

Chapter 3

Family trusts

3.1 Schedule 2 of the bill amends Schedule 2F of the *Income Tax Assessment Act 1936* (ITAA) to narrow the definition of 'family' and limit variations in the 'test individual' in the election rules for family trusts.¹

3.2 The Government's intent is to reduce the scope for family trusts to use tax losses to lower income tax. Minister Bowen described the measures in terms of improving the integrity of the tax system and achieving cost savings to 'help fund more urgent priorities'.²

3.3 The bill essentially reverses some (but not all) changes to family trust arrangements introduced last year in the *Tax Laws Amendment (2007 Measures No. 4) Act 2007*. Treasury explained the changes in the bill as follows:

The trust loss rules in schedule 2F of the *Income Tax Assessment Act 1936* are primarily there to prevent the tax benefits arising from the recruitment of trust losses being passed to beneficiaries that did not bear the economic loss or the bad debt when it was incurred. It does this basically by tracing through the underlying ownership. Many family trusts are discretionary trusts, which means that the beneficiaries may not have a fixed interest, so it will be difficult to trace through their economic ownership in the trust. Therefore, in many cases, they would not be able to meet the standard rules

1 A family trust is generally established for the benefit of members of a 'family group'. It provides a mechanism to pass family assets to future generations and can ensure that all family members use their income tax 'tax-free thresholds'. The family trust can be the subject of a family trust election which provides it with certain tax advantages, provided that the trust passes the family control test and makes distributions of trust income only to beneficiaries of the trust who are within the 'family group'. Family trusts are typically used by farming families and those running small businesses. One witness described them as 'a legitimate vehicle in which to run business and to hold family assets for all the reasons of asset protection, business succession, family protection of assets in the instance of marriage breakdown and the like. Tax is very much an incidental.'; Mr John Brazzale, Taxation Institute of Australia, *Proof Committee Hansard*, 12 August 2008, p. 16.

There are over 400 000 family trusts in Australia; Mr Ali Noroozi, Institute of Chartered Accountants in Australia, *Proof Committee Hansard*, 12 August 2008, p. 9. They may have over \$200 billion in assets; Senator Barnaby Joyce, *Proof Committee Hansard*, 12 August 2008, p. 14. Around 185 000 to 200 000 of these trusts have made family trust elections over the past decade; Mr Raphael Cicchini, Treasury, *Proof Committee Hansard*, 12 August 2008, p. 2.

2 The Hon. Chris Bowen, Minister, Competition Policy and Consumer Affairs, 'Family Trusts—Savings Measure', *Media Release*, 13 May 2008.

for determining whether they can carry forward and utilise a loss to reduce income tax in later years.

As part of that background, in recognition of that, the rules within schedule 2F provide a special concession to family trusts. That is, if you make an election and specify a test individual, you may carry forward your losses and utilise them without meeting the other rules. Provided that you only distribute to family members or members within the family group, you are not subject to family trust distribution tax, which is charged at the top marginal tax rate, plus the Medicare levy, of 46.5 per cent. So, in essence, this is a concession within the tax law to family trusts. The previous government made amendments in 2007 that varied the operation of those rules and made them more concessional...This government has reversed two of those measures, one applying, in effect, with a transitional rule.

You have asked when it might affect people. The answer is that the rules currently provide for variations, and they can only be made in two circumstances. One is where there is a family breakdown and the control of the trust changes to the spouse; in that case, they can make a variation. The other rule was, if you met certain conditions, you could change the test individual once, and only once, going forward. Those conditions were about who you had distributed to previously. So to meet the conditions you had to only distribute or confer present entitlement to people who would have been in the family group, had that person always been the test individual.³

Changes to the definition of 'family'

3.4 The bill amends the definition of 'family' in the family trust election rules to limit lineal descendants to children or grandchildren of the test individual or the spouse of the test individual (excluding lineal descendants of nephews, nieces or great-grandchildren of the test individual).

