New Issues Arising from Trust Distributions

30 November 2022

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Disclaimer

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Trust Distributions

ATO Material

- TR 2022/D1 Section 100A reimbursement agreements
- PCG 2022/D1 Section 100A reimbursement agreements – ATO compliance approach
- TA 2022/1 Parents benefiting from the trust entitlements of their children over 18 years of age
- TD 2022/D1 Division 7A: when will an unpaid present entitlement or amount held on sub-trust become the provision of ;financial accommodation’

TR 2022/D1 – Section 100A reimbursement agreements

ATO view of 4 basic requirements for 100A to apply:

- Connection requirement – there must be a present entitlement (or deemed present entitlement) of a beneficiary to a share of income, which has arisen out of, in connection with, or as a result of a reimbursement agreement;
- Benefit to another requirement – the agreement must provide for a benefit for a person other than that beneficiary (including the payment of money, transfer of property, provision of services or other benefits);
- Tax reduction purpose requirement – a purpose of one or more parties to the agreement must be that a person would be liable to pay less income tax;
- Ordinary dealing exception – the agreement must not be one that has been entered into in the course of 'ordinary family or commercial dealing'.

Connection requirement

48. It follows, from the text of subsections 100A(1) and (2), that for the application of the section there must be an actual or deemed present entitlement for a beneficiary, and the existence of all or part must have the required connection with an identified agreement, arrangement or understanding that is a 'reimbursement agreement'.

12. For an entitlement to arise from (or payment or application to result from) a reimbursement agreement, that agreement must have been in existence prior to the entitlement arising (or before the resulting payment or application of income). However:

- *conduct of the parties before and after that time may be relevant to establishing the existence of an agreement at that time, and*
- *neither the presently entitled beneficiary nor the trustee needs to necessarily be a party to the agreement or even in existence when the agreement is made.*

Benefit to another requirement

15. Despite the label given to 'reimbursement agreements', the payment of money to, transfer of property to or provision of services or other benefits for a person other than the beneficiary alone need not necessarily be a 'reimbursement' as such to meet the requirements of subsection 100A(7). In particular, there is no requirement that the relevant money, property, services or other benefits provided to a person other than the beneficiary alone, be sourced from, equal to or otherwise be referrable to the share of trust income the beneficiary is presently entitled to receive, was paid or that was applied on their behalf.

Tax reduction purpose requirement

18. For there to be a tax reduction purpose, it is not necessary that the person whose tax liability is intended by one of the parties to the agreement to be reduced is themselves a party to the agreement or that a reduction in their tax liability actually be achieved.

19. Where a party acts in accordance with advice from an adviser, the purpose of that adviser can be imputed to the party.

Ordinary dealing exception

An agreement will not be a reimbursement agreement, and therefore not subject to s100A, where the agreement is ‘entered into in the course of ordinary family or commercial dealing’. This phrase is undefined, and limited guidance exists as to what kinds of dealings the phrase refers to.

> *22. The essential feature of ordinary family or commercial dealing is that it is ordinary. Acts undertaken in the course of ordinary family or commercial dealing are capable of explanation by the familial and/or commercial objects they are apt to achieve.*
>
> *23. A dealing is not an ordinary family or commercial dealing merely because it is commonplace or involves no artificiality.*
>
> *25. Whether the agreement was entered into in the course of ordinary dealing is an objective enquiry to be addressed, at least principally, from the perspective (and in the context) of the persons whose purposes are relevant to the operation of section 100A.*

Ordinary dealing exception

87. To explain that acts achieve familial objects without the need for further explanation, a person would need to objectively conclude that the transactions entered into among family members (including via their entities) are adopted as a means to achieve normal or regular familial ends. The characteristics of the dealing, including the circumstances of the parties, the economic and other results of the dealing, and the type of relationship between the parties will be relevant. For example, a dependent child gifting money attributable to a family trust distribution to their parents who could otherwise have been made presently entitled to the trust income would in most cases not have the quality of ordinary dealing.

TR 2022/D1 – Section 100A reimbursement agreements

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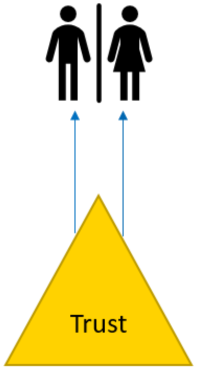
- Tax reduction purpose requirement – a purpose of one or more parties to the agreement must be that a person would be liable to pay less income tax;
- Ordinary dealing exception – the agreement must not be one that has been entered into in the course of 'ordinary family or commercial dealing'.

