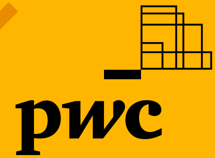
Discretionary trusts and Reimbursement Agreements

June 2023



With the ATO's current focus on the tax arrangements for private groups, distributions from discretionary trusts remain in the spotlight. A recent case concerning "reimbursement agreements" highlights the ongoing uncertainty in this area, which is likely to be an area of focus for the ATO in its Next 5,000 reviews of high wealth private groups.

Guardian Case

On 24 January 2023, the Full Federal Court handed down its decision in Commissioner of Taxation v Guardian AIT Pty Ltd ATF Australian Investment Trust [2023] FCAFC 3 (the Guardian case). This case is an appeal from a 2021 decision of the Federal Court which considered the meaning of "reimbursement agreement" in section 100A of the Income Tax Assessment Act 1936 (Cth) (**ITAA 1936**). In the original 2021 decision, the Court held that section 100A did not apply to the arrangements in place, and this was upheld by the Full Court on appeal. However, the Full Court did find (in the alternative), that the general anti-avoidance provisions in Part IVA of the ITAA 1936 applied to cancel tax benefits arising from the arrangements with respect to the 2013 income year (but not the other years in which the arrangements were entered into or operating, for different reasons).

Section 100A has long been a point of contention between taxpayers, advisers and the ATO. It was originally introduced as an integrity provision, designed to stop arrangements where a beneficiary becomes presently entitled to trust income (and is therefore taxed on that income at their applicable tax rate), but the trust income is effectively transferred or paid to someone else, with the result that less tax is paid on the trust income. Section 100A does this by deeming the beneficiary, who is otherwise presently entitled to the trust income, to not be (and to never have been) presently entitled to the trust income where that purported trust income distribution arose out of a "reimbursement agreement" (with the result that the trustee is then assessed on the taxable part of that income at the top marginal tax rate).

On the face of it, this seems quite straightforward. However the scope of this provision and the meaning of "reimbursement agreement" have been subject to much debate over the years. The ATO has been developing guidance on section 100A for some time, with a particular focus on the exclusion for ordinary family and commercial dealings. This guidance was released in December 2022 (read more here). The outcome in this case highlights that even where the specific integrity provision does not apply, there is scope for the general anti-avoidance provisions to apply to arrangements involving discretionary trusts.

The ATO released a Decision Impact Statement in relation to this case on 24 April 2023.

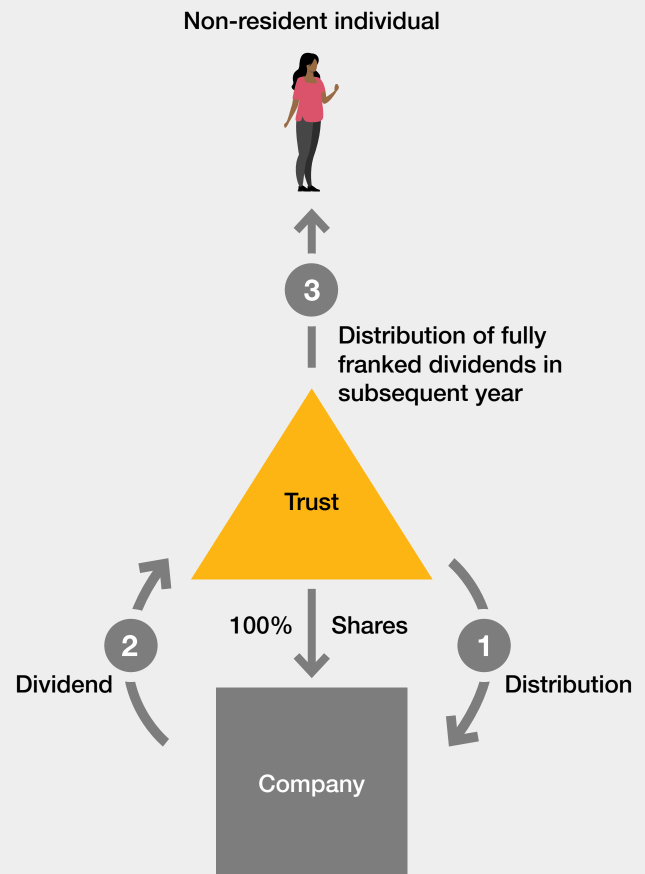
Key facts

The facts associated with the Guardian case are quite complex. However, for the purposes of this update, it can be simplified to the following key facts:

- Step 1: The trustee of a discretionary trust made a wholly-owned company presently entitled to a share of the income of the trust for the 2012 income year (that is, income was distributed to the beneficiary for accounting and tax purposes). The distribution was not paid, but left as an unpaid present entitlement (UPE).
- Step 2: After drawing on the UPE to pay its tax liability for the 2012 year, during the 2013 income year the company declared a fully franked dividend to the trust to discharge the remainder of the UPE (the declaration of the dividend resulted in an amount owing by the company to the trust which was offset against the UPE owing from the trust to the company).
- Step 3: At the end of the 2013 income year, the trustee set aside the fully franked dividend for the benefit of a non-resident individual beneficiary, and made the company presently entitled to the remainder of the trust income for the 2013 year.

