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Taxation of Family Trusts & Trust Distributions

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Types of Trust

• the “bare” trust – the trustee holds property simply as nominee
• the “fixed” trust - interests may be fixed as to income or capital or both
• the unit trust – a variant on the fixed trust is a unit trust
• the discretionary trust - the trustee is given a “discretion” to choose the share or amount of income or capital
• the hybrid trust – has the elements of both a fixed and discretionary trust
• the deceased estate – tax rules in Division 6 ITAA 36 apply
Role of the Settlor

• Best to have an unrelated party in the role of settlor to minimise the potential application of s 102 ITAA 36.

• Section 102 will not be triggered where the settler is a mere contingent beneficiary.

• For s 102 to apply the settlor must have power to revoke or alter the trust so as to acquire a beneficial interest in the trust income or trust property or their children who are under 18 must acquire an interest in the trust income.

Trustees

• Corporate or Individual Trustees
  — The use of an individual as trustee is generally a less costly
  — The trustee is personally liable for the debts incurred in their capacity as trustee and are indemnified from trust assets

• Use of a Corporate Trustee
  — Provides more protection – but do not overuse a corporate trustee
  — See DFC of T (Superannuation) v Fitzgeralds & Anor 2007 ATC 5105
  — The assets of the trustee acting in its own right will be subject to claims against the trustee for liabilities incurred in relation to the trust (but the reverse will not apply provided that necessary documentation and procedures are in place)
Change Beneficiaries / Trustee - Resettlements

- The identity of beneficiaries is an essential element of the trust.

- A change of beneficiaries may result in a re-settlement of a trust.

- A change in the membership of a continuing class of members will not constitute a change in the beneficial ownership.

- The change of trustee does not trigger immediate tax consequences - CGT event A1 does not occur.

Change Beneficiaries / Trustee - Resettlements

- Whether changes to a trust create a new trust (a resettlement) will depend on the particular circumstances.

- In FCT v Clark (2011) 79 ATR 550, Court considered that the indicia of continuity identified in Commercial Nominees apply equally for the purposes of the income tax laws governing trusts.

- Court held that changes which ATO argued had brought about a break in the continuity of the trust estate were insufficient to have had that effect.
Change Beneficiaries / Trustee - Resettlements

- Following *Clarke* decision, ATO withdrew the document - Creation of a new trust – Statement of Principles August 2001 – which set out its views on this issue.
- In TD 2012/21, ATO acknowledged that, as a result of decision in FCT v Clark, approach set out in the Statement of Principles was not sustainable.
- ATO now accepts that "continuity of trust is a function of whether the trust continues in existence under trust law in contradistinction to having terminated".

Vesting of Trust

- Most trust deeds have a standard vesting date of 80 years from the commencement date of the trust.
- More unusual vesting periods include “21 years after death of last living descendant of King George V alive at the time the trust was established”
Vesting of Trust

- Trust deeds generally have default distribution mechanism to distribute trust fund on vesting date where trustee has not exercised discretion to distribute.
- Where the vesting date has been overlooked, the trust fund will usually be held on trust by the trustee for a defined class of beneficiaries (referred to for present purposes as ‘primary beneficiaries’).

Vesting of Trust

- From a tax perspective, the vesting of the trust results in the primary beneficiaries becoming absolutely entitled to the trust fund, and CGT events E5 or E7 would likely occur (depending on the nature of the trust property).
- The effect of CGT event E5 or E7 is that the trustee will make a taxable capital gain on post-CGT assets if the market value of the assets exceeds their cost base. The beneficiaries would acquire the trust property at the vesting date, with a cost base equal to its market value.
Vesting of Trust

- From a revenue perspective, stamp duty is usually chargeable on transfers and certain other transactions relating to land, including transactions resulting in a change in beneficial ownership of land.
- Depending on default distribution provisions in trust deed, vesting of a trust that results in a change in interests in land could be a dutiable transaction.

Can vesting be avoided?

- Generally trust property vests within 80 years
- South Australia has abolished the perpetuity period
- If a trust deed has a shorter vesting date, such as 40 years, the vesting date can potentially be extended to avoid unwanted consequences.
Vesting of Trust

**Extending the vesting date – power under the trust deed**

- Some trust deeds give the trustee power to extend the vesting date.
- If the trustee exercises this power properly, and does not exceed the perpetuity period, the extension will be valid, and the trust can continue.