Consequences of 100A applying

- Beneficiary deemed not to be presently entitled to the share of the trust income
- Does not deem default beneficiaries to be presently entitled
- Trustee assessed on the share of the trust income
- Unlimited amendment period

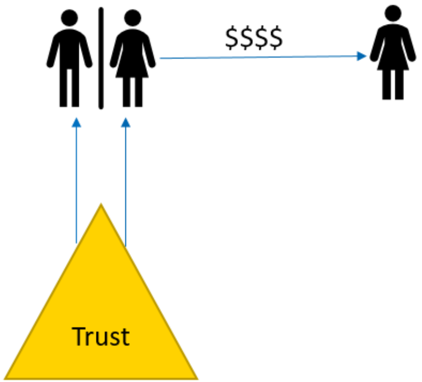
TR 2022/D1 – Example 2



- Rosegum Trust controlled by spouses, Lisa & Matthew
- Lisa and Matthew presently entitled to income in equal proportions
- Lisa and Matthew have shared financial responsibilities and fund lifestyle from common pool of assets

ATO Conclusion:
Usually capable of explanation as achieving ordinary family objects without the need for further explanation

TR 2022/D1 – Example 3



- Rosegum Trust controlled by spouses, Lisa & Matthew
- Lisa and Matthew presently entitled to income in equal proportions
- Lisa and Matthew have shared financial responsibilities and fund lifestyle from common pool of assets
- Daughter, Kate, purchases a property
- Lisa and Matthew pay for the deposit with funds attributable to their distribution from the trust

ATO Conclusion:
A gift for ordinary family purposes, such as a parent contributing to the purchase of a house would usually be capable of explanation as achieving ordinary family objects without the need for further explanation

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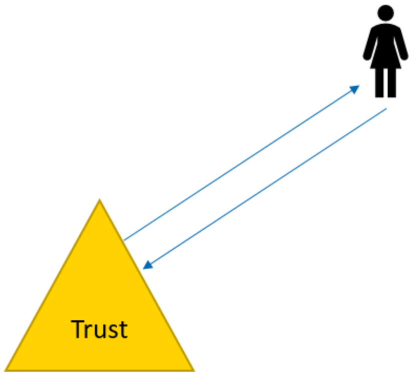
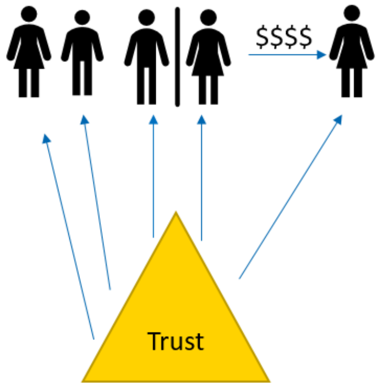
TR 2022/D1 – Example 4



- Trustee of Gallagher Trust makes Pauline presently entitled to trust income
- Pauline is an adult full time student and her trust income is determined based on her not exceeding a particular marginal tax rate
- Pauline gifts her entitlement back to the trustee

ATO Conclusion:
Where Pauline gifts her entitlement back to the trustee each year, it may be reasonable to infer the dealing is not ordinary family or commercial and was instead made to reduce tax.

TR 2022/D1 – Example 6



- Jones Family Trust makes Mr and Mrs Jones and their three kids, Amy, Ben and Claire each presently entitled to 20% of the trust income
- In one year, Mr Jones lends Amy an amount similar to the amount of trust income he is presently entitled, to assist her in moving out of home
- The loan is interest free and requires Amy to pay back the principal when her financial situation permits

ATO Conclusion:
Although the loan is on uncommercial terms, a genuine interest free loan in these circumstances from parent to child because of family relationship is explicable as an arrangement entered into in the course of ordinary dealing

PCG 2022/D1 – Assessing compliance risk

- Intended to assist ATO officers in identifying arrangements to which compliance resources should be applied
- A high risk arrangement means there is a higher chance of being reviewed. It doesn’t necessarily mean that 100A will apply

PCG – Risk Zones

Risk zone	Description and ATO compliance approach
White zone — Low risk	ATO will not commence new compliance activities to consider the application of s100A Arrangements entered into in income years that ended before 1 July 2014, unless it is in the blue zone or red zone **and**: ▪ The ATO are otherwise considering the taxpayer's income tax affairs for those years; ▪ The arrangement continues before and after that date; or ▪ The trust and beneficiary tax returns that were required to be lodged for those years were not lodged before 1 July 2017
Green zone — Low risk	ATO will not dedicate compliance resources to consider the application of s 100A, other than to confirm that the features of the relevant scenario are present in the taxpayer's circumstances. 3 scenarios set out in PCG

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PCG – Risk Zones

Risk zone	Description and ATO compliance approach
Blue zone — Medium risk	Arrangements that do not fall within the white zone, green zone or the red zone are in the blue zone — does not mean that s 100A applies ATO may review arrangement and seek to better understand the arrangement, including whether s 100A applies
Red zone — High risk	Arrangements that attract ATO's attention ATO will dedicate compliance resources to consider the application of 100A ATO will conduct further analysis as a matter of priority — may proceed to audit 6 scenarios set out in PCG

