TA 2013/3 - Purported alienation of income through discretionary trust partners

Australian Government
Australian Taxation Office

Taxpayer Alert

TA 2013/3

FOI status: may be released

TITLE: Purported alienation of income through discretionary trust partners

Taxpayer Alerts are intended to be an early warning of significant new and emerging higher risk tax planning issues or arrangements that the Australian Taxation Office (ATO) has under risk assessment, or where there are recurrences of arrangements that have been previously risk assessed.

This Taxpayer Alert is issued under the authority of the Commissioner.

Overview

This Taxpayer Alert describes arrangements where an individual purports to make the trustee of a discretionary trust a partner in a firm of accountants, lawyers or other professionals (firm); but fails to give legal effect to that structure or fails to account for its tax consequences.

What is the issue?

In the arrangements described in this alert, an individual purports to alienate income attributable to their professional services to a trustee partner.

In this context, 'alienation' refers to a situation where income that would otherwise be assessable to an individual is the income of a different entity. This may occur as the result of the assignment of an existing partnership interest, or by the creation of a new interest.

The ATO is concerned that in some cases the arrangement:

a. may be ineffective in alienating the individual's income,

b. may have CGT consequences for the individual which have not been correctly recognised, or

c. may involve a scheme to which the income tax general anti-avoidance rules apply.

Description

This alert applies to arrangements with features substantially equivalent, but not limited to, those described below. All factors should be weighed up in assessing whether any tax risks are posed by a particular arrangement.

1. An individual causes transactions to occur which purport to make the trustee of a discretionary trust (trustee) a partner in a professional firm. The trustee may be the individual acting in their capacity as trustee or another entity. The beneficiaries of the trust include the individual or their associates.

2. The individual purports to assign their existing interest in the partnership to the trustee. In such a case the individual may not report any capital gain associated with the assignment in their tax return, or report an understated capital gain.

3. Alternatively, the individual may not have had an existing interest in the partnership, but transactions occur which purport to provide the trustee with a new partnership interest.

4. The arrangement has some or all of the following features:

   a. the trustee does not actively engage in the conduct of the firm's practice and may not hold professional qualifications,

   b. the practice is carried on in much the same way as it had been before the trustee purported to become a partner, or would have been if the trustee had not purported to become a partner; specifically:

      (i) the individual renders substantial personal services to clients of the firm, the value of which cannot be attributed solely to the efforts of employees or income producing assets,

      (ii) the individual has the same or similar roles, responsibilities and obligations as they had before the trustee purported to become a partner, or would have had if the trustee had not purported to become a partner,

      (iii) no advice of the trustee arrangement is given to clients of the firm or other third parties,

      (iv) the trustee arrangement does not result in any limitation of liability for the individual, or the individual is exposed to substantially the same level of business risk they were exposed to as a partner, or would have been exposed to, if they had been a partner,

      (v) the trustee arrangement does not assist in the provision of professional services by the individual.

   c. the amount of salary or other remuneration payable to the individual is considerably lower than the income which they formerly derived from the practice, or would have derived if they had been a partner,

   d. the individual has the ability to remove the trustee, revoke or alter the trust arrangement, or otherwise control the trustee's interest in the partnership.

5. In addition, or in the alternative, the arrangement may have some or all of the following features:

   a. inconsistencies in the documentation that make it unclear whether the individual or the trustee is a partner in the firm,

   b. the individual contracts with clients or other third parties on the basis that the individual is a partner,

   c. the firm or the individual represents to the public that the individual is a partner,

d. there is no employment or other contractual relationship between the trustee and the individual,

e. the documentation purports to provide corporate trustees with entitlements (eg leave) which can only be enjoyed by a natural person,

f. the trustee does not have any employees (whether in its capacity as partner or otherwise),

g. the trustee does not hold any significant assets (whether in its capacity as partner or otherwise),

h. the trustee does not contribute any capital to the partnership,

i. the individual purports to make drawings from partnership equity for their personal use.

6. In each financial year:

   a. the firm directs distributions of net profits of the firm to the trustee as partner of the firm. This distribution may correspond to the amount the individual could reasonably be expected to have received if they had not entered into the arrangement.

   b. the trustee resolves to distribute most or all of the income to lower taxed beneficiaries of the trust.

7. The individual does not report any income from the professional firm in their tax return, except to the extent (if any) that such income is part of their entitlement as a beneficiary of the trust.

8. The arrangements described above may alternatively be implemented using a unit trust, units in which are held by lower taxed beneficiaries.

Diagram of arrangement (existing partnership interests)

The following diagram illustrates an arrangement where individuals purport to transfer their existing interests in a partnership to a trustee.

Before Restructure

Partnership of Individuals

Individuals contribute to the partnership, perform the functions on behalf of the partnership and assume risks associated with running the business

Partner A

Partner B

Partner C

Partner A receives and returns interest in net income of $500,000

Partner B receives and returns interest in net income of $500,000

Partner C receives and returns interest in net income of $500,000

Tax paid by each individual prior to restructure:

$206,047

After Restructure

Partnership of Discretionary Trusts

The trustees have only nominal assets to contribute to the partnership and the individual continues to perform the functions of a partner and provides personal guarantees and so assumes business risks.

Individuals may not report a net capital gain from the restructure, or report an understated gain.

