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# Family Trust Elections and Interposed Entity Elections

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## 1. Introduction

The trust loss rules were introduced by the *Taxation Laws Amendment (Trust Losses and Other Deductions) Act 1988* (Cth) ('Trust loss rules'). The legislation was assented to in April 1988; however, the majority of measures have been operative since they were originally announced in the May 1995 Federal Budget, which means that most tax professionals have been faced with the various issues that these rules create. However, the law in this area is inherently complex and this has been exacerbated by a broadening of both the scope and application of some aspects of the rules over time.

Central to the trust loss rules is the concept of a 'family trust' and the 'family group', both of which receive concessional treatment under the Act. To become a family trust, the trustee must make and lodge a 'family trust election' ('FTE'). There are also situations where a related entity (company, partnership or trust) will need to make and lodge an 'interposed entity election' ('IEE') to become a member of the family group and thereby attract concessional treatment.

As noted, FTEs and IEEs emerged from the trust loss rules announced in the 1995 Federal Budget, and as they originally *only* applied to trust losses, very few trusts were affected and hence few FTEs and IEEs were made and lodged with the Australian Taxation Office ('ATO').<sup>1</sup> However, this was all to change from late 1997 (but not legislated until 1999) where the scope and application of FTEs and IEEs was considerably broadened to include dividends received by family trusts (under the franking credit trading measures) and to the tracing of company losses (for companies owned by family trusts). It must be remembered that these changes were announced and took effect in a period

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<sup>1</sup> Letter from the Taxation Institute of Australia ('TIA') and the Institute of Chartered Accountants in Australia ('ICAA') to the Hon Senator Helen Coonan, Minister for Revenue and the Assistant Treasurer, 21 January 2004, available at <[http://www.icaa.org.au/upload/download/FTE\\_letter.pdf](http://www.icaa.org.au/upload/download/FTE_letter.pdf)> ('TIA/ICAA Submission').

of great tax reform, where businesses were faced with a myriad of tax changes with little or no practical guidance as to how such changes might impact on their operations.

It must also be appreciated that the changes to FTEs and IEEs that were ushered in by these reforms are both significant in number and important in revenue terms. One estimate suggests that over half of some 450,000 trusts are potentially impacted by what may be a large number of taxpayers that have failed to make FTEs and IEEs.<sup>2</sup> The same source notes that in respect of a taxpayer that failed to lodge a FTE, in January 2004:

[T]he Commissioner issued a \$2 million adjustment to the taxpayer's original assessment ... A \$2 million bill for merely failing to lodge a piece of paper is indefensible.<sup>3</sup>

These are powerful and sobering examples of the importance of ensuring that FTEs and IEEs are considered carefully and elected for if appropriate. It has also created renewed interest in what was thought to be largely settled law and caused professional bodies like the Taxation Institute of Australia ('TIA') and the Institute of Chartered Accountants in Australia ('ICAA') to petition the Government to express their members' concerns relating to these complex provisions of the Act.

In response, the ATO issued Practice Statement PS LA 2004/1 (GA) on 15 April 2004, which applies to trusts which have elected to be family trusts for the purposes of the trust loss measures, company loss measures or the franking credit trading measures.

In light of these developments, it is both timely and important to revisit FTEs and IEEs and critically examine whether the ATO's Practice Statement represents an adequate response to the stated concerns. The Paper seeks to undertake this examination by looking at the following issues:

1. FTEs – what is a FTE, why should a FTE be considered, where the rules are, and how the election should be made and lodged with the ATO.
2. IEEs – what is an IEE, why should an IEE be considered, where the rules are, and how the election should be made and lodged with the ATO.
3. Factors to be borne in mind in deciding whether an FTE and/or an IEE should be made.
4. Deficiencies with the present rules as they relate to FTEs and IEEs.
5. An examination of Practice Statement PS LA 2004/1 (GA), the ATO response to the problems.
6. Conclusions – does the ATO Practice Statement adequately respond to the issues/problems?

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<sup>2</sup> Ibid.

<sup>3</sup> Ibid.

The Paper is structured in a practical question-and-answer format that will examine not only the theoretical issues but also, and more importantly, it will focus on the practical issues.

## **2. Family Trust Elections ('FTEs')**

### **2.1 What is a FTE?**

A family trust election is the election that is made in order to make a trust a 'family trust' for taxation purposes.<sup>4</sup>

### **2.2 Why should a trustee consider making a FTE?**

In broad terms, a 'family trust' receives concessional tax treatment in the following three areas:

- **The trust loss measures**

One of the main reasons for considering whether to exercise the election is to escape the various tests that may need to be satisfied for a fixed or non-fixed trust to claim its losses and debt deductions. If a trust is a 'family trust', only one test, a modified application of the income injection test, needs to be satisfied.

Hence, by becoming a 'family trust', most of the trust loss measures may not apply to the trust, or only apply in a modified way.