**Extending vesting date – no power under the trust deed**

- Some trust deeds do not contain a power to extend the vesting date.
- Supreme Court in most States has the power to vary trusts under their respective trust legislation where it is for the benefit of the beneficiaries of the trust.
- Recent case of *Re Plator Nominees* [2012] VSC 284 – court agreed to extend vesting date – court considered:
  - benefits and disadvantages of proposed variation,
  - purpose of trust and settlor’s intention in establishing trust.
Vesting of Trust

- Resettlement of the trust should also be considered when extending the vesting date.
- With withdrawal of Statement of Principles August and issuing TD 2012/21 where trustee exercises a valid power to extend vesting date, there should not be a resettlement.
- If no power, consideration should be given to trust structure and settlor’s intention at time trust established
- If there is a clear reason why shorter vesting period was nominated, caution should be exercised before any attempt is made to extend the vesting period.

Trustees that are beneficiaries

- A trustee can be a beneficiary in a trust but it cannot be the only beneficiary
- The fact that the trustee is a beneficiary in a trust may impact on the ability of third parties to make a claim against the assets of the trust – see the case of Richstar Enterprises case
  - the extensive control that the person had over the appointment of the trustees and distributions made by the trust created (at least) a contingent interest in the trust properties sufficient to bring them within the s 9 definition
Taxation of trusts - Division 6

REIMBURSEMENT AGREEMENT – SECTION 100A

- The term “reimbursement agreement” is defined as any agreement, arrangement or understanding providing for:
  - the payment of money (including a payment by way of loan) to
  - the transfer of property to, or
  - the provision of services or any other benefits for,

- any person other than the beneficiary, being an agreement entered into for a purpose (not necessarily the sole or principal purpose) of reducing the tax liability of a person.

- Raftland case and others – presence of reimbursement agreement triggers application of section 100A

- Effect is that “distribution” and transactions relevant to reimbursement agreement are disregarded
Present Entitlement – Reimbursement Agreements

• Anti-avoidance provisions operate to strike down present entitlement in the presence of a reimbursement agreement.

• Raftland Pty Ltd Case – distribution created an indebtedness but it was not a “real debt” that was intended to be paid
  – *It was held that the entitlement under the Raftland Trust deed was not intended to have substantive legal effect. Accordingly s 100A(1) applied*
  – *Trustee was taxed on the income to which no beneficiary was presently entitled*

Default Beneficiaries and Disclaiming Entitlement

• Ramsden’s Case – was the default clause effective and could the beneficiaries disclaim entitlement?

• The default beneficiaries were presently entitled and could disclaim the income but had to do it within a reasonable period – when they became aware of the distribution

• To be effective, a disclaimer had to extend to the whole of that subject matter hence a disclaimer confined to one only of those accounting periods was necessarily ineffective. In the absence of an appointment of income the trust deed will determine that the default beneficiaries are presently entitled
Effective Disclaimers

• Where there is a distribution to a person it vests in the person even before knowledge of the transfer, subject to his right when informed of it to say, if he pleases, 'I will not accept it'.

• **Effect of making a Disclaimer - TD 2001/26**
  - A renunciation by a beneficiary of an actual interest in a discretionary trust (the interest being a CGT asset) would give rise to CGT event C2
  - A disclaimer by a mere beneficiary of a discretionary trust has no tax effect
  - A disclaimer by a default beneficiary may require further consideration

Net income v Trust law income

• Net income of a trust estate – Taxable income as per s 95(1)

• In order to decide on which amounts the beneficiary or trustee will be assessable under s 97, 98, 99 or 99A, it is necessary first to determine the net income of the trust estate.

• The net income is defined in s 95(1) to mean the total assessable income of the trust estate calculated as if the trustee were a resident, less all allowable deductions.

• The net income should be calculated on the basis that the trustee is a resident.
Net income equals Trust law income

- Where net income is identical trust law income the beneficiaries will be entitled to the same share and character of net income.
- However, this is only rarely the case.