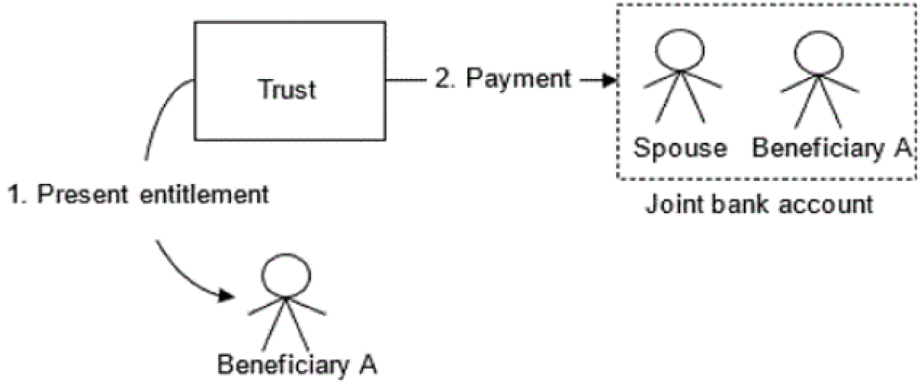
Green Zone

15. We will not dedicate compliance resources to consider the application of section 100A to green zone arrangements, other than to confirm that the features of the relevant scenario are present in your circumstances. If you choose to rely on this Guideline, you should document how your circumstances meet the requirements for the green zone.

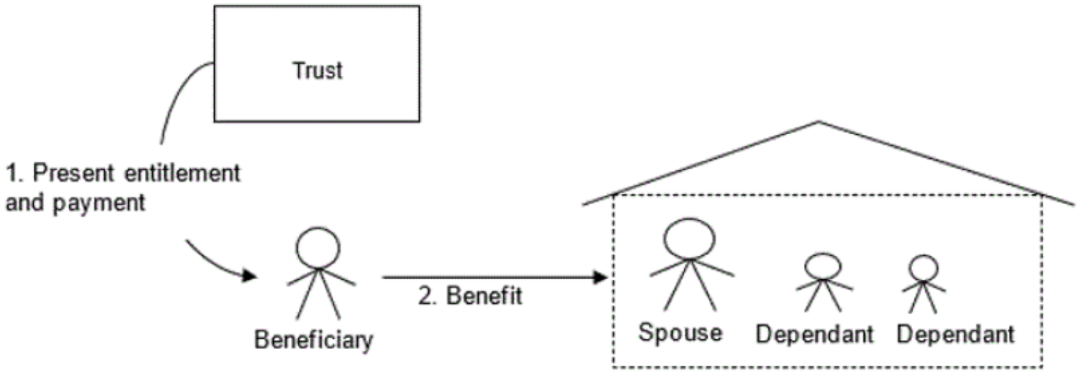
3 Scenarios can be green zone:

- Scenario 1 – certain distributions to individual members of a family
- Scenario 2 - examples described in TR 2022/D1 as being an ordinary dealing
- Scenario 3 - retention of funds by the trustee

Scenario 1 – certain distributions to individual members of a family



Scenario 1 – certain distributions to individual members of a family



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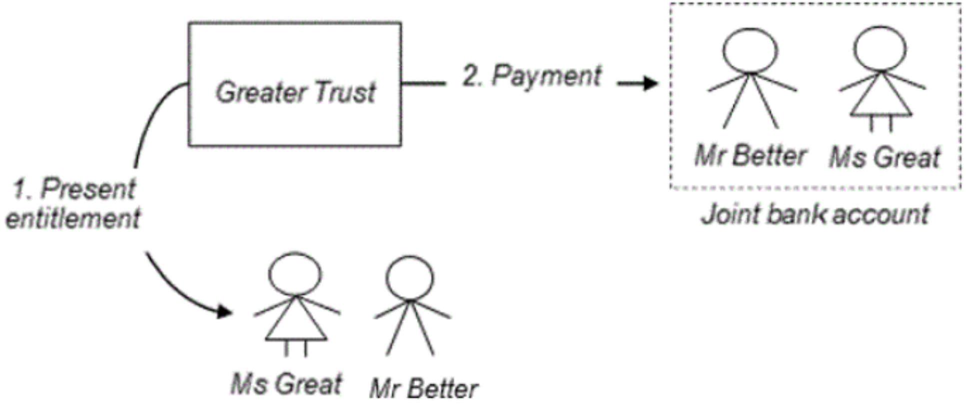


Scenario 2 – examples described in TR 2022/D1 as being an ordinary dealing

- Arrangements that are relevantly identical to an example in TR 2022/D1 which concludes that the arrangement would likely be entered into in the course of ordinary family or commercial dealing