- **The company loss tracing measures**

Amendments to the company loss rules allow a non-fixed (discretionary) trust to benefit from the 'family trust' concession.

Broadly, the concession applies for the purposes of the company loss recoupment rules so that where the relevant interests in a company are held by a 'family trust', the trustee of the 'family trust' will be taken to own the interests as an individual.<sup>5</sup>

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<sup>4</sup> See sections 272-75 and 272-80 of Schedule 2F of the *Income Tax Assessment Act 1936* (Cth) ('ITAA 1936'). References to section numbers in the Paper should be read as references to sections pertaining to Schedule 2F of the ITAA 1936 unless otherwise stated.

<sup>5</sup> In Taxation Determination TD 2000/27, the Commissioner adopted the view that if the trustee of a discretionary trust holds shares carrying 50% or more of the voting, dividend and capital rights in a company in the year in which a loss was incurred, and the trustee continues to hold those shares in the income year, the company could *not* satisfy the continuity of beneficial ownership test in the ITAA 1936. The argument advanced in such a situation was on the basis that the shares would not be beneficially owned by any persons and that beneficiaries of a discretionary trust do not have any interest, either individually or collectively, in the property or income of a trust estate. Several cases support this view – see, eg, *Gartside and Another v. Inland Revenue Commissioners* [1968] 1 All ER

- **The franking credit trading measures**

Broadly, unless a trust has elected to be a 'family trust', the 45-day rule, an anti-franking credit trading rule, applies. This rule generally has the effect of denying beneficiaries of discretionary trusts the franking rebate and other franking benefits, in relation to dividends paid on shares or interests in shares acquired after 3pm on 31 December 1997. Consequently, the franking credits could be lost.

Amendments to the franking credit trading measures now allow a discretionary trust that receives a franked dividend to benefit from the 'family trust' concession. This means that for the purposes of the franking credit trading measures, where a trustee is a qualified person and the trust has elected to be a 'family trust', the 45-day rule is less likely to apply to deny a beneficiary entitlement to franking credits.

### ***2.3 Where can the rules relating to FTEs be found and when do they apply?***

- **The trust loss measures**

Section 272-80 of Schedule 2F to the ITAA 1936.

The measures apply for 1995 and later income years.

- **The company loss tracing measures**

Divisions 165 and 166 of the ITAA 1997 (the concessional tracing measures for company losses can be found at sections 165-207 and 166-165 of the ITAA 1997).

The measures apply for 1997 and later income years.

- **The franking credit trading measures**

Division 1A of Part IIIIAA of the ITAA 1936 (the franking credit trading measures can be found at sub-section 160APHL(10)).

The measures apply for 1998 and later income years.

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121 and *Re Weir's Settlement MacPherson and Another v. Inland Revenue Commissioners* [1970] 1 A All ER 297.

## **2.4 How is the election made and what are the requirements for making the election?**

### **2.4.1 How does a trust become a 'family trust'?**

A trust (whether fixed or non-fixed) is regarded as a 'family trust' at any time when a family trust election in respect of the trust is in force (section 272-75). That is, a trust can *only* be a family trust if it has formally elected under section 272-80 to have that status.

### **2.4.2 What is the nature of the election?**

The election *must* specify a year of income from which it is to take effect and it then applies at *all times* after the beginning of the specified income year: sub-sections 272-80(1), (9), (10).

Only one election can be made under section 272-80 in relation to the trust (sub-section 272-80(11)), though the trustee of a family trust must notify the ATO of the trusts family trust election status each year by inserting a code on the trust return.

### **2.4.3 How is the election made and lodged with the ATO?**

- ***Making the election where an entity is required to lodge a return***

The election *must* be made in the tax return lodged with the ATO as part of that year's return: sub-section 272-80(2).

- ***Making the election where an entity is not required to lodge a return.***

FTEs must be lodged with the ATO no later than 2 months after the end of the tax year specified or such later day as the Commissioner allows: paragraph 272-80(2)(b).

### **Important notes:**

- Elections must be not only be made, but also lodged with the ATO. The TIA and ICAA, in their joint submission to the government, noted that 'some trustees and their advisers inadvertently missed the issue or completed a FTE but were not aware that it had to be physically lodged with the ATO.'<sup>6</sup>
- If an election is not included in the current tax return, then, subject to certain transitional rules, FTEs can only be made for the earliest year for which a tax return has *not yet been lodged*. The election *cannot* be made for the specified income year if it is made *after* the entity's return for that year has been furnished. Hence, an amended return including a FTE will not be accepted as lodging the election for the specified income year.
- There is *no* provision in the legislation to allow an extension of time to make a late election, or to allow extra time to provide details of elections where a tax return is required to be lodged. Under the Act, extensions *only* apply to situations where the trustee is *not* required to furnish a return for the income year – in which case further time can be allowed by the Commissioner under sub-paragraph 272-80(2)(b)(ii) in which to lodge the FTE.

