

A similar discretion is conferred upon the Commissioner in relation to IEEs in subsection 272-85(2).

However, the provisions are currently deficient in that there is no discretion to allow later lodgement of an FTE or IEE where the trust or entity making the election is required to lodge a tax return – it must be made in the trust's or entity's tax return. We can see no reason for not allowing taxpayers the ability to apply for an extension to lodge FTEs or IEEs even when they are required to lodge tax returns. There may be legitimate reasons why a FTE or IEE is not lodged with a tax return:

- Taxpayers or tax practitioners may have been genuinely unaware of the requirement to lodge FTEs and/or IEEs. As mentioned earlier, FTEs are relevant not only for the purposes of the trust loss rules but also the company loss recoupment measures and the holding period rules. There may be a lack of awareness of the application of FTEs in the context of these other areas of the income tax legislation, which may mean that FTEs are not always made when required.
- Given the practical non-revocability of FTEs and the technical non-revocability of IEEs and the consequences of these elections, the decision to make these elections is one that requires considerable analysis and thought. This can require a significant investment in terms of both time and cost. When viewed in the context of a taxation environment that is increasingly complicated and which imposes an ever-growing compliance burden on taxpayers, it is not unreasonable to allow taxpayers further time to make FTEs or IEEs.

Recommendation (v)

We recommend that the Commissioner be granted discretion to extend the lodgement time for FTEs and IEEs. Recognising that taxpayers should not be able to indefinitely extend the time for lodgement of these elections, the discretion would be sought by way of written application to the Commissioner.

5 Death of a test individual

Pursuant to subsection 272-80(3), a trust that makes a FTE must specify a test individual as the individual whose family group is to be taken into account in relation to the election. The ATO's fact sheet on the trust loss rules takes the view that the individual specified in a FTE cannot be deceased when the election is made.

This presents a problem in the following circumstances:

- Generally, a trust must lodge an FTE in respect of a year of income by the due date for lodgement of the trust's tax return for that year of income. Accordingly, even though an FTE, if made, may take effect from, say, 1 July 2003, it would not need to be lodged possibly as late as May 2005. If the proposed test individual dies some time between 1 July 2003 and May 2005, the ATO's view is that it will not be possible to make an FTE at all for the year ended 30 June 2004 and subsequent years of income.
- It is not possible for other trusts to make FTEs specifying the same test individual.

The position in relation to IEEs is not as clear. Pursuant to subsection 272-85(1), an entity makes an IEE to be included in the family group of the test individual specified in the FTE and there is no technical requirement to specify that individual in the IEE. Accordingly, it is debateable whether the test individual that was specified in an FTE needs to be alive at the time an entity makes an IEE to be included in that individual's family group.

This could be an issue if an entity is established or acquired, which members of the test individual's family group do not wholly own. If that entity were prevented from making an IEE because the test individual that was specified in the FTE has died, the family trust would not be able to distribute to the new or acquired entity without incurring FTDT.

Recommendation (vi)

To overcome the deficiencies identified above, we recommend that at least one of the following amendments be made to the trust loss rules:

- FTDT should not be imposed on distributions to entities controlled by the test individual's family group. Currently, entities that are wholly owned by the test individual and his or her family members are included in the test individual's family group (refer subsection 272-90(5)). However, this provision could be amended so that entities that passed the family control test in section 272-87 are automatically included in the test individual's family group. These entities would leave the family group if the family control test were subsequently failed.

- Entities that have made FTEs or IEEs in relation to the test individual should be able to revoke those elections and make new FTEs and IEEs (if required) in relation to a new test individual that is not deceased. These elections would apply prospectively. However, the new test individual would need to be a member of the original test individual's family group.
- The legislation should be amended to allow FTEs and IEEs to be made in relation to a test individual that has died provided an FTE specifying that test individual was made whilst he or she was still alive. The family group would still be defined by reference to the deceased test individual. Reference should also be made to recommendation (vii) below, which suggests the extension of the definition of "family" to remove generational limits.

We note that the second recommendation may create difficulties in some circumstances. For example, a unit trust might have made a FTE in relation to a test individual. The unit holders of the unit trust might be three discretionary trusts, which are family trusts for three children of the test individual. If the test individual dies and it is necessary to choose one of his or her children as the new test individual, it should be noted that the family group of one child for trust loss purposes will necessarily exclude some members of the other children's families. Accordingly, it may be appropriate to also adopt the other recommendations to cater for the varied circumstances of different taxpayers.