Scenario 3 – retention of funds by the trustee

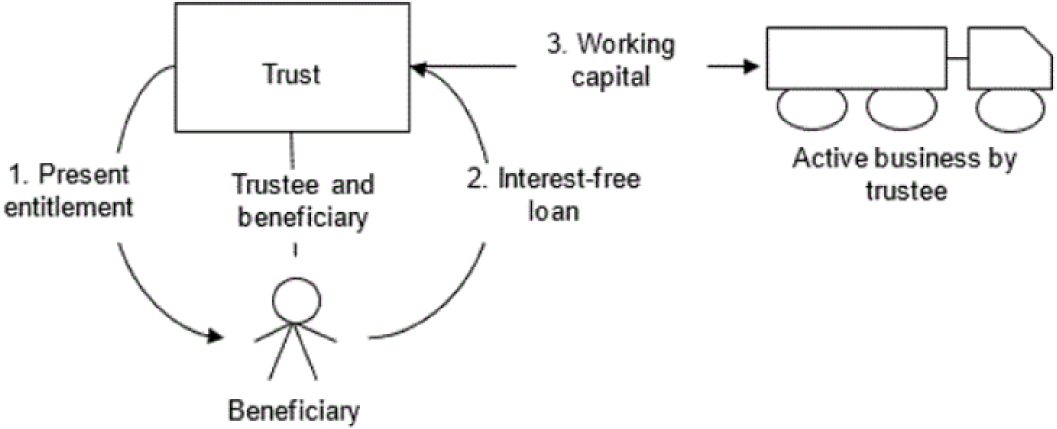
- A beneficiary that is an individual or a private company is made presently entitled to income of the trust estate and there is a 'trustee retention of funds' where all of the following is satisfied:
- the 'use of funds condition'
- none of the following factors are present:
  - Red zone
  - Gifting, disclaimer or forgiveness of their entitlement
  - Income of the trust is less than the net income as a result of trustee exercising certain discretions
  - Certain offset arrangement, such as corporate beneficiary offsetting against a dividend, issuing units in unit trust
  - Tax avoidance
- if that beneficiary is an individual, either
  - the individual and/or their spouse is a trustee of the trust or controls the trustee of the trust
  - the individual is employed in the management of a business that the trustee conducts
- if that beneficiary is a private company
  - the company is controlled by an individual who also controls the trust, and
  - the company's entitlement is made available to the trustee on terms that satisfy section 109N

Scenario 3 – retention of funds by the trustee

- 'Trustee retention of funds' refers to the beneficiary allowing the trustee to retain funds for a period of time or indefinitely that they would otherwise receive in satisfaction of their entitlement. This could be in the form of lending the funds representing their entitlement back to the trustee, or by not yet calling for that entitlement to be satisfied.

- The 'use of funds condition' means that the trustee, as permitted by the trust deed, uses the funds (in its capacity as trustee) that represent the beneficiary's entitlement only
- (i) in the working capital of a business that it actively carries on
- (ii) for the acquisition, maintenance or improvement of investment assets of the trustee, and/or
- (iii) to lend the funds to an associate, on terms that satisfy section 109N, and the associate uses the funds in a way that satisfies either of the criteria above.

Scenario 3 – retention of funds by the trustee



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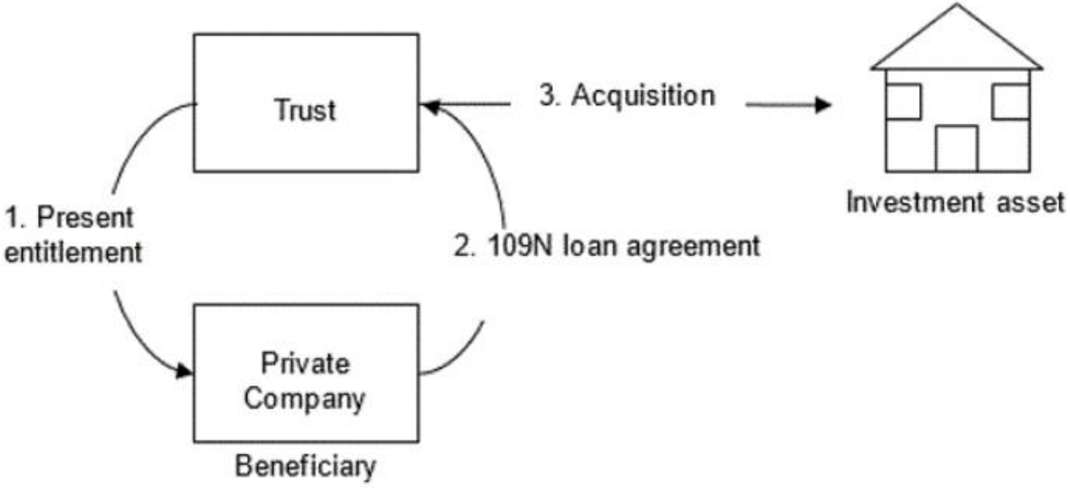