### **Note:**

The points made above represent some of the major problems which led to the TIA/ICAA submission, and the eventual issuance of Practice Statement PS LA 2004/1 (GA) by the ATO (see later discussion).

#### ***2.4.4 Who is the 'test individual'?***

A family trust election must specify one individual (the 'test individual') whose 'family group' is to be taken into account in relation to the election: sub-section 272-80(3). Notes regarding the test individual:

- Only one individual can be specified in a FTE.
- The individual cannot be deceased when the election is made.
- The individual specified in a FTE cannot be changed.
- If the individual specified in a FTE dies *after* it is made, the FTE is unaffected – ie, the family members are still determined by reference to that individual.

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<sup>6</sup> TIA/ICAA Submission, above n 1.

### **2.4.5 Who comprises the 'family group' of a test individual?**

As noted, a family trust election must specify an individual (being the test individual or primary individual) as the individual whose 'family group' is the subject of the election. Whether a person or entity is a member of the family group is determined by reference to that test individual. The members of the family group are set out in section 272-90 and include the following:

1. A member of the primary individual's family. (Note the definition of 'family' in section 272-95 – see below).
2. The trust making the election.
3. A company, partnership or trust if, when the conferral takes place or the distribution is made, any combination of the primary individual, one or more members of his or her family or the trustees of one or more family trusts with the same test person have *fixed entitlements*, directly or indirectly for their own benefit, to all of the income and capital of the company, partnership or trust.

Where family members (including another family trust of the same specified individual) do *not* have fixed entitlements, directly or indirectly, and for their own benefit, to all the income and capital of the interposed entity, it will be necessary for the interposed entity to make an election (known as an 'interposed entity election') before it can be included as part of the family group. (sub-section 272-85(1)).

4. A fund, authority or institution in Australia covered by items 1 and 2 in the gift provisions tables in section 30-15 of the ITAA 1997.
5. Certain tax exempt bodies listed in sub-section 272-90(7).
6. Certain tax exempt institutions where, at the time of the distribution, all of the individual beneficiaries of the trust are deceased.
7. If the primary individual and all of the members of his or her family are dead when the conferral takes place or the distribution is made, the estates of the individuals and of the family members.
8. Certain distributions to SMEs within the meaning of section 128TK of the ITAA 1997.

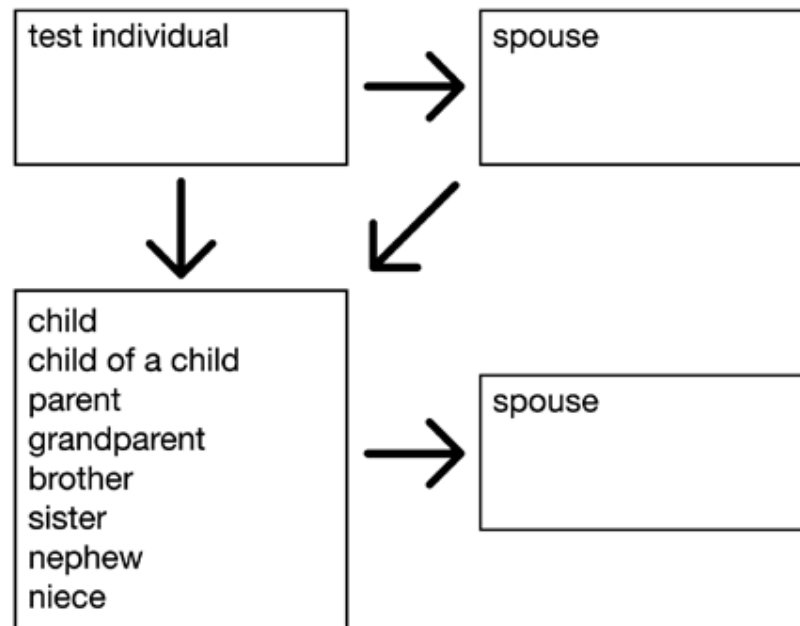
### **2.4.6 Who are regarded as being members of the test individual's 'family'?**

This is covered in section 272-95. The family of a test individual includes the following:

- (a) any parent, grandparent, brother, sister, nephew, niece, child, or child of a child, of:
  - (i) the test individual; or
  - (ii) the test individual's spouse
- (b) the spouse of the test individual or of anyone who is a member of the test individual's family because of paragraph (a).

This may be depicted as follows:<sup>7</sup>

#### **FAMILY MEMBERS**



<sup>7</sup> Australian Taxation Office ('ATO'), 'Trust loss measures, family trust elections (FTEs) and interposed entity elections (IEEs) – Question and answers', 10 February 2004, available at <<http://www.ato.gov.au/print.asp?doc=/content/40272.htm>>.



By virtue of the definition of 'child' in sub-section 6(1) of the ITAA 1936, a child includes a step-child, adopted child or ex-nuptial child. The phrase 'child of a child' is used in defining a family member to ensure that the definition of 'child' applies to grandchildren of the test individual. Note also that the term 'spouse' is defined in sub-section 6(1) of the ITAA 1936 to include a *de facto* spouse.

