

20 June 2022

An open letter to all members

Dear Member,

Section 100A
Distributions for the year ended 30 June 2022

1.0 Introduction

- 1.1 Members have been raising questions about the options available in relation to 2021-22 trust distributions and respective resolutions in respect of adult beneficiaries, having regard to the draft guidance material released on 23 February 2022 by the Australian Taxation Office (ATO), (Draft Taxation Ruling TR 2022/D1, PCG 2022/D1 and Draft Taxation Determination TD 2022/D1- the 'February Draft Guidance') and the subsequent pronouncements made by both the government and the ATO.
- 1.2 By this letter we will explore what those options are, and the risks attached to each option.
- 1.3 Please note, this is no more than general advice and it remains incumbent on practitioners to exercise their own professional judgement, having regard to the individual circumstances of their clients and their own interpretation of the February Draft Guidance.
- 1.4 The discussion that follows will focus on present entitlements appointed to adult beneficiaries. All references made are to the Income Tax Assessment Act 1936.

2.0 Executive Summary

Options for the 2022 Income year – Adult Beneficiaries.

2.1 Option 1

Distribute all income to the controlling individuals involved in managing the business.

Option 1 is to avoid distributing to young adult beneficiaries, and instead distribute all trust income to 'Mum and Dad' who are running the business. If needed, some or all of

the present entitlement to income can be reinvested in the business without attracting s 100A.

This option can extend to distributing trust income to **adult beneficiaries of the family, but only where they have a management role** in the business conducted by the trust.

This is a low-risk option, but one that potentially loses the tax benefit of allocating trust income among other family members and is likely to result in a higher tax liability for the family as a whole.

2.2 **Option 2**

Make distributions to adult beneficiaries for their unfettered personal use.

The ATO has confirmed that s 100A will not apply where the present entitlement to trust income is paid to a young adult beneficiary and used for his/her benefit. From the ATO's perspective, the amount cannot be lent back or gifted to the trustee, or to controlling individuals or any associated entities.

Practitioners may wish to keep a record of how the funds are used by the adult beneficiary in instances where the ATO has questions. This is particularly so where the funds may be used by the beneficiary over an extended period of time (e.g. personal mortgage payments).

Whilst it is arguable whether the distribution of the economic benefit is made to a young adult beneficiary with 'no strings attached', it is generally the case that such pattern of distribution is not favoured by 'Mum and Dad' trustees, in spite of the tax savings legitimately available. As such, this is not likely to be an option chosen by many family businesses.

2.3 **Option 3**

Use of a corporate beneficiary.

Distributions which might otherwise have been appointed to young adult beneficiaries who are not involved in managing the business could instead be directed to a corporate beneficiary (sometimes referred to as a "bucket company").

This limits the income tax in respect of the distributed amount to 30%, assuming the company is not a Base Rate Entity, or 25% if it is. Where the present entitlement (less the company tax due) is lent back to the trust under a complying Division 7A loan agreement, the ATO has indicated that s 100A will not apply. The use of a corporate

beneficiary in this way may create some flexibility around dividend payments in future years.

2.4 **Option 4**

Make distributions to adult beneficiaries but retain an after-tax amount in trust as a UPE.

This is a somewhat more aggressive option which relies on the assurances given by the government and the ATO with regard to the current ATO view of the law. That is, section 100A will not apply where taxpayers have placed reliance **in good faith** on the 2014 guidance (that s 100A does not apply to their arrangements). Given the lack of conciseness in the 2014 guidance this position is an arguable position to adopt, although it is not certain the ATO would necessarily accept the outcome.

Where there are young adult beneficiaries in their capacity to benefit from a distribution, and depending on the quantum of trust income, adopting this approach could result in significant tax savings for the family (see discussion at paragraph 8.0 for comparative numerical example).

If you have any questions in relation to this open letter, please contact Phillip London on 0400 819 698 or p.london@taxandsuperaustralia.com.au

Yours Faithfully,

A handwritten signature in black ink, appearing to be 'P. London', written over a horizontal line.