Trust Partner A

Trust Partner B

Trust Partner C

Trust Rep A

Other Beneficiaries

Trust Rep B

Other Beneficiaries

Trust Rep C

Other Beneficiaries

Trust Rep A (previously Partner A) present entitlement is $50,000

Tax paid: $8,547

Other beneficiaries 4 adult family members each presently entitled to $80,000. Remainder to a bucket company.

Total tax paid post restructure:

$122,535

Trust Rep B (previously Partner B) present entitlement is $50,000

Tax paid: $8,547

Other beneficiaries Company receives and returns $450,000

Total tax paid post restructure:

$143,547

Trust Rep C (previously Partner C) has no present entitlement

Tax paid: $0

Other beneficiaries Loss trust receives and returns $350,000. Remainder to a non-lodging company

Total tax paid post restructure:

$0

What are the ATO's concerns?

The ATO will weigh up all the factors discussed above in determining the application of the law to the facts in each case.

Broadly, the ATO's concerns with these types of arrangements include whether:

a) the transactions referred to above are legally effective, such as:

   (i) whether an interest in the net income of the partnership is an interest of the trustee or the individual for the purposes of section 92 of the *Income Tax Assessment Act 1936* (ITAA 1936),

   (ii) whether assessable income relating to work performed by the individual is derived by the individual or the partnership for the purposes of section 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997),

b) any transactions intended to make the trustee a partner in the firm give rise to or increase a net capital gain for the individual in the year of income, such as:

   (i) whether a CGT event has happened to an interest held by the individual in a partnership,

   (ii) what capital proceeds are associated with the event,

   (iii) whether the individual's net capital gain is reduced by the CGT discount or small business concessions in Division 152 of the ITAA 1997,

c) the general anti-avoidance rules in Part IVA of the ITAA 1936 apply to cancel tax benefits obtained by the individual.

What action is the ATO taking?

The ATO is currently reviewing these arrangements and conducting examinations in appropriate cases.

The ATO is also reviewing relevant Tax Rulings and Determinations.

A number of the features described in this alert were identified in Taxation Ruling IT 2330 (IT 2330) as being factors which point towards the application of the general anti-avoidance provisions to income splitting arrangements; see paragraph 4 of this alert in particular. In this regard, the ATO is considering whether some of the arrangements identified in this alert involve a scheme to which Part IVA of the ITAA 1936 applies.

IT 2330 also states that the anti-avoidance provisions will not apply to assignments of partnership interests of the same nature as that considered in *FC of T v. Everett* 80 ATC 4076; 10 ATR 608 (*Everett*). A similar statement was made in Taxation Ruling IT 2501 in relation to the decisions in *Everett* and *FC of T v. Galland* 86 ATC 4885; 18 ATR 33. The ATO is currently reviewing this position, although arrangements described in this alert may be distinguishable from the arrangements considered in those cases.

The ATO is also reviewing Taxation Ruling IT 2540, which addresses the CGT consequences of disposing of an interest in a partnership.

The ATO is preparing further guidance on these arrangements in the form of an online publication to help professionals understand the risks and how to address them in practice.

The ATO is also consulting with relevant professional bodies on the action it is taking, including the potential application of Part IVA of the ITAA 1936.

The ATO will examine arrangements which the ATO considers are a sham or ineffective in alienating the individual's income, or where CGT has not been correctly recognised.

The ATO will apply compliance resources to consider the possible application of Part IVA of the ITAA 1936 to arrangements of the type covered by this alert in relation to tax benefits arising in the 2013/14 income year and later income years.

What should you do?

If you have entered into a similar arrangement to that described in this alert you may wish to seek independent professional advice. If you would like to correct something in your tax return, more information is available on our website ato.gov.au and search for Self-amendments.

You may also ask us for our view through a private ruling or contact the contact officer named in the Taxpayer Alert.

Frequently asked questions

Who should I contact if I have information about the arrangement?

If you have any information about this arrangement, phone us on 1800 060 062.

How do I make a voluntary disclosure?

Any penalty relating to your involvement will be reduced if you make a voluntary disclosure. Generally, the reduction is greater if you make the disclosure *before* we notify you of an examination of your tax affairs (eg an audit).

More information on voluntary disclosures is available on our website ato.gov.au, and search for Make a voluntary disclosure or phone 13 28 66.

For further information see Miscellaneous Taxation Ruling MT 2012/3.

Where can I find out more about Taxpayer Alerts?

Further information on Taxpayer Alerts, including circumstances in which one may be withdrawn, can be found in PS LA 2008/15.

A full list of Taxpayer Alerts issued by the ATO is available on our website, ato.gov.au

Amendment history

Date	Comment
19 January 2024	Updated ATO tip-off hotline number

References

Subject references:

- anti-avoidance
- capital gains tax
- discretionary trusts
- partnerships
- personal services income
- professional firms
- scheme

Legislative references:

Income Tax Assessment Act 1936

- Section 92
- Part IVA

Income Tax Assessment Act 1997

- Section 6-5
- Part 2-42
- Division 152

Related Practice Statements:

- PS LA 2007/7
- PS LA 2007/24
- PS LA 2008/6
- PS LA 2008/15

Rulings

- IT 2330
- IT 2501
- IT 2540
- MT 2012/3

Case References:

- FC of T v. Everett (1980) 143 CLR 440; 80 ATC 4076; 10 ATR 608
- FC of T v. Galland (1986) 162 CLR 408; 86 ATC 4885; 18 ATR 33

Other References:

- ATO Website
- Self-amendments
- Voluntary Disclosures
- List of Taxpayer Alerts

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