



THE FORTUNA NEWS – ATO “ATTACK’ ON TRUSTS

In one of the most significant updates to taxation on family trust and trust legislation in decades, the ATO has released a series of rulings and guidelines on 23rd February 2022. These directly target how common family trusts distribute income to family members and companies. The changes are squarely targeted to impact the middle-class business owners. Even more concerning, the ATO has indicated that they may apply this modified interpretation retrospectively! That is, it is potentially penalising trust taxpayers on prior year decisions based on new interpretations. If you have a trust, this WILL affect you! There is considerable pushback and lobbying against this from the accounting profession at the moment. However, there is no doubt, this major change in interpretation by the ATO is a Game Changer.

Background

This draft guidance focuses on trust distributions where income from a family trust is distributed to a beneficiary on a lower tax rate, but someone else gets the benefit of the underlying cash and funds. A common example of this is where distributions are made to adult children, who are say, at university who have low incomes, partly to avoid tax. The children then use the funds toward family expenses or gifts it back to the parents.

Example of What is Being Targeted

John and Mary are on the top personal tax rate of 47%. They have a family trust with income of \$100,000 and distribute this to their 19-year-old son, who has no other income.

The son's tax liability on the above \$100,000 is about \$25,000. The trust pays the above tax bill, thus paying down \$25,000 on the son's entitlement. The trust still owes the remaining \$75,000 to the son.

There is a largely unspoken understanding that the son won't call upon that remaining \$75,000 the trust owes him. This allows John and Mary to take the money and use it for their own purposes. This is reflected as a \$75,000 loan by the trust to them. The result is that the trust indefinitely owes \$75,000 to the son, and the other side of that is the \$75,000 loan to John and Mary.

John and Mary could have simply appointed the \$100,000 of trust income to themselves. However, they would have paid \$47,000 in tax, leaving only \$53,000 in their pocket. The above scenario instead leaves them with \$75,000 to enjoy.



Enter Section 100A and TR 2022/D1

The ATO has now released a draft ruling – TR 2022/D1 – setting out their views on where the line is drawn between acceptable and unacceptable practices in relation to an unused section 100A of the Income Tax Assessment Act 1936. They have also released a draft Practical Compliance Guideline (PCG), which provides guidance on whose trust arrangements the ATO will investigate further, and whose they'll leave alone.

The above situation and many others are squarely in the ATO's sights for possibly falling foul of section 100A. The reason is that the understanding between John/Mary and their son might be regarded as a "reimbursement agreement". This is just a label – no actual reimbursing of any kind is required. Broadly, a reimbursement agreement is where a trust appoints income to one person, but someone else gets the benefit of it, and there is a purpose of achieving a tax saving.

The above mentioned PCG sets out a zone system which determines the likelihood of your trust arrangements for any particular year being investigated further by the ATO. The PCG sets out a number of examples and guidance for when arrangements fall into the following zones:

Risk zone	Risk level	Description	ATO's approach
White	Low	Pre-1 July 2014 arrangements.	Bar some exceptions, the ATO will not investigate.
Green	Low	Arrangements that are not regarded as offending s100A.	The ATO will not investigate.
Blue	Moderate	Arrangements where, on the surface, it is not possible to tell whether it offends s100A.	The ATO might or might not investigate. The goal here would be to demonstrate to the ATO that the elements of the arrangements below the surface ought not be regarded as offending s100A, and thus no further investigation is required.
Red	High	Immediately regarded as likely to offend s100A.	The ATO <i>will</i> investigate further. The simple example above falls into this zone.

Again, as noted, the draft PCG sets out guidance and a number of examples of trust income appointment scenarios falling within each zone. Based on these, the John and Mary scenario above would fall into the red zone. The effect of section 100A applying in that scenario is that the trustee of the trust is assessed on the \$100,000 at 47% in place of the son's original assessment, plus charged with ATO penalties and interest. There are any number of possible situations that could breach section 100A, but it basically requires

- Trust appoints income to A (e.g. someone on a lower income tax rate)
- Under an arrangement, by one means or another, B gets the benefit
- The overall tax on that income is less than it would have been, had the trust given that income to B
- The tax saving was the purpose of the arrangement.



Exception – Ordinary Family or Commercial Dealings

There is an exception to the application of section 100A, which is where the arrangement is entered into in the course of “ordinary family or commercial dealing”. In TR 2022/D1, the ATO discusses their views as to what constitutes an ordinary family or commercial dealing. The key feature is that it is “ordinary”. This reflects dealings as a whole that are capable of explanation as achieving normal familial or commercial ends. If that sounds a little wish-washy, it is but they have now provided some examples of this in their recent rulings.

The problem is that until these rulings, the ATO have not provided any guidance as to what they consider to come under this exception and have never challenged the common trust distributions to adult children.

Recent Case

The ATO issued the draft ruling despite a case examining section 100A currently before the courts, *Guardian AIT Pty Ltd v Commissioner of Taxation* [2021]. The Federal Court ruled that there was no reimbursement agreement in place, and what did occur was entered into in the course of ordinary family or commercial dealing in any case. The ATO has lodged an appeal against the decision. Needless to say, everyone, including the ATO is waiting on baited-breath for the result of this appeal.

Impact on Companies

The ATO have indicated that circular arrangements where 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, could also fall within the scope of these rulings.

Date of Effect

Also, there is no time limit on issuing such assessments under section 100A. The ATO have stated that they can go back as far as the 2015 tax year to review trust distributions in an audit, despite the fact that the official start date of this ruling is 1 July 2022!

What Does this Mean for You and Next Steps?

If you have a discretionary trust, the way that trust distributions are made will need to be carefully reviewed moving forward. You may not be able to distribute income in the same way that you have been in the past and this is likely to result in higher tax payments.

These rulings and interpretations are complex but we will guide you through how they will affect you. If you operate through a discretionary trust, we will be contacting you as part of the 2021/2022 tax planning to discuss how this will impact you. In particular, we will

- a) Review the potential audit risk on prior distributions made
- b) Review your current 2022 estimated taxable income and proposed trust distributions
- c) Provide you with an estimated tax payable estimate with trust distributions just in the “green zone”
- d) Meet with you to discuss your options for 2021/2022 tax planning

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