Phillip London
Head of Tax

3.0 Detailed Discussion

3.1 Going forward - beneficiaries should benefit

3.2 The ATO's position as stated in the February Draft Guidance with regard to the function of s 100A going forward is as follows:

- Where a beneficiary receives and enjoys their present entitlement to trust income, s 100A will have no role to play.
- Where another person receives a payment or a benefit in relation to a present entitlement to trust income, and there was a purpose that someone pays less tax, there may be a reimbursement agreement and the provision can apply.
- In this instance, the beneficiary is then taken never to have been entitled to the distribution and the trustee is assessed under s 99A.
- There is an exclusion for ordinary family dealings which the ATO has read down in its February Draft Guidance.

4.0 Date of effect

4.1 The February Draft Guidance will not apply to trust income entitlements conferred before 1 July 2022 where it is concluded by the taxpayer (or their representative), that the outcome for taxpayers would have been more favourable as applied, under ATO website guidance published in July 2014 [at para 47, PCG 2022/D1] when compared to the respective guidance as issued by the ATO.

4.2 On 7 April 2022, then Assistant Treasurer Michael Sukkar issued a media Release confirming that any changes in this area would not apply retrospectively:

"Confirmation that taxpayers can continue to rely on the 2014 guidance for matters that arose while that guidance was in place will be welcomed by small businesses who in **good faith** followed this guidance."

4.3 On 5 May 2022, Deputy Commissioner Clarke sought to further reassure taxpayers and their advisers by way of a Media Release which stated, among other things:

"The ATO will not be pursuing taxpayers that entered into arrangements between 1 July 2014 and 30 June 2022 where, in good faith, they concluded that section 100A did not apply to them based on the previous 2014 guidance.", and

“... we won’t have a retrospective element. We stand by our 2014 guidance for this interim period”

<https://ministers.treasury.gov.au/ministers/michael-sukkar-2019/media-releases/certainty-and-stability-family-trusts>

4.4 We understand that Labor’s Shadow Assistant Treasurer Stephen Jones has expressed support for the notion that the ATO’s view of the law reflected in its February Draft Guidance should not apply retrospectively.

4.5 The ATO Media Release of 5 May 2022 does make it clear that,

- Section 100A would apply to an entitlement received by a full-time student who immediately gifts the entitlement back to the trustee.
- There is no role for s 100A where the beneficiary benefits from the distribution.
- Further, there is no role for s 100A where a family member who has a management role in the business chooses to reinvest in the business conducted by the trust.

5.0 What does relying on the 2014 guidance actually mean?

5.1 While these assurances from the Assistant Treasurer, the Shadow Assistant Treasurer, and the ATO are helpful, both Media Releases place some degree of pressure on the meaning of the 2014 guidance.

5.2 Unfortunately, the guidance material is not as tightly drafted as one might like and it could well be taken to mean different things to different users. This in turn places even greater pressure on the meaning of the Assistant Treasurer and the Deputy Commissioner when they discuss taxpayers relying on the 2014 guidance in ‘good faith’ in concluding that s 100A did not apply to them.

6.0 What’s in the 2014 guidance?

6.1 The 2014 guidance incorporates only a brief analysis of the law, including the meaning of ‘benefit’ and ‘agreement’, as well as some comments about the ordinary family or commercial dealing exception. However, ATO websites are not usually the place where the Commissioner explains the law in detail – that is mainly done by way of taxation rulings and determinations.

6.2 There are five examples in the 2014 guidance, three of which describe circumstances where s 100A would not apply and two where in the ATO's view it would. This immediately begs the question:

1. Do you have to show that you did what the 2014 guidance said was acceptable?
2. Are the examples intended to create a general impression, or an overview, of how the ATO might or might not, apply s 100A?

7.0 Example 1 and Example 4 in 2014 guidance

7.1 **Example 1** is a fact situation and a commonly encountered instance where s 100A would in the ATO's view apply, and involves a presently entitled beneficiary not receiving their appointed trust income. Instead, the money is loaned or gifted to another person.

