Distributions to tax-exempt beneficiaries: anti-avoidance rules

Check the anti-avoidance rules in s100AA and 100AB preventing trustees from using tax-exempt entities to avoid tax.

Last updated 22 April 2016

This information is for trustees with tax-exempt beneficiaries who are presently entitled to trust income.

Specific anti-avoidance rules prevent trustees from using tax-exempt entities to avoid tax (sections 100AA and 100AB of the *Income Tax Assessment Act 1936)*.

Broadly, the anti-avoidance rules apply if a tax-exempt beneficiary is presently entitled to trust income for an income year and:

- the trustee does not notify the beneficiary of their entitlement or pay the income within two months of the end of the year – this is the pay or notify rule, or
- the beneficiary's entitlement exceeds a 'benchmark percentage' – this is the benchmark percentage rule.

If either of these rules apply, the tax-exempt beneficiary is treated as not being – and never having been – presently entitled to the affected share of trust income. This share of net income is instead assessed to the trustee.

Pay or notify rule

Find out when and how the pay or notify rule applies

Benchmark percentage rule

Find out about specific anti-avoidance rules that are called the 'pay or notify' rule and the 'benchmark percentage' rule.

QC 48729

Pay or notify rule

Find out when and how the pay or notify rule applies.

Last updated 22 April 2016

If a tax-exempt beneficiary is not made aware of their present entitlement to trust income within two months of the end of the income year, the trustee will generally be taxed on a corresponding share of the trust's net income.

When the rule applies

The pay or notify rule applies to a trustee if:

- an exempt beneficiary is presently entitled to an amount of trust income
- the exempt beneficiary is not an exempt Australian Government agency
- the trust is not a managed investment trust (or treated like one for the purposes of Division 275 of the ITAA 1997)
- the trustee has not notified the exempt beneficiary in writing of their present entitlement or paid the entitlement to the beneficiary within two months of the end of the relevant income year.

The written notice doesn't have to specify the dollar amount of the present entitlement. It's sufficient if it sets out how the entitlement is calculated – for example, as a percentage of trust income.

How the rule is applied

If the pay or notify rule applies, for tax purposes the exempt beneficiary is treated as not being – and never having been – presently entitled to the affected amount of trust income. Instead, the trustee is taxed on a corresponding share of the net income of the trust (generally under section 99A of the ITAA 1936), unless we exercise our discretion not to apply the rule.

Example: how the rule is applied

In 2014–15, Daley Trust generates $100,000 of rental income. The trust has no other revenue or expenses so its income and net income is $100,000.

The trustee of Daley Trust makes the trustee of Philips Trust (which is a charity and therefore a tax-exempt entity) presently entitled to all of the trust income. However, the trustee of Daley Trust does not provide the trustee of Philips Trust with written notice of its entitlement before 31 August 2015 and makes a payment of only $30,000 to the trustee of Philips Trust before that date.

Without the anti-avoidance rule, the trustee of Philips Trust would be notionally assessed on all of the trust's $100,000 net income. (Because of the Philips Trust’s charitable status, the assessment is ‘notional’ in the sense that the income is exempt).

Under the anti-avoidance rule (and assuming our discretion is not exercised) the trustee of Philips Trust is treated, for tax purposes, as not presently entitled to the other $70,000 of trust income because it is unaware that it is presently entitled to this amount. The trustee of Daley Trust is then taxed on this $70,000 under section 99A of the ITAA 1936.

Commissioner's discretion

We have discretion to disregard a trustee's failure to pay or notify an exempt beneficiary within two months. We can exercise the discretion if the consequences of applying the anti-avoidance rule would be unreasonable.

To exercise the discretion, we must consider the following factors:

- the circumstances that led to the trustee failing to pay or notify

- the extent to which the trustee tried to correct the failure and, if so, how quickly that happened
- whether we have previously exercised this discretion for the trustee and, if so, the circumstances in which this occurred
- any other relevant matters.

Example: exercising the Commissioner's discretion

Continuing the previous example, the trustee of Daley Trust is initially unaware that Philips Trust is an exempt entity (because it is not publicly known to be a charity) and, therefore, does not ensure that Philips Trust is informed of its entitlement before 31 August 2015.

The trustee of Daley Trust prepares its accounts on 30 September 2015 and it's only then that it becomes aware Philips Trust is an exempt entity. The trustee of Daley Trust promptly takes steps to notify Philips Trust of its entitlement.

As Daley Trust has taken immediate action to notify Philips Trust of its entitlement on becoming aware of its tax-exempt status, and it was not unreasonable for Daley Trust to be unaware of Philips Trust's likely tax exempt status, we exercised the discretion to disregard the failure of the trustee of Daley Trust to comply with section 100AA of the ITAA 1936.

Consequently, Philips Trust is notionally assessed on all of Daley Trust's net income of $100,000. No amount is assessed to the trustee.

QC 48729

Benchmark percentage rule

Find out about specific anti-avoidance rules that are called the 'pay or notify' rule and the 'benchmark percentage' rule.

Last updated 22 April 2016

This rule is to prevent manipulation of differences between the trust's income and net income.

The trust income is determined in accordance with the trust deed while its net income is determined in accordance with tax law. The two amounts can be different.

Under the rule, if a tax-exempt beneficiary's share of a trust's income is less than their share of the trust's net income, the trustee is generally taxed on the excess share of the trust's net income.