Also, in ATO Interpretative Decision ID 2001/742, it is noted that the spouse of the individual specified in a family trust election is still a family member after the death of that individual under section 272-95. They will cease to be a spouse, however, if the surviving spouse remarries or enters into a *de facto* relationship.

***Important notes about the definition:***

It is restrictive!

It generally only extends for two generations up and down past the test individual.

Notable exceptions include:

- Test individual's great-grandchildren (this may be important as trusts may have a life of 80 years and may well extend into the 4<sup>th</sup> generation).
- Former spouses (divorced or separated *de factos*). This could cause practical problems if you want to reach an agreement for the ex-spouse to continue to run a joint family business operated through a family trust.
- Children of a former spouse
- Same-sex partners
- Cousins
- Aunts and uncles of the test individual
- Financial dependants

Therefore, the Government has created the extraordinary situation that certain family members who:

- could claim or successfully dispute an inheritance from a deceased estate;
- could be the subject of child support obligations under the *Child Support Assessment Act*; or
- who are dependants for superannuation purposes;

are *not* allowed to be members of family trusts under the rules!

### **2.4.7 What other requirements must be met for the FTE to be effective?**

The trust can only make the election if the trust passes the 'family control test' at the end of the specified start year (sub-section 272-80(4)). Where the trust does not satisfy the family control test for the whole of this year, it only has family trust status from the time when it first can pass the test. Otherwise, family trust status starts from the beginning of the nominated year (sub-section 272-80(10)).

The family control test for trusts is set out in sub-sections 272-87(1) and (2). A trust will satisfy the test if it is controlled at that time by a controlling group consisting of some or all of the following:

- the test individual.
- family members, as defined, to include persons related in specified degrees to the test individual.
- legal or financial advisors to the test individual or a member of his or her family.

A group constituted in this way will have the requisite control if (broadly speaking) it has the power, directly or indirectly, to control or obtain the beneficial enjoyment of the capital or income of the trust or to remove or appoint the trustee of the trust.

### **2.4.8 Can a FTE be revoked?**

Only FTEs made by *fixed trusts* can be revoked if certain conditions are satisfied: sub-section 272-80(6).

FTEs for *non-fixed trusts* are irrevocable: sub-section 272-80(5).

## **3. Interposed Entity Elections ('IEEs')**

### **3.1 What is an IEE?**

An interposed entity election is the election which may be made to make an entity (company, partnership or trust) a member of the 'family group' of the individual specified in a family trust election: sub-section 272-85(1).

### **3.2 Why should a trustee consider making an IEE?**

To become part of the 'family group'. Once part of the 'family group', the interposed entity would then be entitled to the concessions noted earlier (see 2.2 above).

Interposed entities can become part of a family group in two ways:

- **Automatic**  
Where family members (including another family trust of the same primary individual) have *fixed entitlements*, directly or indirectly, and for their own benefit, to all the income and capital of an interposed entity, that entity is *automatically* considered to be a member of the 'family group' for the purposes of sub-section 272-90(5) *without* being required to make an IEE.<sup>8</sup>
- **By election**  
Where family members (including another family trust of the same primary individual) do *not* have fixed entitlements, directly or indirectly, and for their own benefit, to all the income and capital of an interposed entity, then it *will be necessary* for that interposed entity to make an IEE for it to be included as part of the 'family group': section 272-85, sub-section 272-90(4).

### **3.3 Where can the rules relating to IEEs be found and when do they apply?**

Section 272-85 of Schedule 2F to the ITAA 1936.

See also 2.3 above for applicable dates that concessions apply.

### **3.4 How is the election made and what are the requirements for making the election?**

#### **3.4.1 What is the nature of the election?**

An interposed entity (company, partnership or trust) may elect to become a member of the family group of the individual specified in a FTE. The election *must* specify a year of income from which it is to take effect and it then applies at *all times* after the beginning of the specified income year: sub-sections 272-85(1), (6).

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<sup>8</sup> See also, ATO, Interpretative Decision ID 2003/164, where this view is affirmed.

### ***3.4.2 How is the election made and lodged with the ATO?***

- ***Making the election where the interposed entity is required to lodge a return***

The election *must* be made in the tax return lodged with the ATO as part of that year's return: sub-section 272-85(2).

- ***Making the election where the interposed entity is not required to lodge a return.***

IEEs must be lodged with the ATO no later than 2 months after the end of the tax year specified or such later day as the Commissioner allows: paragraph 272-85(2)(b).

### ***3.4.3 Does an interposed entity have to pass the family control test?***

Yes, the company, partnership or trust must pass the family control test at the end of the income year – see sub-sections 272-85(4) and 272-87. Refer to 2.4.7 for a discussion of the family control test.

### ***3.4.4 Can an IEE be revoked?***

No – see sub-section 272-85(5).