7.2 **Example 1** in the ATO's view, amounts to a reimbursement agreement since there is an intention that the presently entitled beneficiary pays a lower amount of tax than the person who actually enjoys the economic benefits of the trust income (who may be the trustee of the discretionary trust or one or more of the controlling individuals - the example is silent on this point).

7.3 Importantly, Example 1 goes on to say that the presently entitled beneficiary may pay less (or no) tax because it:

- is a tax exempt entity;
- is a foreign resident and the trust net income includes foreign source income or income subject to Australian withholding tax;
- has tax losses or excess deductions or capital losses, or
- **is otherwise subject to a lower rate of tax.**

7.4 A young adult beneficiary with no other sources of assessable income is subject to exactly the same rate of tax as any other adult Australian resident. They pay less tax because they have less income, not because they are "otherwise subject to a lower rate of tax". Taken together with the fact that young adult beneficiaries are not specifically referred to in Example 1, it seems logical to conclude that the example was not intended to apply to a young adult beneficiary such as a resident full-time university student who is not an exempt entity nor has accrued losses. If the example was intended to apply to such a beneficiary it can be assumed that the ATO would have said so.

7.5 The alternative view of Example 1 is that an unpaid distribution made to an adult beneficiary is caught since they pay:

“a lower amount of tax than would have been payable by the person who actually enjoyed the economic benefits of that income.”

- 7.6 However, that interpretation is inconsistent with the ensuing examples of why the beneficiary pays less (or no) tax – a tax-exempt entity; a foreign resident or a loss entity.

7.7 Example 4

- 7.8 Example 4 would appear to provide for the instance in which trustees appoint a beneficiary to trust income, over a number of income years, and do not distribute the associated ‘cash’ in relation to the entitlement resulting in the unpaid entitlements accumulating in the trust.

- 7.9 The trustee then provides a loan to the principal beneficiary of the trust on commercial terms.

- 7.10 Prima facie, the example would appear to provide a basis for a trustee to appoint young adult beneficiaries without cash entitlement.

- 7.11 Example 4 states as follows:

The Charlene Family Trust is a discretionary trust controlled by Charlene and administered for the benefit of Charlene and her family.

Each year, the trust makes a range of individual Australian-resident beneficiaries presently entitled to trust income. Typically, the entitlements remain unpaid, except for sufficient cash to enable the beneficiaries to pay tax on their share of the trust's net income.

This pattern continues for several years, with unpaid balances building up over time. The trustee lends the remaining cash to Charlene on commercial terms, requiring the payment of principal and interest over time.

In the absence of other factors, the ATO would not seek to apply section 100A to this arrangement.

- 7.12 In comparing Example 4 and the respective ATO guidance issued in the February Draft Guidance, material questions need to be addressed to confirm whether the 2014 guidance is more favourable to the taxpayer including the following:
- The factual background does not state the marginal income tax rates of the beneficiaries.
 - The factual matter states that it is a discretionary trust for the benefit of Charlene's family. It further states that distributions are made to 'Australian-resident' beneficiaries. Whilst presumably the beneficiaries as stated are members of Charlene's family given the purpose of the trust, it is not clear that such is the case.
 - No factual matter is provided in relation to the accumulation of the unpaid balances. For example, are the balances invested on sub trust for the beneficiaries? Are they utilised in the working capital of the family trust during the period prior to the lending of the funds to Charlene?
 - The trustee lends to Charlene on commercial terms. Are the funds held by the trustee and provided to Charlene as a beneficiary of the trust been the subject of distributions to the beneficiaries (other than Charlene) in which those beneficiaries are on lower marginal tax rates than Charlene?
 - The example provides a favourable outcome to the trustee and the beneficiaries 'in the absence of other factors'. What are those factors?
- 7.13 in summary, the 2014 guidance is far from clear. It is quite open to a reasonable person acting in good faith to conclude that Example 1 and Example 4 were not intended to apply to a distribution made to a young adult beneficiary. While the ATO might take a different view about the meaning and intent of the 2014 guidance, that does not mean that some taxpayers will not have relied on the 2014 guidance in **good faith** in concluding that s.100A did not apply to their circumstances.
- 7.14 This opinion in respect of the reliance of 'good faith' in applying the 2014 Guidance, is enhanced when considering the lack of compliance activity and subsequent direction by the ATO in relation to such distribution patterns made by trustees to adult beneficiaries since 2014.