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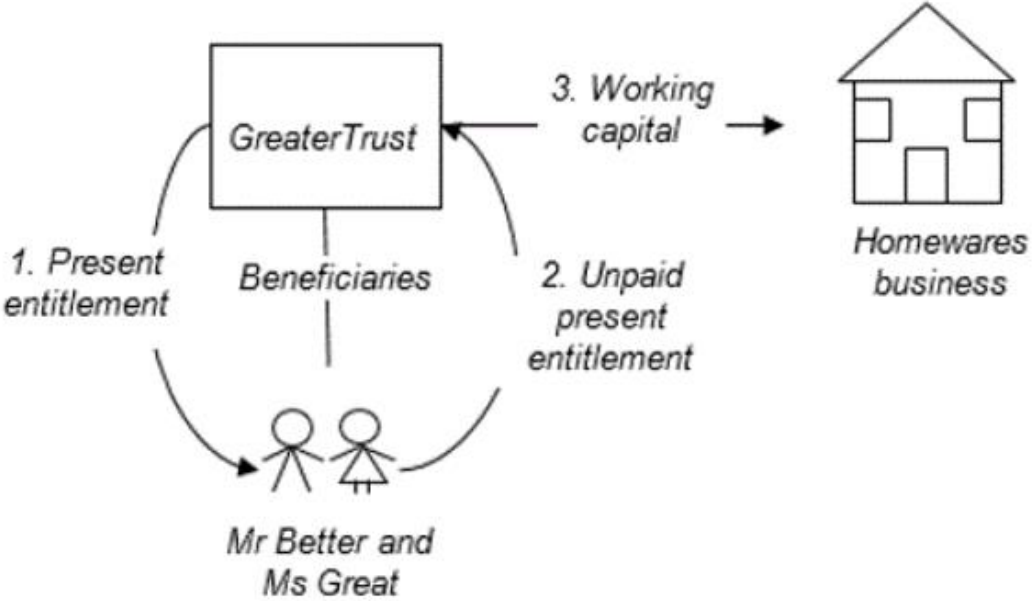


Scenario 1 and 3 – certain distributions to individual members of a family

- Greater Trust carries on a business as a newsagent.
- Danny is aged 18 and is the daughter of Ms Great.
- During the 2022-23 income year, Greater Trust derives income of $150,000 (the trust's net income is also $150,000). On 30 June 2023, the trustee of Greater Trust makes a determination to appoint $18,000 to Danny and 50% of the remainder to each of Ms Great and Mr Better.
- Funds representing Danny's entitlement are paid to her bank account and she subsequently uses them to pay her university fees.
- Ms Great and Mr Better do not call for their entitlements to be satisfied, and funds representing each of their entitlements are retained by the trustee and used in the working capital of the newsagency business.
- The ATO would not dedicate compliance resources to the arrangement in this example, on the basis that:
  - it meets the conditions in green zone scenario 3 of this Guideline in relation to the unpaid entitlements of Ms Great and Mr Better, and
  - Danny enjoys the benefit of her entitlement to trust income.

Blue Zone

25. Arrangements that do not fall within the white zone, green zone or the red zone are in the blue zone.

……..

27. That an arrangement is within the blue zone does not mean that section 100A applies to the arrangement. If you have a blue zone arrangement and are subject to compliance activities, we will engage with you to better understand your arrangement, including whether or not section 100A applies to your arrangement.

Red Zone

- Red zone arrangements are those where the:
  - beneficiaries' entitlements appear to be motivated by sheltering the trust's (taxable) net income from higher rates of tax
  - arrangement involves contrived elements directed at enabling someone other than the presently entitled beneficiary to have use and enjoyment of the economic benefits referable to the trust net income.

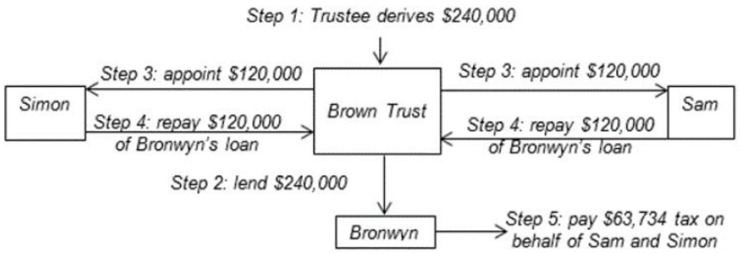
- 6 scenarios:
  - Scenario 1 - arrangements where the presently entitled beneficiary lends or gifts some or all of their entitlement to another party
  - Scenario 2 - arrangements where trust income is returned to the trust by the beneficiary in the form of assessable income
  - Scenario 3 - arrangements where the presently entitled beneficiary is issued units by the trustee (or related trust) and the amount owed for the units is set-off against the beneficiary's entitlement
  - Scenario 4 - arrangements where the share of net income included in a beneficiary's assessable income is significantly more than the beneficiary's entitlement
  - Scenario 5 - arrangements where the presently entitled beneficiary has losses
  - Scenario 6 - arrangements subject to a Taxpayer Alert

Red Zone – Scenario 1

- An individual adult beneficiary is made presently entitled to income of the trust estate and any of the following apply:
  - funds that represent the entitlement are paid to the parent or other caregiver of the beneficiary in connection with expenses incurred by the parent or the caregiver before the beneficiary turned 18 years of age
  - the trustee applies the funds that represent the entitlement against a debit balance account for the beneficiary (for example, an amount recorded in the trust's accounts as a loan) representing expenses incurred by the trustee in respect of the beneficiary before they turned 18 years of age
  - funds that represent the entitlement are made available to the parent or other caregiver of the beneficiary by way of loan or gift
  - the beneficiary is a non-resident and the funds that represent the entitlement are made available to another party by way of loan or gift.

