Family trust income: the ‘new world’ of ATO attention (part 2)

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Family Trust Income – The ‘New World’ of ATO Attention (Part 2)

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In our second Tax Alert on the changing views of the ATO in relation to integrity measures targeting family trust income and beneficiaries, we consider the impact on the taxation landscape that comes with the new views recently expressed by the Commissioner of Taxation in relation to his new Draft Tax Determination **TD 2022/D1**: *Division 7A: when will an unpaid present entitlement or amount held on sub-trust become the provision of 'financial accommodation'?*

The end of the sub-trust era?

Division 7A is a highly complex integrity measure that generally applies where corporate profits are extracted from a group via loan accounts. The intent of Division 7A legislation is to ensure that where such profits are extracted, that they are either done on commercial lending terms, or in a way where the recipients are appropriately taxed and assessed for the "top-up" tax associated with dividends paid from companies.

A common strategy used by those with family trusts has been to distribute the income generated by their family trusts to a company (known as a corporate beneficiary, or "bucket company"). The trust would commonly only pay sufficient cash to the company to allow payment of the tax liability associated with the distribution but would leave the balance owing in the trust for business or investment purposes. These undistributed funds are known as Unpaid Present Entitlements (UPEs).

This gave taxpayers the best of both worlds – access to the company tax rate on their incomes (deferring the "top up tax" payable by individual taxpayers above the company tax rate to a future date), but also preserving future access to the 50% Capital Gains Tax Discount on their trust-held investments and/or businesses.

Back in December 2009, the ATO released rulings that deemed these UPEs to be 'loans' for Division 7A purposes. At the time, the ATO allowed some relief for taxpayers, as you could put these UPEs onto a 7- or 10-year interest-only arrangement, known as a "sub-trust". This relief has been in place for the past 12 years and whilst adding some complexity, has allowed the continued use of corporate beneficiaries.

This relief measure was often seen as a more cashflow effective measure than simply putting the UPEs onto a complying Division 7A loan agreement, which required the payment of interest *and principal* over the 7-year term.

As part of the 2016-17 Federal Budget, the Coalition government announced that Division 7A would be substantially revised. However, there is currently no indication that the government (or opposition) will introduce the proposed changes in the near future. Notwithstanding this, the ATO has now issued further draft interpretation and changes to its practical application of Division 7A to UPEs and sub-trusts in the form of TD 2022/D1.

The previous cash flow relief available for sub-trust amounts has now been removed prospectively. In particular, TD 2022/D1 includes a focus on family trust income that is distributed to a company after 1 July 2022. The ATO discusses when a distribution that is unpaid by the family trust to the company becomes subject to Division 7A.

The ATO indicates that is necessary to analyse each distribution and it advises:-

- Unpaid Present Entitlements not constituting a sub-trust will generally need to be placed on a complying Division 7A loan agreement, unless paid in full.The timing of when this agreement must be put in place is contingent on whether the relevant distribution by the family trust to the corporate beneficiary is of a fixed amount or based on a percentage of the trust income.

  A distribution of a fixed amount would generally be considered financial accommodation at the time that the distribution is made (usually around 30 June). This would mean that ensuring the UPE complies with Division 7A legislation must occur prior to the lodgement of the income tax return for that financial year.

  An opportunity appears to arise under the percentage method (even where that percentage is 100%) to defer the commencement of Division 7A requirements by a year, as the Commissioner considers that the financial accommodation does not take place until the income of the trust is determined, which normally happens after the end of a financial year, as the financial statements are prepared. The financial accommodation would therefore happen in the year after the distribution was declared, meaning there would be an additional 12 months to bring the UPE into compliance with Division 7A.

- After 1 July 2022, there will also be less flexibility associated with utilising sub-trusts, with a requirement to isolate the unpaid amount in the trust rather than have it intermingled with other trust assets.

This has far-reaching implications for trusts that utilise their income generated to reinvest in the assets of the trust (e.g. in a business operated by the trust), or to pay down external debts.

Under this scenario, such trusts would not be able to utilise sub-trust arrangements, as from a practical perspective, they may not be able to isolate the amount of funds representing the sub-trust from the other assets of the family trust.

This would mean that, should the trust not be in a position to pay down the funds to the corporate beneficiary required to satisfy the UPE, the only alternative would be to place the UPE on a complying Division 7A loan agreement.

As we have noted, for those taxpayers who have family trusts, it will be important to consider whether these new interpretations and views of the ATO detailed in Parts 1 and 2 of this Tax

Alert could create issues for you. Whilst these new ATO views are draft only, considering the issues and addressing them well before 30 June 2022 will be vital.

Trusts will continue to provide many benefits and will continue to be an effective structure for managing family wealth, however the taxation of trust incomes will become far more complex under these new guidelines. Most family groups will need to revisit their distribution strategies in the lead up to 30 June 2022.

To discuss how these changes might impact you and the best ways to manage your situation, please contact your Fordham Partner.

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