When the rule applies

The benchmark percentage rule applies to a trustee if an exempt beneficiary is presently entitled to an amount of trust income and the exempt beneficiary's adjusted Division 6 percentage exceeds its benchmark percentage – unless:

- the exempt beneficiary is an exempt Australian Government agency
- the trust is a managed investment trust (or treated like one for the purposes of Division 275 of the ITAA 1997)
- the affected amount is already subject to the pay or notify rule (the same amount will not attract the operation of both rules).

Adjusted Division 6 percentage

The adjusted Division 6 percentage is the exempt beneficiary's entitlement to the trust's income as a percentage of all of the trust's income, but ignoring any capital gains or franked distributions that any beneficiary or the trustee is specifically entitled to (that is, ignoring capital gains and franked distributions that were effectively streamed by the trust).

Benchmark percentage

The benchmark percentage is the tax-exempt beneficiary's present entitlement to any amount that forms part of the trust's adjusted net income, expressed as a percentage. It's calculated as follows:

> The amount the tax exempt beneficiary is presently entitled to from the trust estate, to the extent that the amount forms part of the trust's adjusted net income

divided by

The trust's adjusted net income

Adjusted net income

A trust's adjusted net income is its net income:

- reduced by any capital gains or franked distributions a beneficiary is specifically entitled to
- increased by any CGT discounts and small business concessions that may have been applied to any remaining capital gains
- reduced by any amounts that do not represent net growth of value to the trust estate (other than amounts included under Part IVA of the ITAA 1936, which deals with schemes to reduce income tax).

The effect of the last dot point is to exclude amounts that, unlike monetary additions or acquisitions of property, do not increase the economic value of the trust estate. Examples of these amounts include:

- franking credits
- loans that are treated for tax purposes as a dividend under Division 7A of Part III of the ITAA 1936 (as any loan funds received will be coupled with a corresponding liability to repay)
- the part of a capital gain for tax purposes that exceeds the capital gain made for trust purposes as a result of the market value substitution rules applying.

How the rule is applied

Effectively, if a share of the trust's net income would be notionally assessed to a tax-exempt beneficiary, and that share exceeds the beneficiary's entitlement to the trust's income, the trustee is taxed on the difference.

That is, if the benchmark percentage rule applies, the exempt beneficiary is treated as not being – and never having been – presently entitled to the amount of trust income that's attributable to the percentage by which the beneficiary's adjusted Division 6 percentage exceeds its benchmark percentage.

Instead, the trustee is taxed (generally under section 99A of the ITAA 1936) on the corresponding share of net income, unless we exercise our discretion not to apply the rule.

Example: how the rule is applied

In 2015–16, the Pepper Trust generates $5,000 of rental income and a non-discount capital gain of $95,000. The trust has no expenses or capital losses. The net income of the trust is $100,000 (being the $5,000 rental income and $95,000 capital gain).

The trust deed does not define income for the purposes of the trust nor does it enable the trustee to treat capital receipts as income. Accordingly, the capital gain is not trust income. The trust income is therefore $5,000.

The James Trust and Nick are beneficiaries of the Pepper Trust. The James Trust is an exempt entity.

The trustee appoints all of the income, $5,000, for that year to the James Trust. Three months after the end of the income year, the trustee also distributes a portion of the trust's capital worth $95,000 to Nick. The trustee complies with section 100AA of the ITAA 1936 and notifies the James Trust of its entitlement by 31 August 2015.

Nick is not specifically entitled to the Pepper Trust's capital gain because the legislative requirements for a specific entitlement have not been met. As such, section 100AB does not disregard the capital gain.

The James Trust’s adjusted Division 6 percentage is 100% as it is presently entitled to all of the trust income:

$5,000 $5,000	x	100

However, the James Trust's benchmark percentage is only 5%:

$5,000 $100,000	x	100

The James Trust's adjusted Division 6 percentage exceeds its benchmark percentage by 95%.

The James Trust's share of the Pepper Trust's net income that it is notionally assessed on is confined to $5,000, being its benchmark percentage (5%) of the net income of the trust (0.05 x $100,000).

The trustee of the Pepper Trust is therefore assessed (under section 99A of the ITAA 1936) on $95,000, being the remaining 95% of the net income of the trust.

To avoid this outcome, the trustee of the Pepper Trust could instead have made Nick specifically entitled to the capital gain because a trust's benchmark percentage is calculated disregarding amounts to which a beneficiary or the trustee is specifically entitled. To make Nick specifically entitled to the capital gain, the trustee would need to record the capital distribution to Nick in the records of the trust as referable to the capital gain and ensure Nick's entitlement arose within two months of the end of the income year. Nick, not the trustee, would then be assessed on the capital gain pursuant to Subdivision 115-C of the ITAA 1997.

Commissioner's discretion

We have a discretion not to apply the benchmark percentage rule if it would be unreasonable for it to apply.

To exercise the discretion, we must consider the following factors:

- the circumstances that led to the tax-exempt beneficiary's entitlement to the trust's income being less than its entitlement to the trust's net income, and the extent of the difference
- the extent to which the tax-exempt beneficiary received distributions for that year
- the extent to which other beneficiaries had an entitlement to or would benefit from the trust's income for the relevant year
- any other relevant matters.

QC 48729

Our commitment to you

We are committed to providing you with accurate, consistent and clear information to help you understand your rights and entitlements and meet your obligations.

If you follow our information and it turns out to be incorrect, or it is misleading and you make a mistake as a result, we will take that into account when determining what action, if any, we should take.

Some of the information on this website applies to a specific financial year. This is clearly marked. Make sure you have the information for the right year before making decisions based on that information.

If you feel that our information does not fully cover your circumstances, or you are unsure how it applies to you, contact us or seek professional advice.