TRUST SERIES – PART 3

Trust losses and key CGT events impacting trusts

Presented by

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Questions?

Please ask questions through the Q & A pod not on the chat pod.

Not Answered Questions will be emailed to you along with the **webinar recording**

Introductory remarks

- Another difficult technical session – *Trust losses and key CGT events impacting trusts*
- Last session: present entitlement, Bamford and streaming ('How trusts are taxed in Australia')
- Purpose of the trust loss rules:
  - Anti avoidance
  - Multiple tests
  - Discretionary trusts
  - Family trust exceptions
  - Evolving schemes

Trust losses introduction

- General principle: trusts retain revenue and capital losses, but may be carried forward and claimed as a deduction (or in calculating the trust's net capital gain)

- Divisions 265 to 272 of Schedule 2F of the ITAA 1936: set out the trust loss requirements for different types of trusts. It can deny access to losses of partially restrict use of losses (e.g., losses after change of ownership)

- Purpose: prevent transfer of benefits

- Application: generally all trusts (note: FTE exemptions)

- Summary of tests:

Trust losses introduction

Summary of tests:

Test	Summary
50% stake test	Ensures control of the trust hasn't changed hands by more than 50% within a certain period.
Control test	Focuses on whether someone outside the trust gains control over its income or assets.
Pattern of distribution test	Examines if the income distribution pattern has significantly changed after the loss year.
Income injection test	Prevents situations where someone benefits from the trust's loss by providing financial support in exchange for future income streams.

Types of trusts – *important for the application of the loss rules*

Type of Trust	Description
Fixed trust (s 272-65)	A trust in which persons have fixed entitlements to all the income and capital of the trust.
Closely held trust (s 272-105)	A trust in which: - 20 or fewer individuals, directly or indirectly, have fixed entitlements to 75% or more of the income or capital of the trust; or - no individual has (or no group of individuals have), directly or indirectly, fixed entitlements to 75% or more of the income or capital of the trust.
Widely held unit trust (s272-105)	A fixed trust being a unit trust that is not a closely held trust.
Listed widely held trust (s272-115)	A widely held unit trust. The units are listed on an approved stock exchange.
Unlisted widely held trust (s 272-110)	A widely held unit trust. The units are not listed on an approved stock exchange[1].
Unlisted very widely held trust (s 272-120)	An unlisted widely held unit trust: - with at least 1,000 unit holders provided certain other conditions are satisfied; - that carries on certain activities only.

[1] Classification as an unlisted widely held trust may be affected by the nature of any higher level trust: s 272-127.

Types of trusts – *important for the application of the loss rules*

Type of Trust	Description
Wholesale widely held trust (s 272-125)	An unlisted widely held unit trust: - where 75% or more of the units in the trust are held by certain bodies and the initial amount subscribed for units in the trust by each person to whom units have been issued was at least $500,000; and - that carries on certain activities only.
Non-fixed trust (s 272-70)	A trust that is not a fixed trust.
Family trust (s 272-75)	A trust that has made the election to be a family trust for the purposes of the trust loss measures.
Excepted trust (s 272-100)	A family trust. A complying superannuation fund, complying approved deposit fund or pooled superannuation trust. A unit trust where tax-exempt bodies have fixed entitlements, directly or indirectly, to all the income and capital of the trust. Certain deceased estates.

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What is a ‘fixed entitlement’

- A beneficiary of a trust has a fixed entitlement to a share of the income of a trust if the beneficiary has a vested and indefeasible interest in that share of the income of the trust (s 272-5).

- A person has a fixed entitlement to a share of the capital of the trust if the person is a beneficiary who has a vested and indefeasible interest in that share of the capital of the trust (s 272-5).

- Therefore, if a trustee has discretionary powers to appoint income to particular objects or to accumulate income, this test will not be satisfied so that the trust will be a “non-fixed trust”.

Unit trust vs Fixed trust

- Fixed trust = fixed entitlement
- Not all unit trusts are fixed trusts
- When is it not:
  - Can issue units at non-market value (common one!)
  - Trust deed flexibility
  - Multiple unit classes
  - Partly paid units

What tests need to be satisfied for each trust?