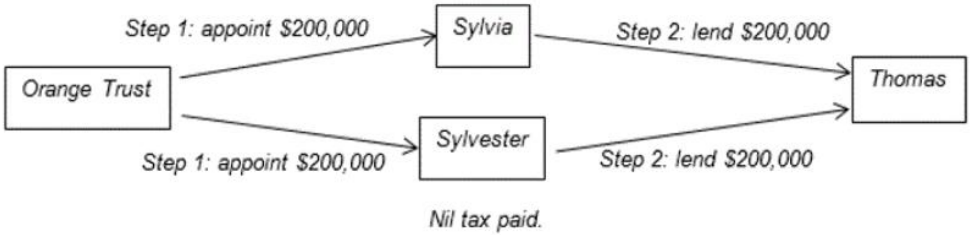
Red Zone – Scenario 1 (example 7 from PCG)

- Bronwyn (Mum), Simon and Sam (Adult children)
- Trust makes regular payments throughout the year to Bronwyn's bank account
- Simon and Sam are made presently entitled to the trust income
- Simon and Sam's entitlements are recorded by the trust as having been fully paid in the accounts of the trust
- Bronwyn assists in the preparation of Simon and Sam's tax returns and pays the tax liability arising in relation to their entitlements from her personal funds.
- Simon and Sam each purportedly have an outstanding debt owed to Bronwyn in respect of education expenses and their share of the Brown household expenses that Bronwyn paid before they each turned 18.



Red Zone – Scenario 1 (example 8 from PCG)

- Thomas (44), his parents are Sylvia (66) and Sylvester (67)
- Sylvia and Sylvester are tax non-residents and reside outside Australia
- Orange Co ATF Orange Trust derives $400,000 income that is comprised of fully franked dividends. The dividends are paid directly into Thomas' bank account. Thomas uses these amounts to meet his personal expenses and mortgage repayments. The trust income paid into Thomas' bank account is recorded as a 'beneficiary loan' in the accounts of Orange Trust
- Orange Co exercises its power to appoint $200,000 income each to Sylvia and Sylvester
- At the time income is appointed to Sylvia and Sylvester, they have agreed to use their entitlements to lend $400,000 to Thomas on interest-free at-call terms.



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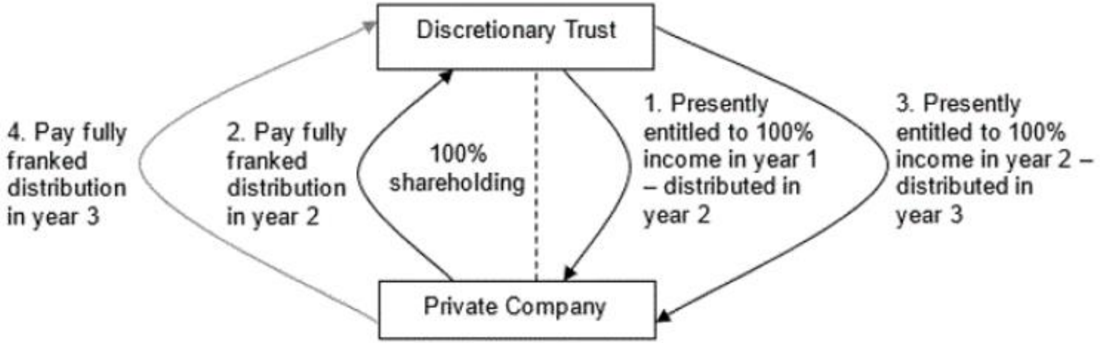
Red Zone – Scenario 2



Red Zone Scenarios

The third scenario considered a “red zone arrangement” is set out below (paragraph 37 of the Draft Guideline):

- *A trustee sets off a beneficiary's unpaid present entitlement (UPE) against an amount the trustee is owed by the beneficiary, being the subscription price for the acquisition of units, and any of the following apply:*
  - *the subscription price of the units is greater than their market value (the market value of the units being determined by reference to the rights and obligations attached to the units and the terms of the trust deed)*
  - *the trust deed provides the trustee with a unilateral right to issue new units in satisfaction of a UPE.*

The fourth scenario considered a “red zone arrangement” is set out below (paragraph 39 of the Draft Guideline):

- The amount of trust net income included in a beneficiary's assessable income is significantly more than the beneficiary's entitlements to income from the trust, and all of the following apply:
  - the difference between the net income and beneficiary's entitlement is the result of contrivance
  - some or all of the amount reflecting that difference has accrued to, or been retained by, an entity other than the presently entitled beneficiary
  - the tax paid by the beneficiary on their share of the trust net income is significantly less than the tax that would have been paid by the entity who accrues or retains the amount, had that entity been assessed on that share of net income instead.