### ***3.4.5 Is an IEE still 'in force' if the trust in respect of which the relevant FTE was made ceases to exist?***

Yes. An IEE is irrevocable and continues to be 'in force'.<sup>9</sup>

### ***3.4.6 Are there any restrictions on multiple elections being made by an interposed entity?***

A company, partnership or trust can make more than one interposed entity election provided each family trust, with which the entity is interposed, has the same individual specified in its family trust election: sub-section 272-85(7).

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<sup>9</sup> See also, ATO, Interpretative Decision ID 2003/236.

However, an entity can *not* make an interposed entity election in respect of two family trusts where the individuals specified in the respective family trust elections are different.<sup>10</sup>

### ***3.4.7 Are there any other general points worth noting about IEEs?***

- A trust can make both a FTE and one or more IEEs provided the individual specified in the FTE is the same as the individual specified in the other FTEs for which each IEE is made.
- A superannuation fund can make an interposed entity election provided it passes the family control test under section 272-87.
- A company, partnership or trust can make an IEE even if it cannot receive distributions from the family trust for which the election is to be made provided it passes the family control test under section 272-87.

## **4. Should a FTE or IEE be exercised?**

### ***4.1 What are the advantages and disadvantages that need to be considered when deciding whether to exercise such elections?***

#### ***4.1.1 Advantages of electing***

1. As noted earlier (refer 2.2 and 3.2 above), the main reason for exercising a FTE and/or an IEE is that a family trust and members of a family group receive concessional treatment under the trust loss measures, the company loss tracing measures and the franking credit trading measures. For example, under the trust loss rules, a 'family trust' need only satisfy the income injection test to claim its losses and bad debt deductions. Also, and importantly, that test is modified so that, if the relevant transactions are within the family group (as defined), that test is always satisfied because there is no 'outsider' involved (sub-section 270-25(1)).

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<sup>10</sup> ATO, Interpretative Decision ID 2002/1082.

2. Where a fixed entitlement is held directly or indirectly, the trustee of the family trust is taken to be an individual who holds the fixed entitlement for its own benefit (sub-section 270-30(2)). This makes it easier for a unit trust owned by discretionary trusts which elect to be family trusts to pass the 50% stake test to claim its losses, because it will be able to point to 'individuals' which own its units.

#### **4.1.2 Disadvantages of electing**

1. A special tax, the 'family trust distribution tax' ('FTDT') (Division 271), is payable if income or capital of the trust is distributed to persons other than those in the 'family group', or such persons become presently entitled to the income or capital. This penalty tax is equal to the top marginal rate applying to individuals, plus Medicare Levy – a penalty that should be avoided!
2. Many small business and farms are owned by family trusts or interposed entities. However, such assets cannot be handed down more than 2 generations (say, to the great-grandchildren) after the test individual without attracting FTDT.<sup>11</sup>
3. Interests in interposed entities which carry on a small business may be difficult to sell because a distribution to the purchaser, after the sale, would be subject to FTDT - will need to sell the underlying asset and dissolve the interposed entity.<sup>12</sup>
4. The list of persons within the family group is, essentially, prescribed by the 'test individual' and is narrow.<sup>13</sup> This will inhibit the usefulness of the trust. It may also truncate the useful life of the trust in that the list extends for only two generations past the test person. The definition of 'family' under section 272-95 and its restrictiveness was examined earlier in the Paper (see 2.4.6 above).

Generally, family membership extends upwards and downwards 2 generations of the test individual. Therefore, if the family patriarch or matriarch (a member of the oldest generation in the family) were to be chosen as the test individual, family trust status would cease upon the death of the grandchildren of the oldest generation.<sup>14</sup>

If one of the "middle generation" were chosen, this would serve to perpetuate family trust status for a further generation, but it would

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<sup>11</sup> Brett Davies Lawyers, 'Technical Update for Small Practitioners: Trust Losses and Family Trust Elections', Paper presented for and sponsored by the Australian Society of CPAs, 26 February 1999, available at <<http://www.taxlawyers.com.au/Publications/New/Trustloss.htm>>.

<sup>12</sup> Ibid.

<sup>13</sup> Exceptions to the definition of family member include great-grandchildren, former spouses, children of a former spouse, same-sex partners, cousins, aunts and uncles of the test individual and financial dependants.

<sup>14</sup> Brett Davies Lawyers, above n 11.