6 Definition of "family"

A test individual's "family group", as defined in section 272-90, includes the following family members of the primary individual (pursuant to the definition of "family" in section 272-95):

(a) any parent, grandparent, brother, sister, nephew, niece, child or child of a child of –

- the test individual; or
- the test individual's spouse;

(b) the spouse of the test individual or anyone who is a member of the test individual's family because of above paragraph (a).

A "spouse" is defined in section 6 of the 1936 Act as "another person who, although not legally married to the person, lives with the person on a bona fide domestic basis as the husband or wife of the person".

The deficiencies in the definition of "family" are that it does not cater for:

- same sex couples;
- former, i.e. divorced spouses;
- cousins, aunts and uncles of the test individual;
- great-grandchildren;
- foster children;
- a widow or widower that remarries (refer ATO ID 2001/742).

There are legitimate reasons why these individuals should be included in the definition of "family". For example, a trust might be required to distribute to a former spouse under a family court order. Similarly, a widow or widower that remarries might be entitled to distributions from a deceased estate that has made an FTE.

Furthermore, the definition of "family" only extends down two generations. We don't perceive any policy rationale for placing a generational limit on the definition of family especially given that the typical life of a trust is 80 years, which means they commonly extend into a fourth generation. This means that many family trusts will eventually have to distribute outside the family group and such distributions will be subject to FTDT.

Recommendation (vii)

We recommend that the trust loss rules be amended to cater for the current exclusions, e.g. aunts, uncles, former spouses, etc. and also to remove the generational limit that unnecessarily limits the definition of family.

Where a trust or another entity is required to make distributions or transfer property to a former spouse of a test individual pursuant to a family court order, an alternative recommendation to extending the definition of "family" to include former spouses is to amend the various definitions of distributions in Subdivision 272-B to exclude distributions made pursuant to a family court order (or to introduce an exclusion in that regard).

7 Extension of advantages of making FTEs to IEEs

The following advantages arise for a trust that makes an FTE:

- It does not need to pass as many tests under the trust loss rules in order to recoup losses. The only test it needs to pass is a modified version of the income injection test.
- The trust is able to pass the benefit of franking credits attached to dividends it receives to its beneficiaries under the holding period rules (referred to in section 1.2 of this submission).
- The trust is treated as an individual for the purposes of the company loss recoupment rules (referred to in section 1.2 of this submission).

Trusts that make FTEs and IEEs are subject to similar restrictions or disadvantages as follows:

(i) FTEs currently cannot be revoked unless the trust that made the election is a fixed trust and there has been a change in control (but refer to section 1.2 above where we recommend that the power to revoke FTEs be extended). IEEs are presently not revocable at all (although refer to section 2.3 above in which we recommend that they should be revocable in some circumstances).

(ii) Distributions by trusts that have made FTEs and IEEs are effectively confined to the family group because any distribution outside that group attracts FTDT.

None of the advantages currently available to a trust that has made an FTE extend to a trust that has only made an IEE even though both trusts are subject to similar restrictions. There is no policy reason for this approach.

Recommendation (viii)

We consider that the trust loss rules should be amended in either of the following ways:

- Trusts that make IEEs should be treated identically to trusts that have made FTEs. This treatment would extend beyond the trust loss rules to the holding period rules and the company loss recoupment measures.
- The concept of IEEs should be removed altogether for trusts. Trusts would only be able to make FTEs. Furthermore, the trust loss rules would need to be amended to recognise that distributions between trusts that had made FTEs in relation to the same test individual would not incur FTDT. More specifically, the definition of "family group" in section 272-90 would need to be amended to include trusts that had made a FTE in respect of the same test individual. Currently, the ATO's view on this is that such distributions attract FTDT (refer ATO ID 2004/697).

  Other entities such as companies, partnerships and superannuation funds will still be required to make IEEs to be included in a test individual's family group (if not already wholly owned by members of that family group).

8 Commercially inhibiting

At section 2.1 of this submission, we discussed the effective non-transferability of shares in a company, or interests in another entity, that has made an IEE.

Another difficulty with IEEs is that a company or a trust that has made an IEE cannot issue shares or, say, units to an individual or entity that is not a member of the test individual's family group. The issue of the shares or interests would potentially constitute a distribution outside the family group (which would attract FTDT) within the meaning of the extended definition of "distributes" (refer section 10 of this submission). However, we note that, pursuant to subsection 272-60(2), a distribution will only arise to the extent that the property transferred exceeds the amount or value of any consideration given in return.

