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ATO takes aggressive stance on trust distributions

The Tax Office recently released its long-awaited guidance on how it will treat distributions from a family trust in situations where it believes that someone other than the recipient of the trust distribution will actually obtain the benefit of it, and the reason for distributing to the initial recipient was to save tax.

The package

The guidance is in draft form and is released together as a package because of the overlap of the subject matter - the tax treatment of entitlements to certain amounts from private trusts:

- *Draft Taxation Ruling TR 2022/D1* - Income tax: section 100A reimbursement agreements
- *Draft Practical Compliance Guideline PCG 2022/D1* - Section 100A reimbursement agreements – ATO compliance approach
- *Draft Taxation Determination TD 2022/D1 Income tax: Division 7A: when will an unpaid present entitlement or amount held on sub-trust become the provision of 'financial accommodation'?*
- *Taxpayer Alert TA 2022/1 Trusts: parents benefitting from the trust entitlements of their children over 18 years of age.*

Trust distributions and the Tax Office

Section 100A of the *Income Tax Assessment Act 1936* is an anti-avoidance rule that applies where lower taxed beneficiaries of a trust are made entitled to trust income by the trustee, while the income is enjoyed by another person who would otherwise have had to pay more income tax if they were made entitled to the trust income. When the rule applies, the trustee (and not the beneficiary) is liable to tax on the income at the top marginal rate.

Importantly, section 100A does not apply to arrangements entered into in the course of "ordinary family or commercial dealings" or where no party to the arrangement has a tax avoidance purpose.

However, the Tax Office is taking a very narrow view of what constitutes "ordinary family or commercial dealings." Plus, there is an unlimited period in which the Commissioner can amend assessments under section 100A.

In particular, under the Taxpayer Alert, the following types of family trust distributions to adult children of parents who are the trustee (or directors of the trustee) are potentially caught and are not covered by the "ordinary family dealings" exclusion – which may be surprising to many:

- Payments towards expenses incurred in relation to the children's upbringing or while they were minors (for example, school fees, school uniform costs or their share of the family holidays);
- Amounts to meet their share of family costs for the current year in excess of amounts it would reasonably be expected an adult child would meet (for example, a reasonable rate for their board, lodgings or rent if living away from home, or car expenses).

Draft Taxation Ruling TR 2022/D1 gives several examples that are particularly noteworthy, including:

- A trust established under a Will (i.e. a testamentary trust) – whilst the example given of a fixed trust for a sole beneficiary was considered not to be caught by the Tax Office, one would suspect that a *testamentary discretionary trust* (which is more commonplace in modern Wills where they are primarily set up for asset protection purposes but can also be utilised for significant tax savings by making distributions to adult children and corporate beneficiaries) would potentially attract the attention of the Tax Office;
- Gifts from parents out of their trust distributions to a child (e.g. to help fund a home deposit, which by itself the Tax Office accept is an ordinary family dealing), where the parent is on a lower tax rate than their child, may be caught – however, unpaid trust entitlements of an adult child held on separate trust but are retained as indicated by the child so as to eventually be used to fund a home deposit are not caught;
- Trust entitlement gifted to trustee, where trust distributions to an adult child are gifted back to the trust, are caught;
- Circular flow of funds where the trust has a corporate beneficiary (often referred to by advisers as a "bucket company"), the trustee owns the shares in the company, and the trust distributes income to the corporate beneficiary to be taxed at the company tax rate, which the company subsequently pays back to the trust by way of a franked dividend to the trustee / shareholder, and the process is repeated, is considered caught by the provisions.

Interestingly, the example involving a circular flow of funds between the trust and its corporate beneficiary is the subject of an appeal by the Tax Office against the decision of Justice Logan on section 100A in *Guardian AIT Pty Ltd ATF Australian Investment Trust v Commissioner of Taxation* [2021] FCA 1619. In that case, a trust had a corporate beneficiary in which it owned all the shares, and to which it made distributions which were taxed at the company tax rate.

The corporate beneficiary subsequently paid a dividend to the trust, which the trust distributed to a non-resident beneficiary (who was effectively the trust controller) who was not required to pay any further tax on the distribution. The Court found that section 100A did not apply to the arrangement, in that there was no reimbursement agreement, no purpose to reduce or eliminate a tax liability, and the introduction of a corporate beneficiary for (purportedly) risk minimisation was nothing more than an ordinary family or commercial dealing.

Clearly the result of this appeal is going to be very significant in terms of how far the Tax Office can go in its pursuit of trust distributions based on section 100A. In the meantime, the guidance recently issued by the Tax Office flags its intention to continue to watch trust distributions very closely.

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