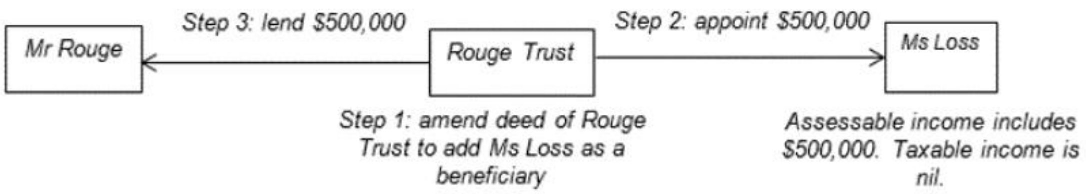
- The ATO have stated that they will not treat an arrangement as being as the result of a contrivance for the above purposes where the difference is merely due to franking credits.

Red Zone – Scenario 5

The fifth scenario considered a “red zone arrangement” is set out below (paragraph 42 of the Draft Guideline):

- A beneficiary's taxable income is less than the trust net income included in the beneficiary's assessable income or the beneficiary's net capital gain is less than the beneficiary's share of trust capital gains, and each of the following applies:
  - a reasonable person would conclude that the beneficiary was made entitled so the beneficiary's deductions or capital losses could be utilised against the trust net income (including trust capital gains)
  - the economic benefit associated with that trust net income is utilised by the trustee or an entity other than the beneficiary.

An exception to this would include where the beneficiary's taxable income is less than the beneficiary's share of the trust net income due to a tax depreciation measure.



Red Zone – Scenario 6

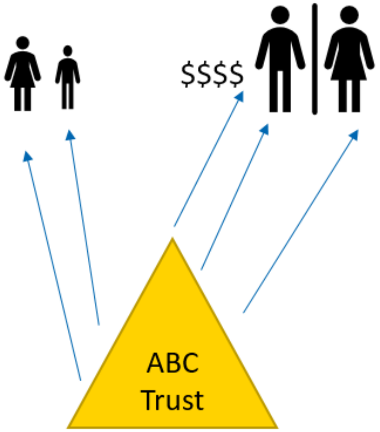
- Arrangements covered by a Taxpayer Alert where the Commissioner expresses a concern that section 100A applies will be considered a red zone arrangement.
- The ATO have issued a taxpayer alert concerning section 100A which is TA 2022/1: Parents benefitting from the trust entitlements of their children over 18 years of age

TA 2022/1 – Parents benefitting from trust entitlements of children

The arrangements covered by TA 2022/1 commonly display the following features:

- The trustees of a discretionary trust (Trust), or the directors of a corporate trustee, are either one or two individuals who are the parents in a particular family (Parents).
- Income derived by the Trust is used to meet the expenses of the Parents. These may be recorded as beneficiary loans made from the trustee to the Parents throughout the year.
- Resolutions of the trustee for the year show one or more of the Children presently entitled to a share of the income of the Trust.
- The entitlements are for substantial amounts but do not generally result in the Children's taxable income exceeding $180,000.
- Amounts are not paid to the Children. The entitlements are satisfied by the amounts being either
  - paid to their Parents, or
  - applied against any beneficiary loans owed by the Parents.
- The parties contend that the entitlements are paid or applied in this manner because
  - the Children are required to repay their Parents for expenses incurred in relation to their upbringing or while they were minors
  - the Children are required to pay or repay their Parents amounts to meet their share of family costs for the current year in excess of amounts it would reasonably be expected an adult child would meet for their personal living expenses while they remain living at home or otherwise supported to some extent by their Parents, or
  - there is an agreement that the Parents will manage the pooled family members' entitlements from the Trust for the benefit of the family members.
- There is no expectation or understanding that the Children's income they derive from sources other than the Trust distributions will be used to either repay their Parents for expenses incurred when they were a minor or pay more than their reasonable share of the household expenditures, or be placed in a pool to be managed by the Parents for the benefit of the family members.