3.5 This change was criticised by the Institute of Chartered Accountants in Australia. They argued:

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.⁴

3 Mr Raphael Cicchini, *Proof Committee Hansard*, 12 August 2008, p. 2.

4 *Submission 1*, p. 2. FTDT stands for Family Trust Distribution Tax

3.6 CPA Australia argued that the measures proposed in Schedule 2 of the 2008 bill effectively amounts to a de facto inheritance tax; and is 'wholly inconsistent' with trust law and commercial practice.⁵

3.7 On the broader issue of the definition of a family, CPA Australia gave the example of a family living with (elderly) grandparents, parents and children. If one of the parents is nominated as the test individual, the lifespan of the trust is limited to the lifespan of the grandchildren (if Family Trust Distribution Tax is to be avoided). If one of the children is nominated, the lifespan of the trust may be longer but the descendants of their siblings will be disadvantaged since only one generation beyond the sibling can benefit from the trust without incurring the tax.

3.8 CPA Australia thereby argued:

It is difficult to see a policy justification for placing a generational limit on trusts that have made a FTE. Most trusts typically have a life span of 80 years, which will commonly span four generations. In our view there is no compelling reason why two generations should be sliced off the normal lifespan of a trust.⁶

Limitations to variations in 'test individual'

3.9 The bill prevents family trusts from making a once-off variation to the test individual specified in a family trust election (other than for the 2007–08 income year or in the case of marriage breakdown).

3.10 The Institute of Chartered Accountants in Australia argued there were cases where it was justified to change the test individual. They cited the Explanatory Memorandum from the 2007 Act which refers to :

the situation where a trust has chosen the wrong test individual in its family trust election but the trust had acted in the past as if the proposed new test individual was always the test individual.⁷

3.11 CPA Australia argues the bill would add significant complexity to tax law, such as in cases where an inappropriate person is selected as the test individual by family businesses especially from an estate planning and succession perspective.⁸

The extent of budget savings

3.12 The Government estimates that the measure will save \$1 million in 2008–09 and \$6 million each in the following three years.⁹ As the provisions refer to events occurring in future generations, there may be more substantial savings in distant years.

5 *Submission 2*, p. 1.

6 *Submission 2*, p. 3. FTE stands for family trust election.

7 *Submission 1*, p. 2.

8 CPA Australia notes that the test individual cannot be a deceased person. *Submission 2*, p. 3.

3.13 This estimate is consistent with the revenue costs estimated last year for the 2007 Act, which this bill largely revokes.¹⁰ The estimated costs for the 2007 bill were \$8 million a year but not all its provisions are being revoked.

3.14 Mr Mark Leibler of Arnold Bloch Leibler questioned the basis for this estimate:

it is inconceivable to me that the estimate of \$8M per annum could have related to the inclusion of the lineal descendents of family members. The inclusion of lineal descendents is only likely to have revenue cost implications - if at all - well into the future.¹¹

3.15 Mr Leibler told the committee that he had 'seen some work' from Pitcher Partners showing that family trust distribution tax on average to the year 2005-06 was just under \$1.5 million. The committee took evidence from the Director of Pitcher Partners who made no mention of this revenue estimate.

3.16 Mr Leibler argued that the government's costing assumes the reversal of family trust status for people who were included in a family trust group under last year's amendments. However, he believed the removal of the 'lineal descendants of family members' provision would not involve 'a reversal of family trust status'. Accordingly, Mr Leibler reasoned that there will be a significantly smaller revenue gain than the Treasury estimates. He claims:

The idea that even \$1 million per annum would be saved in relation to the lineal descendants issue is a complete and total nonsense.¹²

There's no revenue in it. All it will do is create complications and anomalies.¹³

3.17 In a similar vein, the Institute of Chartered Accountants opined:

We doubt very much if it will save the government any money and, if it does, it will be very little.¹⁴

3.18 The Taxation Institute of Australia also argued the lineal descendants measures in the bill will not result in any significant savings:

in respect of the lineal descendants, I do not see these measures raising anywhere near the amount of revenue that perhaps our friends from

9 *Explanatory Memorandum*, p. 4.