Net income exceeds Trust law income (1)

- Net income > trust law income (both amounts > 0 and the excess results from an income amount)
- Net income > trust law income (both amounts > 0 and the excess results from a capital amount)
- Net income > trust law income (trust law income < 0)
- Net income consists only of a capital gain and trust law income < 0.
Net income exceeds trust law income (2)

- Where the trust law income < 0, no beneficiary will be presently entitled - the trustee will be assessed on the income under s 99A.

- Example – Net income > trust law income

- Quantum View – excess is assessable to the trustee under s 99A

- Proportionate View – no amount assessable to the trustee under s 99A

Proportionate v Quantum Approach

- The proportionate approach has received greater support from decided cases where the excess of net income results from an income amount

- The proportionate approach does not deliver the fairest result where the income beneficiaries are not entitled to a share of the capital of the trust – See Richardson’s Case

- The Zeta Force Case supports the proportionate approach where the difference is of an income nature
The Importance of Trust Income

• Section 97(1) relies on the presence of trust law income (income in accordance with the trust deed or generally accepted accounting principles) - in the absence of trust law income the proportionate or quantum approach cannot be applied satisfactorily.

• Cajkusic’s Case demonstrates the difficulties in applying either view where there is no trust law income and so the net income is assessed to the trustee under s 99A.

• In Bamford V FCT, High Court sanctioned proportionate approach as appropriate methodology

Is streaming of capital gains effective for tax law purposes?

Flow-through of capital gains — Subdivision 115-C

• Subdivision 115-C ensure that, where net capital gain flows through to a beneficiary, capital losses of the beneficiary can be applied in calculating the ultimate assessable amount before application of any discounts

• This is done by
  – First, reversing, in beneficiary’s hands, any discounts claimed at trust level in calculating net capital gain included in trust net income,
  – Second, this grossed up amount is reduced by any available capital losses of the beneficiary, and
  – Third, the applicable CGT discounts is reinstated as recalculated on the reduced amount (together with a deduction to overcome any double counting of income as a result of the gross-up)
Is streaming of capital gains effective for tax law purposes?

Flow-through of capital gains — Subdivision 115-C

- Thus, if only the general 50% CGT discount was claimed, a multiple of 2 is used as the gross-up factor, whereas if both the general and CGT small business discounts were claimed a multiple of 4 is used as gross-up factor
- Any capital losses of the beneficiary are then applied to grossed-up amount and the beneficiary then reapplies the applicable discount to this reduced amount.

Taxation of Trusts - Recent Government Initiatives

- On 24 October 2012, the Government released a policy options paper for reforms to the taxation of trusts
- The options paper articulates the design of 2 alternative models:
  - Economic Benefits Model (EBM); and
  - Proportionate Assessment Model (PAM)
- Adoption of either EBM or PAM means that trusts will not be taxed as companies!!! – legal and tax status remain in current framework
Overview of nature and scope of Government options proposed

**EBM**
- is a quantum approach model
- seeks to allocate taxable income to beneficiaries based on the amount actually distributed to each beneficiary
- trustee (effectively) obtains a tax deduction for distributions made to beneficiaries and bears the tax on any undistributed balance.

**PAM**
- is a proportionate approach model (proportionate within a class or classes)
- seeks to allocate taxable income to beneficiaries based on their proportionate share of "trust profit" (to be legislatively defined)

General observations

- Both approaches endorse an unencumbered ability to stream income classes to different beneficiaries - expense allocation rules ensure that various classes of income are appropriately calculated.
- Also, proposal to extend distribution date from 30 June to 31 August (i.e. the provision of a 2-month extension) - will overcome the type of compliance problems faced at 30 June 2012.
- However, many trust deeds would need to be updated to accommodate this proposal
Overview of nature and scope of Government options proposed

Path Ahead
• Submissions have closed.
• Govt will issue Exposure Draft Bill in mid-2016 (further consultation will be sought)

Trust Losses

<table>
<thead>
<tr>
<th>Type of trust</th>
<th>50% stake test</th>
<th>Same business test</th>
<th>Pattern of distributions test</th>
<th>Control test</th>
<th>Income injection test</th>
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<td>Non-fixed trust</td>
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<td>Excepted trust (other than a family trust)</td>
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</table>
Trust Losses

FIXED TRUSTS

Case Study

- Perkins Panes Pty Ltd has a 40% fixed entitlement to both the income and capital of a trust. Elizabeth holds 60% of the shares in Perkins Panes Pty Ltd, all of which are of the same class.
- What is the quantum percentage of Elizabeth’s fixed entitlement to income and capital of the trust? How is it calculated?