This pattern then continued for 2 more years, with the company's entitlement to trust income remaining initially as a UPE, which was then discharged by, firstly, paying the company's tax liability, and then declaring a fully franked dividend to the trust.

The diagram below illustrates the distribution from the trust to the company, and the subsequent declaration of a dividend to offset the unpaid present entitlement to the distribution.



Findings - section 100A

The facts in this case are similar to a classic "washing machine" arrangement that the ATO has long had issue with. However, both the primary judge in the Federal Court and all three judges in the Full Federal Court found in favour of the taxpayer, concluding that there was no relevant "reimbursement agreement" to trigger the application of section 100A.

The primary judge held that for section 100A to apply, something answering the description of a reimbursement agreement must have existed prior to the present entitlement to trust income arising. After a thorough analysis of the evidence, the judge held there was no relevant "reimbursement agreement" before the company was made presently entitled to the trust income. In addition, the primary judge held that the agreement to incorporate the wholly-owned company and make it presently entitled to a share of the trust income was an ordinary family or commercial dealing.

This finding was largely based on the primary judge's reliance on evidence from the taxpayer that the company was incorporated to receive distributions from the trust to minimise exposure to risks associated with trading businesses previously carried on by the group, that had been sold and/or wound up, and to act as a new corporate vehicle for wealth accumulation and passive investment.

The focus of the appeal in the Full Federal Court was whether an agreement was in place prior to the present entitlement to trust income arising. The Full Court found no fault in the primary judge's conclusion that there was no such agreement, noting in particular that any purpose of the taxpayer's advisor could not be attributed to the taxpayer, even if it was common practice for the taxpayer to follow their advisor's advice.

In its Decision Impact Statement, the ATO noted the importance of the existence of the reimbursement agreement at, or prior to, the time the beneficiary in made presently entitled to income of the trust, and that in administering the law, "the Commissioner will evaluate the reliability of particular assertions regarding the existence or otherwise of an agreement in light of all of the surrounding circumstances. This approach recognises that an agreement may comprise or include understandings which are informal or unwritten. In some cases, it will be necessary to interview participants in the transactions under consideration, or those with knowledge of those transactions."

Findings - Part IVA

The Commissioner argued in the alternative that the general anti-avoidance provisions (Part IVA of the Income Tax Assessment Act 1936) applied to one or more "schemes", on the basis that the dominant purpose of these schemes was to derive a tax benefit.

At first instance, this argument also failed, with the primary judge finding there was no tax benefit, and even if there was, an analysis of the relevant factors would lead to a conclusion that the dominant purpose of the scheme was risk minimisation and wealth accumulation, as noted above. However, the Full Court held that Part IVA did apply to what was identified as the "2013 related scheme" - that is:

- the appointment of the unfranked income of the trust to the company for the 2013 year
- the drawing down on part of the UPE to discharge the company's tax liability for the 2013 year
- the declaration of a a fully franked dividend to the company in the 2014 year in satisfaction of the remaining UPE from the 2013 year, and
- The appointment of the fully franked income of the trust to the non-resident individual for the 2014 year.

The Full Court concluded that the non-resident individual received a tax benefit in the year ended 30 June 2013, on the basis that, in the absence of the scheme, it might reasonably be expected that the trust would have made the individual presently entitled to the unfranked income of the trust (as opposed to franked income that would effectively only be subject to the corporate tax rate). In reaching this conclusion, the Full Court noted the importance of the 2013 amendments to Part IVA that require any tax cost to be disregarded when determining what reasonably might have happened had the scheme not been entered into. In addition, the Full Court held that the 2013 related scheme was entered into for the dominant purpose of enabling the non-resident individual to obtain a tax benefit (in contrast to the 2012 related scheme which was the product of an evolving set of circumstances).

Looking ahead

With the Commissioner successful in applying Part IVA in this case, this is a time for caution.

This case signals a renewed focus on discretionary trusts from the ATO, and follows another case last year where the ATO was successful in applying Part IVA to a hybrid trust with discretionary features - Minerva Financial Group Pty Ltd v Commissioner of Taxation [2022] FCA 1092 (read more here).

With the release of the final ATO guidance on section 100A in December 2022, and the ramping up of the Next 5,000 program for high wealth private groups, it is expected that potential historical exposure to section 100A will be on the ATO's agenda. And as this case demonstrates, the ATO can also successfully apply Part IVA to discretionary trusts.

Given the potential exposure for high rates of tax and penalties to apply to any section 100A arrangement or Part IVA scheme, and the fact that there is no time limit for the Commissioner to amend assessments pursuant to section 100A, it is recommended that all private groups which operate with a discretionary trust review their past transactions and arrangements and prepare for potential ATO inquiry.

Find out more:

For a more detailed discussion on the implications of the Guardian case, please get in touch with your PwC advisor or contact:

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