Type of trust	50% STAKE TEST Section 269-50 to Section 269-55	BUSINESS CONTINUITY TEST Section 269-100	PATTERN OF DISTRIBUTIONS TEST Section 269-60 to Section 269-85	CONTROL TEST Section 269-95
Fixed trust other than a widely held unit trust (Subdivision 266-B)	✓			
Unlisted widely held trust (Subdivision 266-C)	✓			
Listed widely held trust (Subdivision 266-D)	✓	✓		
Unlisted very widely held trust and wholesale widely held trust (Subdivision 266-E)	✓			
Non-fixed trust (Division 267)	✓		✓	✓
Family trust (s267-20)				
Excepted trust (other than a family trust) (s267-20)				

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The relevant tests

Test	Requirement
50% stake test for fixed trusts (except excepted trusts)	The same individuals have fixed entitlements, directly or indirectly, to more than 50% of the income of the trust at the relevant times. AND The same individuals (not necessarily the same as those that hold fixed entitlements to income) have fixed entitlements, directly or indirectly, to more than 50% of the capital of the trust at the relevant times.
50% stake test for non-fixed trusts (except excepted trusts)	If individuals have fixed entitlements to more than 50% of the income of the trust at any time in the test period, then at all times in the period from that time, the same individuals must hold more than a 50% stake in the income of the trust. AND If individuals have fixed entitlements to more than 50% of the capital of the trust at any time in the test period, then at all times in the period from that time, the same individuals (not necessarily the same as those that hold fixed entitlements to income) must hold more than a 50% stake in the capital of the trust.
Alternate test for fixed trusts • Applies to fixed trusts (other than excepted trusts) that are not widely held unit trusts if: ▪ at all times in the test period, 50% or more of the fixed entitlements to income or capital of the trust or a holding entity of the trust are directly held by a non-fixed trust(s) (other than a family trust), and ▪ individuals do not have more than a 50% stake in the income or capital of the trust at the start of the test period.	There is no change in the persons directly holding fixed entitlements to shares of the income or capital of the trust or holding entity, nor the percentage of their shares. AND Every non-fixed trust (that is not a family trust or other excepted trust) that holds fixed entitlements in the fixed trust, directly or indirectly, would satisfy the relevant tests that apply to non- fixed trusts if they stood in place of the loss trust.

The relevant tests continued…

<table>
<tr><th>Test</th><th>Requirement</th></tr>
<tr><td>Business continuity test</td><td>
The trust satisfies a same business test or (for tax losses for, or debts incurred in, 2015–16 or a later income year) a similar business test.
For the same business test to be satisfied all of the following are met:

the trust carried on the same business as it carried on before a particular time
the trust did not derive income in the income year from:

a business of a kind that it did not carry on before a particular time, or
a transaction of a kind that it did not enter into in the course of its business operations before a particular time

the trust did not do things for the purpose, or for purposes including the purpose, of being taken to have carried on the same business as it carried on before a particular time. The things are:

start to carry on a business of a kind it did not carry on before the particular time, or
enter into a transaction of a kind that it had not entered into in the course of its business operations before the particular time

the trust does not incur expenditure in carrying on a business of a kind that it did not carry on before a particular time,
the trust did not incur expenditure in entering into a transaction of a kind that it had not entered into in the course of its business operations before the particular time.

For the similar business test to be satisfied the trust needs only to carry on a business that is similar to the business it carried on immediately before a particular time. However, the trust must not before a particular time have begun to carry on a business it had not previously carried on or, in the course of its business operations, entered into a transaction of a kind that it had not previously entered into, for the purpose, or for purposes including the purpose, of being taken to have carried on a similar business.
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The relevant tests continued…

Test	Requirement
Pattern of distributions test	More than 50% of the relevant distributions of the relevant income years (as specified in Subdiv 269-D) are distributed (directly or indirectly) to the same individuals
Control test	A group must not begin to control the trust, directly or indirectly, during the test period
50% stake test for non-fixed trusts (except excepted trusts)	If individuals have fixed entitlements to more than 50% of the income of the trust at any time in the test period, then at all times in the period from that time, the same individuals must hold more than a 50% stake in the income of the trust. AND If individuals have fixed entitlements to more than 50% of the capital of the trust at any time in the test period, then at all times in the period from that time, the same individuals (not necessarily the same as those that hold fixed entitlements to income) must hold more than a 50% stake in the capital of the trust.

Additional test – Income Injection test

- Applies to all trusts and denies deductions.

- Applies where a trust has a loss or other allowable deduction and there is a scheme under which a person not connected with the trust (i.e., an outsider) injects income or provides some other benefit (directly or indirectly) to the trustee or a beneficiary (or an associate), with the result (which is not merely incidental) that no or less tax is payable.

- **Family trust:** this test does not apply if benefits flow to members of the family group (this is done by modifying the definition of 'outsider')

Family trust elections

- What is it? A trust return election

- Why make one? Protect losses and imputation credits

- Disadvantages: FTDT; irrevocable

- Family control test must be satisfied to make a FTE:

    - Trusts – when the family group has power to obtain beneficial enjoyment of income and capital directly or indirectly e.g. the family group has the power to remove and appoint the trustee (s272-87(1)).

    - Companies – relevant for the interposed entity election where the family group control at least 50% of the company (s272-87(3)).