We also note that the issue of shares for consideration that is less than market value may also have value shifting consequences under Division 725 of the 1997 Act. There does not appear to be any "tiebreaker" provision that confers precedence on either the trust loss rules or the value shifting rules.

Furthermore, FTDT would also be imposed on any dividends or distributions subsequently paid in respect of shares that are issued by a company that has made an IEE to an individual or entity that is not a member of the test individual's family group. This creates difficulties where a company or trust may have a commercial justification for issuing shares or other interests to entities outside the test individual's family group. A company might, for example, wish to grant equity to a key employee. Alternatively, a trust might wish to raise equity to fund an investment or business acquisition. The trust loss rules therefore effectively prohibit entities that have made IEEs from entering into commonplace commercial transactions where no tax mischief is intended.

Recommendation (ix)

We consider that there should be an exception introduced into the trust loss rules allowing distributions outside the family group in certain circumstances. This would be similar to the exception adopted under the consolidation rules, which allows subsidiary companies to be a member of a consolidated group even though they are not wholly owned because of the existence of employee shares.
Alternatively, we reiterate our recommendation made that FTDT should not be imposed on distributions to entities controlled by the test individual's family group (refer section 6 of this submission). Entities that passed the family control test in section 272-87 would automatically be included in the test individual's family group and no IEE would be required.

9 Distributions between trusts that have made FTEs

Currently, where trusts that have made FTEs specifying the same test individual wish to distribute to each other, they must also make interposed entity elections in relation to each other (refer ATO ID 2004/697). Having to make IEEs in addition to FTEs imposes an unnecessary compliance burden on taxpayers. Where the family trusts both have the same test individual, there is no policy reason why those trusts should not be considered part of the same family group.

Recommendation (x)

We would like to request that the law be changed to avoid the need for unnecessary IEEs. At section 7 of this submission, we have recommended that the definition of "family group" in section 272-90 should be amended to include trusts that had made a FTE in respect of the same test individual.

10 Specific election for franking credit trading purposes

A family trust is subject to FTDT on any distribution it makes outside the family group.

Pursuant to section 272-45, a trust "distributes" income or capital of the trust to a person if it:

(a) pays or credits the income or capital in the form of money; or
(b) transfers the income or capital in the form of property; or

(c) reinvests or otherwise deals with the income or capital on behalf of the person or in accordance with the directions of the person; or
(d) applies the income or capital for the benefit of the person;

in the person's capacity as a beneficiary of the trust.

This definition of "distributes" is extended by section 272-60, which provides that a company, partnership or trust also "distributes" income or capital to a person 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.

The purpose of the holding period rules was set out in paragraph 4.2 of the explanatory memorandum to the *Taxation Laws Amendment Act (No. 2) 1999* as follows:

"The purpose of the amendments is to protect the revenue by introducing a holding period rule and related payments rule for shares to curb the unintended usage of franking credits and misuse of the intercorporate dividend rebate by persons who are not effectively owners of shares or who are only very briefly owners of shares. This will counter certain tax avoidance schemes under which franking credits or the intercorporate dividend rebate are made available to such persons."

By making an FTE, a trust effectively restricts the benefit of any franking credits it receives to members of the test individual's family group. It is pertinent to note here that the benefit of franking credits attached to dividends received by a trust will generally be passed to beneficiaries via a distribution that falls within the ordinary meaning of "distributes" in section 272-45, not within the extended meaning of "distributes" in section 272-60. Accordingly, the trust loss rules operate unfairly because they effectively restrict distributions within the extended meaning of that term even though such distributions cannot confer the benefit of franking credits on the recipients.

Recommendation (xi)

We recommend that consideration be given to the possibility of introducing a new election should be introduced for the purposes of the holding period rules. If made by a trust, this election, the "franked distribution election" ("FDE"), would effectively only allow franked distributions to be made to members of a test individual's family group. Any franked distribution made by the trust outside of the family group would be subject to FTDT at a rate of 48.5%. Non-franked distributions, e.g. a loan to someone not in the family group, would not attract FTDT. A trust that had made a FDE would not be an "excepted trust" for the purposes of the trust loss rules.