10 Mr Colin Brown, Treasury, *Proof Committee Hansard*, 12 August 2008, p. 7.

11 Mr Mark Leibler, *Submission 4*, p. 1.

12 Mr Mark Leiber, *Proof Committee Hansard*, 12 August 2008, p. 12.

13 Mr Mark Leiber, *Proof Committee Hansard*, 12 August 2008, p. 14.

14 Mr Ali Noroozi, Institute of Chartered Accountants in Australia, *Proof Committee Hansard*, 12 August 2008, p. 8.

Treasury [expect] ... it will be many, many, years before trusts will hit a position where the only surviving beneficiaries that are able to receive distributions might be great grandchildren. At that point in time, the trust will restructure and perhaps vest rather than incur a penalty tax.¹⁵

3.19 However they suggested a capital gains tax event could be triggered sooner as a result of the measures in the bill.¹⁶ Similarly, Family Business Australia suggested the measures could convert some assets currently exempt from capital gains tax due to being purchased before the tax was introduced into assets that now would be subject to the tax, but they also did not quantify the impact.¹⁷ Mr Leibler also referred to capital gains tax implications in the longer term:

it is likely going forward that capital gains are going to be brought forward because people are going to want to vest their trusts because, as you run into grandchildren or great-grandchildren who are no longer beneficiaries rather than paying penalty tax on distributions you may want to vest the trust in relation to beneficiaries who are still alive and who comply.¹⁸

3.20 Treasury's Colin Brown agreed the changes to rules on lineal descendants did not have large revenue implications in the short-term and there was a degree of uncertainty around them:

The bulk of the cost saving in this measure comes from the reversal of the measure to be able to change the test individual over the forward estimates period. The component that is related to changing the lineal descendants has a different cost over a different time frame. It has a longer term cost, which is larger.¹⁹

My recollection of the costing of this is that the lineal descendants, over the forward estimates period, is a very small part, probably around \$1 million [each year] ... but that that number outside of the forward estimates period would grow...the costings are very indicative. There is not a lot of data on which to base an assessment.²⁰

Committee view

3.21 The committee does not believe that, because the revenue savings from the lineal descendants amendment is allegedly only a quarter that of Treasury's estimate,

15 Mr John Brazzale, Taxation Institute of Australia, *Proof Committee Hansard*, 12 August 2008, p. 16.

16 Mr John Brazzale, Taxation Institute of Australia, *Proof Committee Hansard*, 12 August 2008, p. 16.

17 Mr Donald O'Brien, Family Business Australia, *Proof Committee Hansard*, 12 August 2008, p. 19.

18 Mr Mark Leiber, *Proof Committee Hansard*, 12 August 2008, p. 12.

19 Mr Colin Brown, Treasury, *Proof Committee Hansard*, 12 August 2008, p. 5.

20 Mr Colin Brown, Treasury, *Proof Committee Hansard*, 12 August 2008, p. 6.

the amendment should be cut from the bill. The proposed amendment will achieve the government's stated objective of cost savings (however large) and fulfil its pre-election commitment to tighten family trust arrangements. Beyond the forward estimates period, the lineal descendents amendment could potentially realise quite significant cost savings. It is, moreover, in keeping with the broader objective of Schedule 2 of the bill which is to preserve the integrity of the tax system.

Compliance costs

3.22 The Government stated 'these amendments are expected to have a small impact on compliance costs'.²¹

3.23 This was contested by some submitters and witnesses. The Taxation Institute of Australia argues that the 2007 amendments were 'specifically targeted to overcome a number of acknowledged problems with the operation of the family trust election rules and reduce the onerous associated compliance costs'.²² This would seem to imply that the 2008 bill would render compliance costs once again onerous.

3.24 CPA Australia also argue the bill runs counter to the objective of reducing the compliance burden on taxpayers.²³

3.25 Senator Joyce suggested it will only be accountants that benefit as a large number of trusts need to rearrange their affairs.²⁴

Senator Annette Hurley

Chair

21 *Explanatory Memorandum*, p. 4.

22 *Submission 3*, p. 1.

23 *Submission 2*, p. 1.

24 Senator Barnaby Joyce, *Proof Committee Hansard*, 12 August 2008, pp 14 and 20.