# The ATO puts the final nail in the Family Trust coffin...

As we approach the end of the 2022-2023 financial year, both trustees and accountants will be focussing on the question of trust distributions to beneficiaries and how to navigate the latest guidance from the ATO in the light of recent Australian court decisions.

This year the ATO will be paying closer attention to how trust distributions are allocated and used, so it's important to ensure you remain compliant.

If you have a family trust, you may have heard of Section 100A of the 1936 Tax Act introduced in the late 1970s to prevent a specific type of anti-avoidance scheme.

Its purpose is to prevent trustees from distributing income to beneficiaries who are subject to a lower marginal tax rate rather than the beneficiaries who receive the funds – such as cash or assets – and are therefore intended to pay tax on them.

***For example,***

*Let's say that Jo's family trust has a distributable tax income of $250,000 in the 2022/23 financial year. Jo's adult children are in a lower income tax bracket than he is.*

*One of Jo's children is married to Larry Loss who has little income and significant tax losses. They agree that Larry will receive 100% of the income even though there is no intention for him to receive the entitlements or benefit from the trust's assets. This results in no tax for the Jo Group on the distribution of $250,000.*

*Larry then forgives the outstanding entitlement of $250,000 and agrees for Jo, as the beneficiary, to have the entitlement reflected as a loan to Jo.*

*Until recently, the measure has largely remained dormant, with most accountants and tax advisers believing it only had a very narrow application in extreme tax avoidance cases. This has been reinforced by decades of inactivity by the ATO in relation to Section 100A.*

***As a result, it is unlikely that Jo's Family Trust would have been reviewed.***

## However things have now changed.

In December 2022, the ATO finalised two documents relating to the taxation of trust income. These signify a significant shift in how the ATO views Section 100A.

This is not a change in the law itself, but rather an opportunity for the ATO to scrutinise how trustees are distributing income and how they are receiving income to reduce the overall tax required to be paid.

The ATO has made it very clear that it believes Section 100A applies more broadly than what most accountants and tax advisers initially thought by releasing its long-awaited guidance on Section 100A in these two documents.

**It is now essential for you to understand how Section 100A operates and how it may affect your trust.**

If the ATO believes that Section 100A applies to your trust under this ruling, it means that the trust itself will be taxed at the highest marginal tax rate on every dollar of distribution to a beneficiary instead of the beneficiary being taxed on the income.

In our example, Jo's trust would be taxed at 47% (top personal marginal rate plus Medicare) amounting to $117,500 with no offsetting credits available. The trustee (Jo) would be liable for paying this tax.

To assess the risk of Jo's trust being scrutinised by the ATO, they have provided a traffic light system where the red, white and green zones are best described as follows (extracted from the ATO website and ruling):

**WHITE LOW RISK**

Arrangement in this zone will not be subject to ATO compliance in respect of income years which ended before 1 July 2014.

**However we note that there are caveats to this zone including:**

- If the arrangement falls outside the green zone (see below)
- The ATO is of the view that the taxpayer's income for years prior to 1 July 2014 need to be considered, and
- The arrangement has been entered into before 1 July 2014 and continues after that date.

**GREEN LOW RISK**

**Arrangements in this zone will not be determined to require further investigations other than those to confirm the arrangements comply with the following scenarios:**

- Scenario 1 – distribution to persons who are family members
- Scenario 2 – the entitlement is received by the intended beneficiary and used by the same
- Scenario 3A – retention of funds by trustee on behalf of an individual for an approved purpose
- Scenario 3B – retention of funds by the trustee by a trust beneficiary or company, and
- Scenario 4 – ordinary family or commercial dealings

The Guideline further outlines 10 green zone examples and sets out 11 arrangements which will not comply with this zone.

**RED HIGH RISK**

Arrangements in this zone will be considered high risk and attract the attention of the ATO. The ATO will dedicate resources and conduct an in-depth investigation to determine whether the trust distributions are in breach of Section 100A of the ITAA 1936. **These arrangements may include where:**

- beneficiary distributions are made for the purpose of accessing lower marginal tax rates, and
- the arrangement allows for a person other than the entitled beneficiary to receive a benefit from the entitlement.

**There are six scenarios that satisfy this zone:**

- Scenario 1 – where entitlements of an intended beneficiary are given to another party
- Scenario 2 – where entitlements of a beneficiary in respect of trust income are returned to the trust as assessable income
- Scenario 3 – where units are issued to the entitled beneficiary to set off against any such entitlement owed to that beneficiary
- Scenario 4 – where the entitled beneficiary's net income is included and has a higher value then their entitlement
- Scenario 5 – where the entitled beneficiary has losses and is outside the family group, and
- Scenario 6 – where arrangements are associated to a Taxpayer Alert such as TA 2022/1 where parents benefit from distributions to their adult children

The Guideline sets out five red zone examples which, in the Commissioner's perspective, clearly fall foul of Section 100A of the ITAA 1936.

According to the ATO, trust arrangements that comply with the law and have a low risk are categorized in the Green Zone.

These arrangements involve distributions that align with the trust deed terms and beneficiaries who use the funds for their benefit.

In contrast, trust arrangements that have high risk and may not comply with the law are classified in the Red Zone.

These arrangements typically involve distributions that do not align with the trust deed terms and beneficiaries who use the funds for non-beneficial purposes.

As a result, discussions and agreements between trust controllers and beneficiaries will be subject to intense scrutiny.

**Jo's trust falls in the Red Zone and is at a high risk of being reviewed by the ATO.**

## How do you prepare?

If you use a trust to manage your investments or business, it is important to thoroughly analyse how you decide to distribute the trust's income and how beneficiaries use the distributed funds.

This may require a more detailed level of documentation than in the past as the ATO expects documentation to be readily available in the event of an investigation into your trust arrangements.

As you make decisions on income distribution as of 30 June 2023, seeking more detailed advice on your trust's tax affairs is highly recommended.

*It is also wise to review past distributions for any risk and ensure future distributions do not expose you to unnecessary risk.*

To discuss your individual circumstances and how Section 100A may apply to your trust, contact the office at your earliest convenience.

Seeking early advice can prevent potential or prolonged investigations by the ATO.

For further guidance on obligations and potential ATO issues, book in a call with our tax advisors.

Contact us for examples on what may be considered GREEN or RED scenarios.

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