11 Control tests

A trust making a FTE or IEE must pass the family control test in section 272-87. The group that must control the trust is defined as:

(i) the test individual who is specified in the FTE or, in the case of an IEE, the test individual that is specified in the FTE to which the IEE will relate; or
(ii) one or more members of the test individual's family; or
(iii) the test individual and one or more members of the test individual's family; or
(iv) a person or persons covered by (i), (ii) or (iii) and one or more legal or financial advisers to the test individual or to a member of the test individual's family; or
(v) the trustee of a family trust with the test individual specified in the FTE of that trust; or
(vi) the trustee of a family trust with the test individual specified in the FTE of that trust and a person or persons covered by (i), (ii) or (iii).

The control test is Subdivision 269-E, which must be passed by a non-fixed trust in respect of recoupment of prior or current year losses defines a group in subsection 269-95(5) as a person, a person and one or more associates, or two or more associates of a person. Accordingly, unlike the family control test in section 272-87, the non-fixed trust control test in section 269-95 does not include legal or professional advisers in the definition of a "group". Accordingly, a change of control could result under section 269-95 if a legal or professional adviser is made the appointor of a trust, which is quite a common practice.

Recommendation (xii)

We recommend that the definition of group in subsection 269-95(5) be amended to include legal or professional advisers of any other person in the group. This would place the non-fixed control test on the same footing as the family control test thereby introducing more consistency into the trust loss rules.

12 Company loss rules

Section 165-207 of the 1997 Act provides that a trustee of a family trust, that is a trust that has made a FTE, is taken to beneficially own shares in a company for the purposes of the continuity of ownership test. This provision applied for losses incurred in the 1997 and subsequent years of income.

For the 1996 and earlier years of income, the ATO adopted the following approach set out in paragraph 13 of Taxation Determination TD 2000/27, which reads:

"In the light of these changes, and having regard to Taxation Ruling TR 92/20, it is proposed that, for losses incurred in the 1995-96 or earlier years of income, the continuity of beneficial ownership test will be interpreted consistently with the broad principles that have been adopted in relation to section 160ZZS. For section 80A, this means that the onus will be on the taxpayer to show, for example, that:

- *the trustee has administered the trust for the benefit of members of a particular family at all times during the relevant years of income; and*

- *the trustee has not exercised discretionary powers to appoint beneficiaries or amend the trust deed, the practical result of which was to effect a change of 50%or more in the underlying interests in the trust assets."*

Furthermore, a company could apply the special alternative test contained in s 165-215 where the trust has not made a FTE but where it would (generally) satisfy the trust loss provisions had it incurred the loss itself.
A difficulty arises where a company, all the shares in which were held by a discretionary trust, made losses after the year ended 30 June 1997 but the trust does not make a FTE until a year of income after that in which the losses were incurred. The trust might choose not to make a FTE in the year of income in which the losses were made because there may have been distributions that would be outside the proposed test individual's family group during the relevant years of income. Alternatively, a FTE might not be made because some beneficiaries of the trust would be outside the proposed test individual's family group in respect of any future distributions.

In such cases, the losses in the company will be forfeited (or subject to the same business test) because the continuity of ownership test will be failed when the trust makes a FTE. For example, if a company made losses in the year ended 30 June 1999 but the trust did not make a FTE until the year ended 30 June 2000 (effective from 1 July 1999), the continuity of ownership provisions do not cater for the period from 1 July 1998 to 30 June 1999. The making of the FTE effective from 1 July 1999 would in fact cause the continuity of ownership test to be failed because the trust would be recognised as beneficial owner of the shares in the company from 1 July 1999 pursuant to section 165-207 but prior to that time there would be no beneficial owner. This would be the case even if the trust would otherwise have passed the special alternative test in section 165-215 during the period from 1 July 1998 to 30 June 1999.

Recommendation (xiii)

In light of the above, there needs to be some legislative mechanism that prevents failure of the continuity of ownership test where a company that is owned wholly or partly by a trust makes losses but a FTE is not made by the trust until a year of income after that in which the losses were made, where there has not been an underlying change in the control or ownership of the trust.

One possible solution in this regard would be to adopt the fourth condition of the alternative test in section 165-215 and apply it to the trust in respect of the period during which a FTE was not in effect.

Alternatively, the problem could be corrected by modifying subsection 165-215(1) so that the trust shareholder in that provision is deemed to beneficially own the shares in the same fashion as section 165-207 deems the trust shareholder to beneficially own the shares. If this amendment were made, the making of an FTE would not result in a change in beneficial ownership.