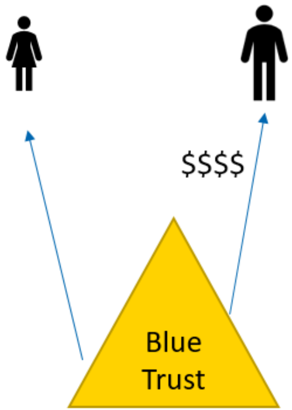
TA 2022/1 – Example 1



- David sole trustee of ABC Trust
- David is married to Rani
- Two children, Jenny (22) and Paul (19)
- Jenny and Paul full time students and earn approx. $12,000 each from casual jobs
- ABC Trust derives $720,000 net income
- Present entitlements: David $200k, Rani $200k, Jenny $160k, Paul 160k
- Jenny and Paul not actually paid any amounts; the amount is transferred to David and Rani's mortgage offset account. Recorded in accounts as fully paid

ATO Conclusion:
David and Rani receive the same economic benefit from that income as if it had been appointed to them directly, but without the amounts being included in their assessable income and subject to tax at a higher marginal tax rate. The arrangement involving the making of the trust distributions and use of those amounts appears to be motivated by the tax outcome achieved rather than ordinary familial objectives.

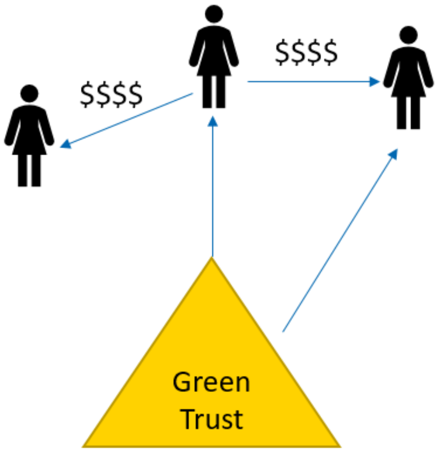
TA 2022/1 – Example 2



- Azure Pty Ltd ATF Blue Family Trust. Trevor sole shareholder and director of Azure
- Trevor’s daughter, Simone (18) works part time and derives approx. $20,000 from that job
- Before EOFY, Simone meets with her father and agrees that any distribution to her, after the payment of tax, will be paid to Trevor to reimburse him for part of her school fees and costs of other extracurricular activities since she was five. Records maintained by the family show this to be $315,000.
- The Trustee resolves to distribute $160,000 to Simone and pays this amount into an account held in Trevor's name. Trevor pays income tax on Simone's behalf.

ATO Conclusion:
The arrangement, which results in Trevor obtaining the economic benefit of the trust income without that income being subject to tax at the top marginal tax rate he would otherwise have paid, appears to be more readily explained by the tax outcomes achieved, rather than any familial objectives.

TA 2022/1 – Example 3



- Mary Green sole trustee of Green Trust
- Mary has a daughter, Genevieve (19) who lives with her grandmother whilst at Uni
- It is agreed between Mary and Genevieve that Genevieve's tuition fees of $20,000 will not have to be met by Genevieve. It is agreed between Genevieve and her grandmother that she will pay $10,000 board
- Genevieve made presently entitled to $40,000, Mary the balance
- $20,000 of the $40,000 that Genevieve is presently entitled to is paid to Mary, who has previously paid the tuition fees as they fell due. $10,000 of that $40,000 is paid directly to the grandmother. The remaining $10,000 is paid to Genevieve, some of which is used to meet her tax obligations on the $40,000.

ATO Conclusion:
Although $30,000 of the $40,000 is not received directly by Genevieve, the $30,000 is applied to repay loans for legitimate expenses that might ordinarily be borne by an adult child and were temporarily met on Genevieve's behalf. The remaining $10,000 was actually received by Genevieve. Accordingly, the concerns raised in this Alert do not arise in arrangements of this type.

TD 2022/D1

- TD 2022/D1 — Income tax: Division 7A: when will a UPE or amount held on sub-trust constitute the provision of ‘financial accommodation’
- TR 2010/3 and PS LA 2010/4 will be withdrawn with effect from 1 July 2022
- Corporate beneficiary with UPE taken to provide financial accommodation (and therefore make a loan to the trustee) if it:
  - consents to the trustee retaining that amount for use for trust purposes;
  - has knowledge of an amount that it can demand immediate payment of from the trustee; and
  - does not demand payment
- Timing:
  - Depends on whether the corporate beneficiary is entitled to a fixed amount distribution, or a percentage
  - A time lag if entitled to a percentage

Some comments on the ATO material

- The need to classify the types of beneficiaries of family trusts:
  - The key individual and their spouse;
  - A range of other family members; and
  - Corporate beneficiaries.
- Quantum of the distributions
- Documentation and explanation of scenario
- Purpose of entities within the group
- Professional practice arrangements
- One off vs repetition

Some comments on the ATO material

- Actual flow of funds vs asserted flow of funds
- A greater use of corporate beneficiaries in the future?
- Family trust by actions, not just by name?
- Non-tax matters e.g.:
  - Are they an eligible beneficiary under the trust deed;
  - Potential impact on Centrelink entitlements of the beneficiary;
  - Asset protection implications of the distributions;
  - Estate planning issues;
  - Other tax issues such as future eligibility for small business CGT concessions (for example who is connected with the trust, whether assets are active assets etc).

We look forward to working with you

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Thank you