Trust Losses

FIXED TRUSTS

- **fixed trust** other than a widely held trust (an “ordinary fixed trust”)
- **unlisted widely held trust** (UWHT) – unlisted and > 20 unitholders beneficially entitled to at least 75% of the total units
- **listed widely held trust** (LWHT) – listed and > 20 unitholders beneficially entitled to at least 75% of the total units
- **unlisted very widely held trust** (UVWHT) — at least 1,000 unitholders and units carry same rights same rights
- **wholesale widely held trust** (WWHT) — unlisted and 75% of units held by LWHT, UVWHT, life assurance company, complying superannuation fund - initial amount subscribed for units by each unitholder was at least $500K and all units carry the same rights.
- UVWHT and WWHT can engage only in investment or business activities conducted at arm’s length in accordance with trust deed / prospectus
Trust Losses

TESTS – 50% STAKE TEST

Trust satisfies 50% stake test if, at all times during the test period:
• the same individuals have fixed entitlements, directly or indirectly, to more than 50% of the income of the trust, and
• the same individuals have fixed entitlements, directly or indirectly, to more than 50% of the capital of the trust (these individuals need not be the same as those who hold the fixed entitlements to income).

NOTE
• In the case of a widely held unit trust, the 50% stake test will be satisfied where it is reasonable to assume that the requirements of the test are met

Trust Losses

TESTS – SAME BUSINESS TEST

Same business test is satisfied in respect of a LWHT if:
• at all times in the same business test period the trust carries on the same business it carried on immediately before the start of that period
• at any time in the same business test period, the trust does not derive assessable income from a business of a kind it did not carry on before the test time or from a business transaction of a kind it had not entered into before the test time
• before the test time, the trust does not start to carry on a business it had not previously carried on or enter into a business transaction of a kind it had not previously entered into, for the purpose (whether or not there are other purposes) of satisfying the same business test
Trust Losses

TESTS – PATTERN OF DISTRIBUTION TEST

• Only applies to non-fixed trusts
• The pattern of distributions test is satisfied if, within two months of the end of the income year the trust has distributed, directly or indirectly, more than 50% of every “test year distribution” of income and/or capital to the same individuals for their own benefit
• The test is not relevant if the trust has not made any distributions.
• The term “distribution” includes paying or crediting money (including loans), reinvesting money, transferring property, allowing the use of property, dealing with money or property on behalf of a person or as the person directs, applying money or property for the benefit of a person and extinguishing, releasing or waiving a debt or other liability (but only to the extent that the amount or value exceeds any consideration given in return for the loan, payment, etc)

Trust Losses

TESTS – PATTERN OF DISTRIBUTION TEST

• A distribution will also be taken to have been made to an individual where the distribution is made to a chain of interposed entities and one of the interposed entities distributes an amount to the individual.
• A “test year distribution” of income or capital is the total of all distributions of income or capital in a relevant period (generally an income year) made by the trust, but excluding income years beginning more than six years before the start of the income year in which the trust seeks to deduct the prior year loss or debt deduction
• NOTE - There are anti-avoidance measures that ensure that persons do not enter into schemes to enable passing the pattern of distributions test
Trust Losses

TESTS – CONTROL TEST

• The control test requires that no group (i.e. a person and their associates) begin to control the non-fixed trust directly or indirectly, in the test period.

• A group is taken to control a non-fixed trust if:
  – the group has the power to obtain, or is capable of obtaining, the benefit of the income or capital of the trust
  – the group is able to control, directly or indirectly, or is capable of obtaining control of, the application of the income or capital of the trust
  – the trustee is accustomed, is under an obligation or might reasonably be expected, to act in accordance with directions or wishes of the group
  – the group is able to remove or appoint the trustee(s), or
  – the group gains fixed entitlements to more than 50% of the income or capital of the trust.