8.0 Example Distribution

No detriment where cash distribution is not made to adult beneficiary by Trustee

- 8.1 As an example, a family business conducted by Mum and Dad through a discretionary trust in which there are the following facts:
- Trust income (equal to taxable income) of \$560,000.
 - They have 19-year-old twins who are full-time university students with no other income.
 - Mum and Dad take a distribution of \$180,000 each.
 - Leaving the balance of \$200,000 to either be added to their own distributions or distributed to the twins.
- 8.2 The tax outcomes are as follows:
- Tax plus the Medicare Levy on \$100,000 for an individual with no other income is approximately \$25,000, or \$50,000 on the \$200,000 if making distributions to the twins.
 - This compares to \$94,000 at the top marginal rate if the \$200,000 balance of trust income is distributed to Mum and Dad – a difference of \$44,000.
 - Mum and Dad decide to distribute \$100,000 to each of the twins. Those amounts are left in the trust to help provide finance for the business, although the trustee provides the twins with the funds they require to pay their tax liability of \$25,000 each.
- 8.3 Notwithstanding the various assurances given, the ATO may review the pattern of distributions and determine that s 100A applies to the distributions made to the twins since a person other than the twins themselves have benefited from their distributions (the trustee of the trust).
- 8.4 The twins would be treated as if they had never been entitled to their \$100,000 distributions and the trustee would be assessed on \$200,000 at the top marginal rate.
- 8.5 This is exactly the same primary tax outcome that would obtain if Mum and Dad had increased their respective distributions by \$100,000 each.
- 8.6 The potential downside might be where the ATO decides to impose penalties on the trustee in respect of the s 99A assessment. While there is no practical direction with respect to the imposition of penalties, it is difficult to see any sort of penalty surviving a challenge, given the assurances given about retrospectivity and reliance in good faith on the 2014 guidance.

- 8.7 For a potential tax saving of \$44,000, a lot of trustees as 'Mums and Dads' might be prepared to risk the position with the ATO. After all, they are already potentially at risk in relation to their 2020-21 and earlier distributions to adult beneficiaries unless they can say they relied in good faith on the 2014 guidance. The transitional concession is clearly intended to apply to appointments of trust income made up to and including 30 June 2022.

9.0 Ordinary family dealings exception

- 9.1 It should not be forgotten that the Federal Court decision at first instance in the Guardian case (Logan J), held that something is an ordinary family dealing unless it has an element of artificiality.
- 9.2 While the Commissioner has appealed against that decision (as is his right), the ruling by Logan J represents the law of the land, at least for now. It seems unlikely there will be decision by the Full Court until after 30 June 2022, which provides further support for making a distribution to adult beneficiaries in respect of the 2021-22 income year. In our view, there is nothing 'artificial' about young adult beneficiaries who are the children of the controlling individuals not calling for payment of their present entitlement and instead leaving it in the trust as working capital for the financial benefit of the family.

10.0 Going forward

- 10.1 In our view, s 100A is an anachronistic throw-back to the wild bottom of the harbour days which is an inappropriate sanction to apply to what most practitioners and their clients regard as normal and unexceptional trust distribution practices which have not been challenged by the Commissioner in more than 40 years. T&SA will be approaching the new government to discuss whether the provision should be modified or abolished altogether.
- 10.2 In the meantime, practitioners and their clients have challenging decisions to make about 2021-22 distributions.