    - Partnerships – relevant for the interposed entity election where the family group control at least 50% of the partnership (s 272-87(3)).

- Section 272-80(4A) allows a backdated FTE (in certain situations).

Meaning of 'family' (s 272-90)

- Primary test individual.
- Primary test individual's family, including spouse, child, child of a child, parent, grandparent, brother, sister, nephew, or niece of the test individual or of his/her spouse. The spouse of any of those individuals is also within the family group.
- A trust in respect of which a family trust election has been made specifying the same primary test individual.
- An entity that has made an interposed entity election in relation to the primary test individual.
- Any entity in which the primary test individual or family members or primary test individual's trust have fixed entitlements to all of the income and capital.
- Charities.
- Certain tax exempt bodies, e.g. hospitals.

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FTDT

- Consequences of distributing outside family group – Family Trust Distribution Tax (FTDT) – at the top marginal rate. Imposed on the trustee and its directors (joint and several liability)
- Amounts that have previously been subject to FTDT are not assessable, nor are they exempt income (s271-105).

Introducing CGT events for trusts

- CGT E Events – 10 events relating to trusts
- We will go through the key events and when they most commonly apply

CGT Event E1 and E2

- Under subsection 104-55(1), CGT event E1 happens if a trust is created over a CGT asset by declaration or settlement. Under subsection 104-60(1), CGT event E2 happens if you transfer a CGT asset to an existing trust.
- All of the controversy is around whether a certain action constitutes an E1 resettlement (many private rulings on it)
- Paragraph 1 of TD 2012/21 provides that CGT events E1 and E2 do not happen if the terms of a trust are changed pursuant to a valid exercise of power contained within the trust's constituent documents unless
  - the change causes the existing trust to terminate and a new trust to arise for trust law purposes; or
  - the effect of the change or court approved variation is such as to lead to a particular asset being subject to a separate charter of rights and obligations such as to give rise to the conclusion that that asset has been settled on terms of a different trust.
- Main case: *Commercial Nominees* (HCA case)

CGT Event E3

- CGT event E3 under subsection 104-65(1) happens if a trust over a CGT asset is converted into a unit trust and, just before the conversion, a beneficiary was absolutely entitled to the asset as against the trustee.

- Paragraph 13 of Draft Taxation Ruling TR 2004/D25 (Income tax: capital gains: meaning of the words 'absolutely entitled to a CGT asset as against the trustee of a trust' as used in Parts 3-1 and 3-3 of the ITAA 1997) states that an object of a discretionary trust cannot be absolutely entitled to one or more trust's assets prior to an exercise of the trustee's discretion in their favour.

- CGT event E3 will not happen when the Trust is converted into a unit trust

CGT Event E4

- CGT event E4 (section 104-70 of the ITAA 1997) happens where the trustee of a trust makes a payment to a taxpayer in respect of their unit or interest in the trust acquired after 20 September 1985 (except for CGT event A1, C2, E1, E2, E6, or E7 happening in relation to it), and some or all of the payment is not included in the taxpayer 's assessable income, described as a non-assessable part (non-assessable distribution), which may be reduced by exclusions and adjustments under section 104-71.

- The Revised Explanatory Memorandum to the New Business Tax System (Miscellaneous) Act (No. 2) 2000 explains the operation of the provision as follows:

  - *10.8 Section 104-70 of ITAA 1997 reduces the cost base of a unit or fixed interest in a trust where the trustee pays a non-assessable amount to the beneficiary. If the payment is more than the beneficiary's cost base, a capital gain is made.*

- Where the Trustee makes such a payment, the beneficiary will need to make an adjustment to the cost base of their trust asset or unit. This adjustment will affect the calculation of any capital gain or capital loss on the sale of the trust asset or unit. However, if the amount of the payment exceeds the cost base of the trust interest or unit, the excess is treated as a capital gain in the year it is paid to the beneficiary.

CGT Event E5

- Section 104-75 of the ITAA 1997 provides that CGT event E5 happens if a beneficiary becomes absolutely entitled to a CGT asset of a trust as against the trustee.
- A beneficiary of a discretionary trust does not have any interest in the trust assets except to the extent that the trustee exercises a discretion in favour of that beneficiary.
- Does not happen to unit trusts or deceased estates
- Paragraphs 10 and 11 of TR 2004/D25 provide:
  - The core principle underpinning the concept of absolute entitlement in the CGT provisions is the ability of a beneficiary, who has a vested and indefeasible interest in the entire trust asset, to call for the asset to be transferred to them or to be transferred at their direction.
  - The nature of the beneficiary's interest in the asset, and whether it meets the requirements of absolute entitlement, therefore depends on the particular trust instrument, and whether the trustee has made a resolution in favour of a beneficiary (such that the beneficiary would be absolutely entitled).

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