(subject to the transitional provisions) be achieved at the expense of excluding brothers and sisters of the patriarch or matriarch (uncles or aunts of the test individual) from qualification as "family members".<sup>15</sup>

5. The elections are generally irrevocable (sub-sections 272-80(5), 272-85(5)).<sup>16</sup>
6. The requirements as to making and lodging either a FTE or IEE are very restrictive and as noted, there is *no* provision in the legislation to allow for an extension of time to make a late election, or to allow extra time to provide details of elections where a tax return is required to be lodged.<sup>17</sup>
7. Test individuals for FTE purposes once nominated cannot be changed. This means that the long-term implications given the locking in of the family members of the test individual need to be carefully considered.
8. The income injection test will capture "freebies" given to family members who are not recognised as being part of the family group.<sup>18</sup>

#### ***4.2 What other things need to be considered in deciding whether to exercise either the FTE and/or IEE?***<sup>19</sup>

1. Start with the position that the trust will *not* elect to be a Family Trust and then consider the implications, if any of not making the election:
  - will the trust have loss or bad debt deductions?
  - will the losses be recouped internally?
  - will the losses require an income injection by outsiders?
2. Consider whether the tests applicable for your type of trust can be satisfied easily - if yes, there may be no point making the election.

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<sup>15</sup> Ibid.

<sup>16</sup> However, a family trust that is a fixed trust is able to revoke a FTE if some or all of the interests in the trust are disposed of to non-family members or if any of them cease to be family members (sub-section 272-80(6)).

<sup>17</sup> As noted earlier, under the Act, extensions only apply to situations where the trustee or interposed entity as the case may be is *not* required to furnish a return for the income year – in which case further time can be allowed by the Commissioner under sub-paragraphs 272-80(2)(b)(ii) and 272-85(2)(b)(ii) in which to lodge the FTE or IEE as appropriate.

<sup>18</sup> Brett Davies Lawyers, above n 11.

<sup>19</sup> An excellent Paper which deals with the main considerations is Brett Davies Lawyers, above n 11. What follows on this point summarises the main points made by this source.

3. Consider each of the applicable tests carefully because they may not apply to some situations:
  - income injection test - there must be a scheme (similar meaning as Part IVA).
  - pattern of distribution test - there must be a distribution.
4. Consider also the Trust Deed to see if there are deemed distributions to primary beneficiaries if the Trustee fails to distribute net income or an automatic vesting of entitlements to income to unit holders.
5. Consider the Trust Deed to see if the Trustee will be in breach if it favours beneficiaries belonging to a family group over other beneficiaries that are considered outsiders - especially if the objects of the trust include both family group and non-group members (to overcome conflict, may need separate trusts).
6. The choice of the test individual is crucial as it locks in the class of family members that comprise the family group forever.
7. A related problem is a potential dilemma between choosing the husband or wife as the test individual:
  - if they separate (in case of *de facto*) or divorce, the ex-spouse falls outside the family group.
  - a distribution under an order of the Family Court to the test individual's ex-spouse would be subject to FTDT.
  - if shares retained in private company and distributions received from the family trust, FTDT is payable.

## **5. Deficiencies with the Existing Legislative Provisions**

### ***5.1 What are the problems with the existing provisions?***

Apart from the disadvantages associated with exercising FTEs and IEEs already noted, the existing provisions contain several restrictions and problems. These include:

- The Commissioner currently has *no express discretion* to allow the making of a FTE/IEE *after* the tax return for a year of income has been lodged. Under the Act, extensions *only* apply to situations where the trustee is *not* required to furnish a return for the income year – in which case further time can be allowed by the Commissioner under sub-paragraphs 272-80(2)(b)(ii) or 272-85(2)(b)(ii) in which to lodge the FTE/IEE.



- The ATO would *not* amend a return to accept a FTE or IEE if it was not lodged for the specified year of income.
- Many taxpayers may not have lodged FTEs and IEEs where relevant, not realising they were impacted by changes to the franking credit trading and company loss tracing measures. It was noted earlier in the Paper that though FTEs emerged from the trust loss rules originally announced in the May 1995 Federal Budget, it only affected a few trusts and so few FTEs were necessary. However, the scope and application of FTEs and IEEs was considerably broadened from late 1997 (but not legislated until 1999), at a time of great tax reform, to apply to ordinary dividends received by family trusts and to tracing of company losses (for companies owned by family trusts). The TIA/ICAA notes that '[t]hese rules [were] buried in highly complex law, with little or no ATO guidance material provided.'<sup>20</sup>

In the face of a failure by many businesses to recognise changes implemented from 1 July 1999 (the so-called 45 day rule and the company loss tracing measures) due to their attention being diverted with other major changes including the impending introduction of the GST and other major reforms that followed, it appears that a large number of trustees and their advisers have either not made a FTE (and IEE where relevant) or alternatively may have made the relevant election but not lodged it as required with the ATO.

As already noted, the size of the problem is not small, as anecdotally over half of the over 450,000 trusts are potentially impacted.<sup>21</sup> Similar anecdotal evidence reveals that many smaller firms have in excess of 30 clients affected with imputation credits as high as \$3m in doubt.<sup>22</sup> The stated \$2m adjustment case noted earlier also gives dimension to the size and nature of the identified problem.