Trust Losses

INCOME INJECTION TEST

The income injection test applies where:

• the trust has a deduction (including a prior year loss) in the income year being examined

• there is a scheme under which:
  – the trust derives assessable income;
  – a person not connected with the trust provides a benefit (directly or indirectly) to the trustee or a beneficiary (or their associates); and
  – a return benefit is provided to the outsider, and
  – it is reasonable to conclude that the assessable income has been derived, or the benefits have been provided, wholly or partly (but not merely incidentally) because the deduction is allowable.
Trust Losses

INCOME INJECTION TEST

• The income injection test also applies where a person who was an outsider before the scheme was entered into ceases, pursuant to the scheme, to be an outsider (by becoming the trustee of the trust or by receiving a fixed entitlement to a share of the income or capital of the trust)
• If the income injection test is failed, no deduction is allowable in the income year being examined against the scheme assessable income
• As a result, if the net income of the trust for that year is less than the scheme assessable income, the net income is increased to equal the full amount of the scheme assessable income
• However, any deduction not related to the derivation of the scheme assessable income is still allowable to the trust (e.g. it can be deducted against other assessable income derived in the income year or can be deducted in a later year in the form of a tax loss).

In Corporate Initiatives 2005 ATC 4392 a trust loss scheme was caught under the income injection test where a trustee resolved to make a distribution equal to accumulated tax losses of the recipient.

• By not calling for payment of funds distributed (but not actually paid) to it, the recipient provided a benefit to that trust estate. Allowing the trust to retain use of those distributions meant that the benefit was received under a scheme, in the sense that the scheme operated to produce that effect.
• TIP – Income injection test does not apply to related parties (i.e. persons that are not “outsiders”) – e.g. family members of family trust
• TRAP – be wary of reimbursement agreement under sec 100A
• TRAP – Part IVA still applies
Advantages of a family trust

The advantages of a family trust:

• Easy access to trust losses – only income injection test to be satisfied

The income injection test applies where:

• Trust has a deduction (including a prior year loss) in the income year
• There is a scheme under which:
  – the trust derives assessable income;
  – a person not connected with the trust provides a benefit (directly or indirectly) to the trustee or a beneficiary (or their associates); and
  – a return benefit is provided to the outsider, and
  – it is reasonable to conclude that the assessable income has been derived, or the benefits have been provided, wholly or partly (but not merely incidentally) because the deduction (loss) is allowable.

Advantages of a family trust

The advantages of a family trust:

• Entitlement to franking / imputation credits for beneficiaries of a discretionary trust
  – “Qualified person” test can be satisfied – 45-day holding period rule
  – Trustee treated a “qualified person”
  – Qualified person requirement need not to be met when de minimis concession applies (franking credits less than $5,000)
Advantages of a family trust

The advantages of a family trust:

• Normally no access to prior year losses in companies by satisfying COT where shares held by discretionary trust
• However if trust is family trust, COT can be met and access to company tax losses available
  – Trustee of family trust treated as one shareholder
  – No need to trace through beneficiaries

Disadvantages of a family trust

The disadvantages of a family trust:

• Limiting distributions to family members otherwise Family Trust Distributions Tax at 45%
• Only revocable if not utilised
Family trust election (FTE)

CONDITIONS

• The trustee of the trust makes the election
• The election must be in writing and in the approved form
• The trustee nominates an income year, called the “specified income year”, that is the first year in which the trust is “family trust”.
• The election must name an individual as the person whose family group is taken into account in relation to the election and it must contain such other information as the Commissioner requires
• FTE must be in writing in the approved form. The Commissioner releases the approved form each year. For example, the Commissioner released the “Family trust election, revocation or variation 2012” form which may be used for making a FTE specifying the 2004/05 or a later income year, revoking a FTE in the 2011/12 income year, or varying the test individual.

Family trust election (FTE)

CONDITIONS

• The trustee may make an FTE that applies to and from a particular income year, in the trust’s income tax return for that year.
• The FTE is made on the form approved by the Commissioner.
• The trust must pass the family control test at the end of the specified income year
Family trust election (FTE)

Family control test

- A trust cannot make a family trust election unless it satisfies the family control test. 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 (s 272-87):
  1. the individual specified in the family trust election (the “primary individual”) and/or one or more members of the individual's family
  2. any of the persons listed in (1) above and a professional or legal adviser to the family, or
  3. the trustees of one or more family trusts (provided the primary individual is specified in the family trust election of each of those trusts and the group has more than a 50% stake in the income or capital of the trust).

