ATO Cracking Down on Family Trust Distributions

The long-awaited draft guidance materials on the application and operation of section 100A of the Tax Act were released on 23 February 2022.

The package of draft guidance materials released comprises:

- Draft Taxation Ruling TR 2022/D1: section 100A reimbursement agreements (draft Ruling)
- Draft Practical Compliance Guideline PCG 2022/D1: section 100A reimbursement agreements — ATO compliance approach (draft PCG)
- Taxpayer Alert TA 2022/1 — Parents benefitting from the trust entitlement of their children over 18 years of age (TA).

In addition, the ATO released a draft Taxation Determination (TD 2022/D1) on when an unpaid present entitlement or amount held on a sub-trust is the provision of "financial accommodation" by a private company under Division 7A of the Tax Act.

Click here to access these draft guidance materials.

Accountants and their clients will now need to reconsider their approach in making distributions between family members.

What is section 100A?

100A is an anti-avoidance provision that allows the Commissioner to disregard trust distributions that form part of a "reimbursement agreement" and instead impose tax on the trustee at the top marginal tax rate of 47% (including the 2% Medicare levy).

A "reimbursement agreement can exist where a beneficiary is made presently entitled to trust income (that is, the trustee's exercise of discretion is in their favour) and the beneficiary's present entitlement arises out of, or in connection with, an arrangement:

- involving a benefit being provided to another person (e.g. payment of money, transfer of property or provision of services);
- intended to have the result of reducing someone's tax liability (e.g. the beneficiary pays a lower amount of income tax than that someone who had benefited from the income would have paid); and
- is not entered into in the course of an ordinary family or commercial dealing.

It is important to note that there is no statute of limitations in section 100A. While taxpayers are ordinarily required to keep their relevant tax records for five years from the date they lodge their return, section 100A has an unlimited application period meaning it can be applied many years back.

Some key points from the new ATO guidance:

Ordinary family or commercial dealing exception – TR 2022/D1

- Given the wide scope of section 100A, the ordinary/commercial dealing exception is key. Agreements that are entered into "in the course of ordinary family or commercial dealing" are not subject to section 100A.
- The meaning of the term "ordinary family or commercial dealing" is not any clearer under the new guidance.

- Having said that, the ATO's view is that there is an "ordinary family or commercial dealing" where the arrangement is capable of being explained by regular familial or commercial objects and do not demonstrate a purpose of tax avoidance. This will depend on the facts at hand.

- To determine whether the exception can apply, an assessment is required of the particular familial or commercial relationships of relevant parties (e.g. the family group) and determine whether the trust distributions (or arrangement) are capable of being explained by *ordinary* familial and/or commercial objects.

- An arrangement that is commonplace and involves no artificiality is not necessarily an "ordinary family or commercial dealing". However, an arrangement that is clearly tax driven and which make the arrangement appear artificial or contrived is unlikely to satisfy the exception.

- For example, a trustee making a lower-taxed beneficiary presently entitled to trust income while paying the underlying funds to another person or persons who would otherwise pay higher tax will not be an agreement entered into in the course of ordinary dealing solely because it can be explained as increasing collective post-tax family or group wealth.

- The ATO sets out 9 examples in TR 2022/D1 on how section 100A can apply. These examples include:

(a) Trusts established under a will;
(b) Distribution to spouses;
(c) Gifts from parents to a child;
(d) Unpaid entitlements held on separate trusts; and
(e) Loans on commercial terms.

ATO compliance approach on section 100A – PCG 2022/D1

The Practical Compliance Guideline shows the sorts of trust arrangements that the ATO is dedicating compliance resources on section 100A. There are 4 risk zones – White, Green, Blue and Red - both ends of the "risk spectrum" are considered below:

White zone

The ATO will not consider the application of section 100A for arrangements entered into in income years that ended before 1 July 2014 unless:

- the ATO is already reviewing the taxpayer's income tax affairs for those years;

- the arrangement was entered into *before*1 July 2014 and continues after that date; or

- the trust and beneficiary tax returns that were required to be lodged for those years were not lodged before 1 July 2017.

Red zone

These are arrangements where:

- the beneficiaries entitlements appear to be motivated by sheltering the trust's net income from higher rates; and

- the arrangement involves contrived elements directed at enabling someone other than the presently entitled beneficiary having the use and enjoyment of economic benefits referable to the trust net income.

Examples include:

- (Scenario 1) The beneficiary lends or gifts some or all of their entitlement to another party;
- (Scenario 2) Trust income is returned to the trust by the beneficiary in the form of assessable income (i.e. a washing arrangement);
- (Scenario 3) The presently entitled beneficiary is issued units by the trustee and the amount owed for the units is set-off against the beneficiary’s entitlement;
- (Scenario 4) The share of net income included in a beneficiary's assessable income is significantly more than the beneficiary's entitlement;
- (Scenario 5) The presently entitled beneficiary has losses; and
- (Scenario 6) Arrangements subject to a Taxpayer Alert (e.g. see below).

Parents benefiting from trust entitlements of their children over 18 years of age – TA 2022/1

The ATO has warned that they are already reviewing trust arrangements where parents enjoy the economic benefit of trust income appointed to their children who are over 18 years of age.

The common feature of these arrangements is that trust income is appointed between members of the family group but, in substance, it is the parents who exercise control over and enjoy the economic benefit of the income.

The ATO’s concern is a manipulation of the tax rate through the use the lower marginal tax rate applying to adult children (e.g. the tax-free threshold of $18,200) in circumstances where the benefit of the income is being enjoyed by the parents (e.g. to meet household expenses). This is a very common arrangement.

What to do next?

The ATO will undertake public consultation on TR 2022/D1 and PCG 2022/D1. Once finalised, the TR 2022/D1 and PCG 2022/D1 are intended to apply prospectively and retrospectively.

TA 2022/1 is not subject to public consultation.

Taxpayers and accountants assisting with family trust arrangements need to consider the new guidance with respect to both prior year and future distributions of income. As a starting point, there should be a review of larger distributions of income in the last few income years and, if necessary, consider seeking specialist tax advice on your position and options. If you are documenting and/or considering a current trust distribution, it is prudent that you consider the new guidance.