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— Opinion

The $100m tax trap that could force family businesses into bankruptcy

Family trust compliance has become forensic genealogy, as tax laws threaten to destroy family wealth and small business viability in one fell swoop.

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If the Australian government wants to boost productivity by cutting red tape, it should begin by simplifying one of the most damaging compliance traps in the tax system for private groups: family trust distribution tax (FTDT).

For nearly three decades, the FTDT regime has sat quietly in the background. But no longer, with the Australian Taxation Office now focusing on issues that may not have attracted their attention before.

The crackdown is associated with what are known as family trust elections and the payment of distributions tax dating back to 1998. **Bethany Rae**

The original idea behind the tax was that family trusts would be able to use tax losses so long as distributions remained within the "family group", and that FTDT would apply only in cases of deliberate non-compliance. That is not how it has turned out.

What was described as an "optional" tax, one the government hoped would never need to be collected, has become a trap. It now ensnares ordinary families, businesses and advisers in technical breaches that carry devastating consequences.

The legislation's complexity, inflexibility and outdated concepts are causing harm far beyond its intended purpose, and it's time for change. This is not a deterrence – it's a paperwork tripwire.

Why make a family trust election?

To access basic tax concessions such as revenue losses and franking credits, many family trusts make a family trust election (FTE). This election nominates a "test individual" around whom the family group is defined.

Once made, the election is binding, largely irrevocable and unforgivingly rigid.

If a trustee ever distributes income or capital to someone outside the family group, FTDT applies at a punishing 47 per cent. The same rules extend to entities that make an "interposed entity election" (IEE).

In newer family groups, coordinated elections can be managed. But in larger, long-established families, multiple trusts – often set up years apart by different relatives – may have different test individuals, or none.

A deceased patriarch, a misplaced election, or a forgotten form can turn an ordinary intra-family distribution into a taxable event.

The result is work that looks less like tax compliance and more like forensic genealogy.

A regime gone rogue

FTDT was never meant to raise revenue. The explanatory materials are explicit: it was a behavioural measure, not a fiscal one, aimed at preventing loss trafficking.

That objective was achieved long ago, yet FTDT is now producing decades-old liabilities that can be financially ruinous.

Unlike most other taxes, FTDT has no amendment period. A small administrative oversight from the early 2000s can trigger multi-million-dollar debts once interest is added and some exposures have surpassed $100 million.

The quantum of FTDT imposed can – in theory – be greater than the denial of the losses or franking credits that the rules were designed to target, highlighting the disproportionate nature of this tax.

Worse still, the ATO's tax agent portal record-keeping system has been, until recently, incomplete.

Many accountants, unable to locate an election, lodged a new one in good faith only for old records to resurface years later. Since only the first election counts, these well-intentioned corrections have created catastrophic liabilities.

Most affected taxpayers are not the bad actors FTDT was designed to target. They are compliant families and private groups that made honest and inadvertent clerical errors causing distributions to family-controlled entities that were 'outsiders'.

The bigger picture is a human and economic toll

Australia's tax laws were never meant to destroy family wealth or small business viability in one fell swoop.

Yet, some taxpayers now face bankruptcy over long-tail liabilities they, and until recently the ATO, never knew existed. Entire family groups that have operated honestly for decades risk losing everything.

The rules apply indiscriminately: to small passive groups, large operating businesses and major employers.

When an operating business collapses under an unexpected FTDT bill, the consequences ripple outward: employees lose jobs, creditors go unpaid, and the community suffers.

Advisers, too, are paralysed by fear. The risk of professional indemnity claims has turned once-routine compliance work into a minefield.

Small accounting firms may simply stop advising on trusts altogether, creating a widening divide between clients who can afford sophisticated advice and those who cannot, a divide that cuts to the heart of tax fairness.

Shrinking advisory capacity hits hardest where Australia can least afford it: among small and medium enterprises, the backbone of growth and employment.

FTDT has become the worst nightmare of the red-tape costs that policymakers claim to oppose, unnecessarily occupying ATO, court and taxpayer resources.

A practical path forward

FTDT provisions ultimately need rewriting, but two targeted reforms could prevent further harm immediately.

1. The government should pause ATO FTDT reviews or audits for 24 months and suspend compliance resources allocated to this area. This will allow Treasury, the ATO and tax professionals time to consult and design reforms without causing fresh injustices.

2. Short-term legislative fixes are essential and should:

- Introduce a time limit for FTDT amendments for cases not involving fraud or evasion, so taxpayers can draw a line under old years and system resources can be redirected from archaeological audits to current-year compliance.
- Grant the ATO discretion to waive or reduce FTDT where breaches are accidental and promptly rectified, aligning tax penalties with behaviour that justifies it.
- Standardise FTEs and IEEs by requiring digital lodgement with clear validity criteria and introduce a safe harbour for minor defects where intent is evident.
- Allow amendments to FTEs and IEEs where mistakes or unforeseen events lead to inadvertent breaches and ongoing liabilities.
- Create a single documentary 'source of truth' by building a real-time ATO lookup for FTE/IEE status so taxpayers can confirm the validity of elections before making distributions. This is classic red-tape reduction: prevent the error rather than punish it.

These changes would not weaken the guardrails against loss trading or the inappropriate use of franking credits. They simply remove traps that catch compliant taxpayers and waste administrative effort.

Tax policy should support economic activity, not paralyse it. The current FTDT regime erodes trust in the system and punishes those acting in good faith. It undermines confidence in both tax law and the institutions that administer it.

We have fixed flawed provisions before. Now, we must do so again.