CASE STUDY

- The O'Reilly Family Trust was established in 2005.
- At the end of 2010/11 it had significant unrecouped tax losses.
- Bill, the trustee of the O'Reilly Family Trust, wishes to make an FTE that will be effective from the 2011/12 income year.
Family trust election (FTE)

CASE STUDY SOLUTION

- Bill should arrange for the *Family trust election, revocation or variation 2012* form to be completed
- Bill must specify 2011/12 as the “specified income year”
- Bill must lodge the FTE form with the 2011/12 tax return.
- Bill should ensure that the trust satisfied the family control test at the end of the 2011/12 income year.
- If the trust satisfied the test *at all times* during 2011/12, the FTE will be “in force” for the whole of that year and until such time as it is revoked.

Family trust election (FTE)

RETROSPECTIVE ELECTION

- Trustee has flexibility to make an FTE that applies to an earlier income year, going back as far as 2004/05
- This allows trustee to obtain retrospective protection from trust loss measures.
- To make a retrospective FTE, the trust must meet two conditions:
  - First, it must pass the family control test at all times from the start of the first income year in which the FTE is planned to be in force until 30 June in the income year before the election is made.
  - Second, any conferrals of present entitlement to, or any actual distributions of, income or capital of the trust during that period must have been made to the test individual and/or family group members
Family trust election (FTE)

CASE STUDY - RETROSPECTIVE ELECTION

• Marius is the trustee of the Billiton Family Trust and is arranging the preparation of the trust’s income tax return for the 2011/12 income year.
• Marius wishes to make an FTE that will be effective from the 2007/08 income year.

CASE STUDY SOLUTION - RETROSPECTIVE ELECTION

• Marius should arrange for the *Family trust election, revocation or variation 2012* form to be completed,
• Marius must specify 2007/08 as the “specified income year”, and lodge the form with the 2011/12 tax return.
• He should ensure that:
  – the trust satisfied the family control test at all times from the beginning of the 2007/08 income year until 30 June 2012; and
  – no conferrals of present entitlement to, or any actual distributions of, income or capital of the trust during that period have been made outside of the test individual’s family group.
Family trust election (FTE)

REVOCATION OF FTE

• The trustee of a trust in respect of which an FTE is in force may revoke the election, on condition that the trust or another entity has not benefited from the protection afforded by the FTE while it was in force.

• For example, the trustee may wish to revoke the FTE if it is planned to make distributions of income or capital to persons outside the family group as distributions outside the family group would ordinarily trigger a liability for family trust distribution tax (FTDT).

REW0CATION OF FTE

• When a trustee revokes an FTE it is effective from the end of an income year.

• The revocation must be made on the approved form in the trust’s tax return for the income year in which the revocation is effective.

• If the trustee is not required to lodge a trust return for the year from which the revocation is effective, the revocation must be in writing in the approved form, must specify the income year from which the revocation is effective and must be given to the Commissioner no later than two months after the end of that income year or later if the Commissioner allows.
Family trust election (FTE)

CASE STUDY - REVOCATION OF FTE

• Eric is trustee of Acme Trust
• Eric in his capacity of trustee of Acme Trust, decides to revoke Acme’s FTE, effective for the 2011/12 income year which ends on 30 June 2012.

Family trust election (FTE)

CASE STUDY SOLUTION - REVOCATION OF FTE

• Eric must revoke the FTE, using the Commissioner’s approved form, in Acme’s 2011/12 tax return.
• The FTE ceases to be in force at the end of Acme’s 2010/11 income year.
• In Acme’s case, this is after 30 June 2011.
Family trust election (FTE)

Interposed entity election

- A company, trust or partnership is required to make an interposed entity election (IEE) before it can be included as part of a family group.
- IEE will be relevant where members of the primary individual’s family do not have fixed entitlements to all of the income and capital of the interposed entity.
- IEE can be made for an income year later than the year in which the family trust election is made.
- IEE must specify a date in the income year from which it takes effect.
- IEE can be made at any time in relation to an earlier income year, rather than having to be included in the tax return.
- This option is only available to entities that have acted as if they were a family entity, but an IEE cannot be made if the entity does not pass the family control test at the end of the relevant income year.
- IEE is revoked when FTE is revoked.

CLOSE

QUESTIONS??????