## **5.2 How could the problems be overcome?**

The joint TIA/ICAA submission advocated that a satisfactory resolution of this matter requires the following:<sup>23</sup>

1. Extension of the previous transitional provisions relating to the introduction of the 45 day rule and the company loss tracing measures allowing additional time to lodge FTEs (and IEEs where relevant) in respect of previous years (say back to the 1997 year) to the 2003 year.

<sup>20</sup> TIA/ICAA Submission, above n 1.

<sup>21</sup> Ibid.

<sup>22</sup> Ibid.

<sup>23</sup> Ibid.

This would allow adequate time for taxpayers and their advisers to make an informed decision as to whether a FTE/IEE should be made.

2. Appropriate educational support from the ATO. The TIA/ICAA, in their joint submission, indicated their willingness to take such a role in such a process.
3. Granting the Commissioner discretion to allow lodgement of a FTE (and IEE where relevant) *after* the return has been lodged. This would be to cover situations such as where there are simple errors or omissions (in appropriate circumstances). Amendments to sub-sections 272-80(2) and 272-85(2) could be made to achieve this.

## **6. The ATO Response**

### ***6.1 How has the ATO responded to the stated concerns?***

According to the joint TIA/ICAA submission, the issues raised in relation to FTEs and IEEs have been advanced since June 2002 by the professional bodies through numerous meetings of the National Tax Liaison Group ('NTLG'). Subsequently, various consultations and submissions on this issue have been pursued with the ATO.

The culmination of these sustained efforts has finally resulted in the ATO's release of Practice Statement PS LA 2004/1 (GA), which provides entities with time to inform the ATO of elections that should have been made in previous financial years. The one-off opportunity that the Practice Statement affords applies to entities that have not lodged FTEs and IEEs and the Practice Statement applies to trusts electing to be 'family trusts' for the purposes of the trust loss measures, the franking credit trading measures and the company loss measures.

The Practice Statement is effective from 15 April 2004, and is available at the ATO website at the following location:

[http://law.ato.gov.au/pdf/ga04\\_001.pdf](http://law.ato.gov.au/pdf/ga04_001.pdf)

### ***6.2 What is a 'Practice Statement' and what is its status?***

Given that the response to the joint TIA/ICAA submission at this stage has been via the ATO rather than a legislative response, it is instructive to briefly consider the nature and status of a Practice Statement.

The nature of Practice Statements is set out in Practice Statement PS LA 1998/1, a revised version of which was published on 14 May 2003.<sup>24</sup> All Practice Statements are issued under the authority of the Commissioner and must be read in conjunction with PS LA 1998/1.

Practice Statements 'provide direction and assistance to staff [of the ATO] on the approaches to be taken in performing duties involving the application of the laws administered by the Commissioner ... [they] supplement public rulings.'<sup>25</sup>

In terms of their status, PS LA 1998/1 states that it is *mandatory* for staff to search for and follow Practice Statements relevant to tasks that they are performing unless doing so creates unintended consequences.<sup>26</sup> Failure to follow a Practice Statement can result in disciplinary action under the *Public Service Act 1999* (Cth).

### **6.3 What are the key features of the ATO Practice Statement relating to FTEs and IEEs?**

The key features of Practice Statement PS LA 2004/1 (GA) may be summarised as follows:

1. The Practice Statement provides a 'one-off' opportunity for entities to inform the ATO of FTEs and/or IEEs that should have been made in previous financial years.<sup>27</sup>
2. The Practice Statement applies to trusts electing to be 'family trusts' for the purposes of the trust loss measures, company loss measures or the franking credit trading measures.
3. The opportunity is *only* available to entities that have acted as if they were a 'family entity'. An entity will satisfy this requirement if *at all times* from the beginning of the specified income year (see point 4 below) until 30 June 2004:
  - the entity passes the family control test, and
  - the entity has made no distributions of income or capital to persons other than the individual specified in the FTE, or members of that individual's family group.

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<sup>24</sup> ATO, Practice Statement PS LA 1998/1, available at <[http://law.ato.gov.au/pdf/ga04\\_001.pdf](http://law.ato.gov.au/pdf/ga04_001.pdf)>.

<sup>25</sup> Ibid paragraph 1.

<sup>26</sup> Ibid paragraphs 4 and 6.

<sup>27</sup> As noted elsewhere in the Paper, to become a 'family trust', the trustee must make and lodge a FTE with the ATO and in certain situations a related entity (partnership, company, trust) will need to make and lodge an IEE to become a member of the family group.

4. Entities satisfying the above conditions will be able to specify a year that the ATO treat as the relevant election year, from the relevant range of income years as follows:
  - 1995-96 to 2002-03 for trust loss purposes;
  - 1996-97 to 2002-03 for company loss tracing purposes; and
  - 1997-98 to 2002-03 for franking credit trading purposes.
5. Entities will *not* be permitted to revoke a previously lodged election unless this revocation is in accordance with subsection 272-80(6).

#### **6.4 When does the information need to be provided to the ATO?<sup>28</sup>**

Entities that want to take advantage of the opportunity to make a FTE or IEE (where relevant) afforded by the Practice Statement are *not* required to provide anything to the ATO until after 30 June 2004.

