The ATO's Attack on Trusts & Trust Distributions

Late last month, the Australian Taxation Office (ATO) released a package of new guidance material that directly targets how trusts distribute income. Many family groups will pay higher taxes (now and potentially retrospectively) as a result of the ATO's more aggressive approach.

Family trust beneficiaries at risk

The tax legislation contains an integrity rule, section 100A, which is aimed at situations where income of a trust is appointed in favour of a beneficiary but the economic benefit of the distribution is provided to another individual or entity. If trust distributions are caught by section 100A, then this generally results in the trustee being taxed at penalty rates rather than the beneficiary being taxed at their own marginal tax rates.

The latest guidance suggests that the ATO will be looking to apply section 100A to some arrangements that are commonly used for tax planning purposes by family groups. The result is a much smaller boundary on what is acceptable to the ATO which means that some family trusts are at risk of higher tax liabilities and penalties.

ATO redrawing the boundaries of what is acceptable

Section 100A has been around since 1979 but to date, has rarely been invoked by the ATO except where there is obvious and deliberate trust stripping at play. However, the ATO's latest guidance suggests that the ATO is now willing to use section 100A to attack a wider range of scenarios.

There are some important exceptions to section 100A, including where income is appointed to minor beneficiaries and where the arrangement is part of an ordinary family or commercial dealing. Much of the ATO's recent guidance focuses on whether arrangements form part of an ordinary family or commercial dealing. The ATO notes that this exclusion won't necessarily apply simply because arrangements are commonplace or they involve members of a family group. For example, the ATO suggests that section 100A could apply to some situations where a child gifts money that is attributable to a family trust distribution to their parents.

The ATO's guidance sets out four 'risk zones' – referred to as the white, green, blue and red zones. The risk zone for a particular arrangement will determine the ATO's response:

White zone

This is aimed at pre-1 July 2014 arrangements. The ATO will not look into these arrangements unless it is part of an ongoing investigation, for arrangements that continue after this date, or where the trust and beneficiaries failed to lodge tax returns by 1 July 2017.

Green zone

Green zone arrangements are low risk arrangements and are unlikely to be reviewed by the ATO, assuming the arrangement is properly documented. For example, the ATO suggests that when a trust appoints income to an individual but the funds are paid into a joint bank account that the individual holds with their spouse then this would ordinarily be a low-risk scenario. Or, where parents pay for the deposit on an adult child's mortgage using their trust distribution and this is a one-off arrangement.

Blue zone

Arrangements in the blue zone might be reviewed by the ATO. The blue zone is basically the default zone and covers arrangements that don't fall within one of the other risk zones. The blue zone is likely to include scenarios where funds are retained by the trustee, but the arrangement doesn't fall within the scope of the specific scenarios covered in the green zone.

Section 100A does not automatically apply to blue zone arrangements, it just means that the ATO will need to be satisfied that the arrangement is not subject to section 100A.

Red zone

Red zone arrangements will be reviewed in detail. These are arrangements the ATO suspects are designed to deliberately reduce tax, or where an individual or entity other than the beneficiary is benefiting.

High on the ATO's list for the red zone are arrangements where an adult child's entitlement to trust income is paid to a parent or other caregiver to reimburse them for expenses incurred before the adult child turned 18. For example, school fees at a private school. Or, where a loan (debit balance account) is provided by the trust to the adult child for expenses they incurred before they were 18 and the entitlement is used to pay off the loan. These arrangements will be looked at closely and if the ATO determines that section 100A applies, tax will be applied at the top marginal rate to the relevant amount and this could apply across a number of income years.

The ATO indicated that circular arrangements could also fall within the scope of section 100A. For example, this can occur when a trust owns shares in a company, the company is a beneficiary of that trust and where income is circulated between the entities on a repeating basis. For example, section 100A could be triggered if:

- The trustee resolves to appoint income to the company at the end of year 1.
- The company includes its share of the trust's net income in its assessable income for year 1 and pays tax at the corporate rate.
- The company pays a fully franked dividend to the trustee in year 2, sourced from the trust income, and the dividend forms part of the trust income and net income in year 2.
- The trustee makes the company presently entitled to some or all of the trust income at the end of year 2 (which might include the franked distribution).
- These steps are repeated in subsequent years.

Distributions from a trust to an entity with losses could also fall within the red zone unless it is clear that the economic benefit associated with the income is provided to the beneficiary with the losses. If the economic benefit associated with the income that has been appointed to the entity with losses is utilised by the trust or another entity then section 100A could apply.

Who is likely to be impacted?

The ATO's updated guidance focuses primarily on distributions made to adult children, corporate beneficiaries, and entities with losses. Depending on how arrangements are structured, there is potentially a significant level of risk. However, it is important to remember that section 100A is not confined to these situations.

Distributions to beneficiaries who are under a legal disability (e.g., children under 18) are excluded from these rules.

For those with discretionary trusts it is important to ensure that all trust distribution arrangements are reviewed in light of the ATO's latest guidance to determine the level of risk associated with the arrangements. It is also vital to ensure that appropriate documentation is in place to demonstrate how funds relating to trust distributions are being used or applied for the benefit of beneficiaries.

Companies entitled to trust income

As part of the broader package of updated guidance targeting trusts and trust distributions, the ATO has also released a draft determination dealing specifically with unpaid distributions owed by trusts to corporate beneficiaries. If the amount owed by the trust is deemed to be a loan then it can potentially fall within the scope of another integrity provision in the tax law, Division 7A.

Division 7A captures situations where shareholders or their related parties access company profits in the form of loans, payments or forgiven debts. If certain steps are not taken, such as placing the loan under a complying loan agreement, these amounts can be treated as deemed unfranked dividends for tax purposes and taxable at the taxpayer's marginal tax rate.

The latest ATO guidance looks at when an unpaid entitlement to trust income will start being treated as a loan. The treatment of unpaid entitlements to trust income as loans for Division 7A purposes is not new. What is new is the ATO's approach in determining the timing of when these amounts start being treated as loans. Under the new guidance, if a trustee resolves to appoint income to a corporate beneficiary, then the time the unpaid entitlement starts being treated as a loan will depend on how the entitlement is expressed by the trustee (e.g., in trust distribution resolutions etc):

- If the company is entitled to a fixed dollar amount of trust income the unpaid entitlement will generally be treated as a loan for Division 7A purposes in the year the present entitlement arises; or
- If the company is entitled to a percentage of trust income, or some other part of trust income identified in a calculable manner, the unpaid entitlement will generally be treated as a loan from the time the trust income (or the amount the company is entitled to) is calculated, which will often be after the end of the year in which the entitlement arose.

This is relevant in determining when a complying loan agreement needs to be put in place to prevent the full unpaid amount being treated as a deemed dividend for tax purposes when the trust needs to start making principal and interest repayments to the company.

The ATO's views on "sub-trust arrangements" has also been updated. Basically, the ATO is suggesting that sub-trust arrangements will no longer be effective in preventing an unpaid trust distribution from being treated as a loan for Division 7A purposes if the funds are used by the trust, shareholder of the company or any of their related parties.

The new guidance represents a significant departure from the ATO's previous position in some ways. The upshot is that in some circumstances, the management of unpaid entitlements will need to change. But, unlike the guidance on section 100A, these changes will only apply to trust entitlements arising on or after 1 July 2022.

If you require any further assistance please do not hesitate to contact your client manager or our office.

Kindly note: **This article is intended for general information purposes only.**