- Entities that are required to lodge a tax return for the 2004 income year will be able to update their paperwork when they lodge their return.
- Entities that are *not* required to lodge a return for the 2004 year will be required to provide details of any elections, together with the approved declaration within two months of the end of the 2004 income year.

Entities making an election specifying the 2004 income year, and *not* wishing to request that that election be treated as applying from some earlier income year should make and provide details of that election in accordance with sections 272-80 (FTE) or 272-85 (IEE).

Finally on this point, some entities may have already lodged an election for a specified income year and may not have been able to specify an earlier year, as the transitional rules were no longer available to them. These entities will now be able to ask the ATO to request that the election apply to an earlier year of income, providing the conditions set out in the Practice Statement are satisfied and no other changes are being made to the election.<sup>29</sup>

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<sup>28</sup> ATO, Practice Statement PS LA 2004/1 (GA), paragraphs 1, 6, 8 and 9.

<sup>29</sup> Ibid paragraph 6.

### **6.5 What are the potential pitfalls of acting in accordance with the opportunity offered by the ATO Practice Statement?**

Trustees and their advisers need to carefully consider whether to make an election in accordance with the opportunity provided for by the Practice Statement. Some of the things that should be carefully considered include the following.<sup>30</sup>

- If taxpayers can pass alternative tests for losses or qualify for the small shareholder exemption, losses and franking credits may be available *without* the need to consider making an election.
- An IEE cannot be revoked in *any* circumstances and the ability to revoke a FTE is extremely limited (see earlier discussion).
- Lodgement of a FTE or IEE will result in any distributions of income or capital outside the family group of the specified individual being taxed at the top marginal rate applicable to individuals plus the Medicare levy.

### **6.6 What needs to be done to take advantage of the ATO Practice Statement?**<sup>31</sup>

1. Identify the clients who have not yet lodged FTEs and IEEs (where relevant).
2. Having regard to the foregoing discussion, consider carefully whether the client should make the election, i.e. can they pass the alternative tests for trust and company losses? do they qualify for the small shareholder exemption in relation to franking credits? etc.
3. If an election is considered necessary, determine if the entity satisfies the conditions enabling them to take advantage of the opportunity provided for in the ATO Practice Statement.
4. Provide the necessary information to the ATO in accordance with the requirements discussed above.

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<sup>30</sup> See also, Anne-Marie Backberg, 'Family Trust and Interposed Entity Election Opportunity', Weekly Tax Bulletin, Issue 15, 16 April 2004, Thomson ATP, [562].

<sup>31</sup> See also, Letter from Mark Carter, Assistant Commissioner to Tax Agents, 'Family Trust and Interposed Entity Elections', 15 April 2004.

## 7. Conclusions

In concluding, one question needs to be asked: does Practice Statement PS LA 2004/1 (GA) solve the problems and concerns as expressed by professional bodies such as the TIA/ICAA?

On the positive side, it does represent an opportunity for trustees to lodge FTEs and IEEs which did not previously exist, thereby recognising that taxpayers and their advisers have been dealing with substantial changes brought about by the new tax system.

However, as against this opportunity, which is a 'one-off' administrative response, it does not provide a long term solution, which it is submitted, can only be achieved by legislative amendment to the relevant provisions governing FTEs and IEEs.<sup>32</sup> In the words of the President of the TIA:

Although the administrative announcement does address all our immediate concerns, it does not provide a long term solution.

Further, and finally, the parameters for exercising the one-off opportunity are restrictive and trustees and their advisers will need to carefully consider whether to exercise elections as long-lasting and detrimental consequences may result from an inappropriate exercise of the elections.

## POSTSCRIPT

The Federal Budget handed down on 11 May 2004, had the following statement regarding further measures that the Government contemplates introducing to respond to the problems with FTEs and IEEs. On the face of it, this is encouraging, but like all Government announcements, the proof of the pudding will come when the amending legislation arrives!

### *Family trust and interposed entity elections*

The Government will respond to concerns raised by tax professional bodies that the current requirements to make a valid family trust election are too inflexible.

To provide greater flexibility and remove the possibility of any ongoing uncertainty, the Government will allow family trust elections to be made **at any time in relation to an earlier income year**, subject to certain conditions.<sup>33</sup> (emphasis added)

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<sup>32</sup> The joint TIA/ICAA submission suggested that the Government should amend the relevant provisions to grant the Commissioner discretion to allow lodgement of a FTE (and IEE where relevant) after the return has been lodged: See TIA/ICAA Submission, above n 1. An amendment to subsections 272-80(2) for FTEs and 272-85(2) for IEEs could be made to accomplish this.

<sup>33</sup> Treasurer's Press Release, No 036/04, 11 May 2004, available at <<http://www.treasurer.gov.au/tsr/content/pressreleases/2004/036.asp>>.