MARCH 2022

Momentum Knowledge Newsletter

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THE ATO'S ATTACK ON TRUSTS AND TRUST DISTRIBUTIONS

Late last month, the Australian Taxation Office (ATO) released a package of new guidance material that directly targets how trusts distribute income. Many family groups will pay higher taxes (now and potentially retrospectively) as a result of the ATO's more aggressive approach.

FAMILY TRUST BENEFICIARIES AT RISK

The tax legislation contains an integrity rule, section 100A, which is aimed at situations where income of a trust is appointed in favour of a beneficiary but the economic benefit of the distribution is provided to another individual or entity. If trust distributions are caught by section 100A, then this generally results in the trustee being taxed at penalty rates rather than the beneficiary being taxed at their own marginal tax rates.

The latest guidance suggests that the ATO will be looking to apply section 100A to some arrangements that are commonly used for tax planning purposes by family groups. The result is a much smaller boundary on what is acceptable to the ATO which means that some family trusts are at risk of higher tax liabilities and penalties.

ATO redrawing the boundaries of what is acceptable

Section 100A has been around since 1979 but to date, has rarely been invoked by the ATO except where there is obvious and deliberate trust stripping at play. However, the ATO's latest guidance suggests that the ATO is now willing to use section 100A to attack a wider range of scenarios.

MOMENTUM FINANCIAL GROUP

There are some important exceptions to section 100A, including where income is appointed to minor beneficiaries and where the arrangement is part of an ordinary family or commercial dealing. Much of the ATO's recent guidance focuses on whether arrangements form part of an ordinary family or commercial dealing. The ATO notes that this exclusion won't necessarily apply simply because arrangements are commonplace or they involve members of a family group. For example, the ATO suggests that section 100A could apply to some situations where a child gifts money that is attributable to a family trust distribution to their parents.

The ATO's guidance sets out four 'risk zones' – referred to as the white, green, blue and red zones. The risk zone for a particular arrangement will determine the ATO's response:

White zone

This is aimed at pre-1 July 2014 arrangements. The ATO will not look into these arrangements unless it is part of an ongoing investigation, for arrangements that continue after this date, or where the trust and beneficiaries failed to lodge tax returns by 1 July 2017.

Green zone

Green zone arrangements are low risk arrangements and are unlikely to be reviewed by the ATO, assuming the arrangement is properly documented. For example, the ATO suggests that when a trust appoints income to an individual but the funds are paid into a joint bank account that the individual holds with their spouse then this would ordinarily be a low-risk scenario. Or, where parents pay for the deposit on an adult child's mortgage using their trust distribution and this is a one-off arrangement.

Blue zone

Arrangements in the blue zone might be reviewed by the ATO. The blue zone is basically the default zone and covers arrangements that don't fall within one of the other risk zones. The blue zone is likely to include scenarios where funds are retained by the trustee, but the arrangement doesn't fall within the scope of the specific scenarios covered in the green zone.

Section 100A does not automatically apply to blue zone arrangements, it just means that the ATO will need to be satisfied that the arrangement is not subject to section 100A.

Red zone

Red zone arrangements will be reviewed in detail. These are arrangements the ATO suspects are designed to deliberately reduce tax, or where an individual or entity other than the beneficiary is benefiting.

High on the ATO's list for the red zone are arrangements where an adult child's entitlement to trust income is paid to a parent or other caregiver to reimburse them for expenses incurred before the adult child turned 18. For example, school fees at a private school. Or, where a loan (debit balance account) is provided by the trust to the adult child for expenses they incurred before they were 18 and the entitlement is used to pay off the loan. These arrangements will be looked at closely and if the ATO determines that section 100A applies, tax will be applied at the top marginal rate to the relevant amount and this could apply across a number of income years.

The ATO indicated that circular arrangements could also fall within the scope of section 100A. For example, this can occur when a trust owns shares in a company, the company is a beneficiary of that trust and where income is circulated between the entities on a repeating basis. For example, section 100A could be triggered if:

- The trustee resolves to appoint income to the company at the end of year 1.
- The company includes its share of the trust's net income in its assessable income for year 1 and pays tax at the corporate rate.
- The company pays a fully franked dividend to the trustee in year 2, sourced from the trust income, and the dividend forms part of the trust income and net income in year 2.
- The trustee makes the company presently entitled to some or all of the trust income at the end of year 2 (which might include the franked distribution).
- These steps are repeated in subsequent years.

Distributions from a trust to an entity with losses could also fall within the red zone unless it is clear that the economic benefit associated with the income is provided to the beneficiary with the losses. If the economic benefit associated with the income that has been appointed to the entity with losses is utilised by the trust or another entity then section 100A could apply.

Who is likely to be impacted?

The ATO's updated guidance focuses primarily on distributions made to adult children, corporate beneficiaries, and entities with losses. Depending on how arrangements are structured, there is potentially a significant level of risk. However, it is important to remember that section 100A is not confined to these situations.

Distributions to beneficiaries who are under a legal disability (e.g., children under 18) are excluded from these rules.

For those with discretionary trusts it is important to ensure that all trust distribution arrangements are reviewed in light of the ATO's latest guidance to determine the level of risk associated with the arrangements. It is also vital to ensure that appropriate documentation is in place to demonstrate how funds relating to trust distributions are being used or applied for the benefit of beneficiaries.

COMPANIES ENTITLED TO TRUST INCOME

As part of the broader package of updated guidance targeting trusts and trust distributions, the ATO has also released a draft determination dealing specifically with unpaid distributions owed by trusts to corporate beneficiaries. If the amount owed by the trust is deemed to be a loan then it can potentially fall within the scope of another integrity provision in the tax law, Division 7A.

Division 7A captures situations where shareholders or their related parties access company profits in the form of loans, payments or forgiven debts. If certain steps are not taken, such as placing the loan under a complying loan agreement, these amounts can be treated as deemed unfranked dividends for tax purposes and taxable at the taxpayer's marginal tax rate.

The latest ATO guidance looks at when an unpaid entitlement to trust income will start being treated as a loan. The treatment of unpaid entitlements to trust income as loans for Division 7A purposes is not new. What is new is the ATO's approach in determining the timing of when these amounts start being treated as loans. Under the new guidance, if a trustee resolves to appoint income to a corporate beneficiary, then the time the unpaid entitlement starts being treated as a loan will depend on how the entitlement is expressed by the trustee (e.g., in trust distribution resolutions etc):

- If the company is entitled to a fixed dollar amount of trust income the unpaid entitlement will generally be treated as a loan for Division 7A purposes in the year the present entitlement arises; or
- If the company is entitled to a percentage of trust income, or some other part of trust income identified in a calculable manner, the unpaid entitlement will generally be treated as a loan from the time the trust income (or the amount the company is entitled to) is calculated, which will often be after the end of the year in which the entitlement arose.

This is relevant in determining when a complying loan agreement needs to be put in place to prevent the full unpaid amount being treated as a deemed dividend for tax purposes when the trust needs to start making principal and interest repayments to the company.

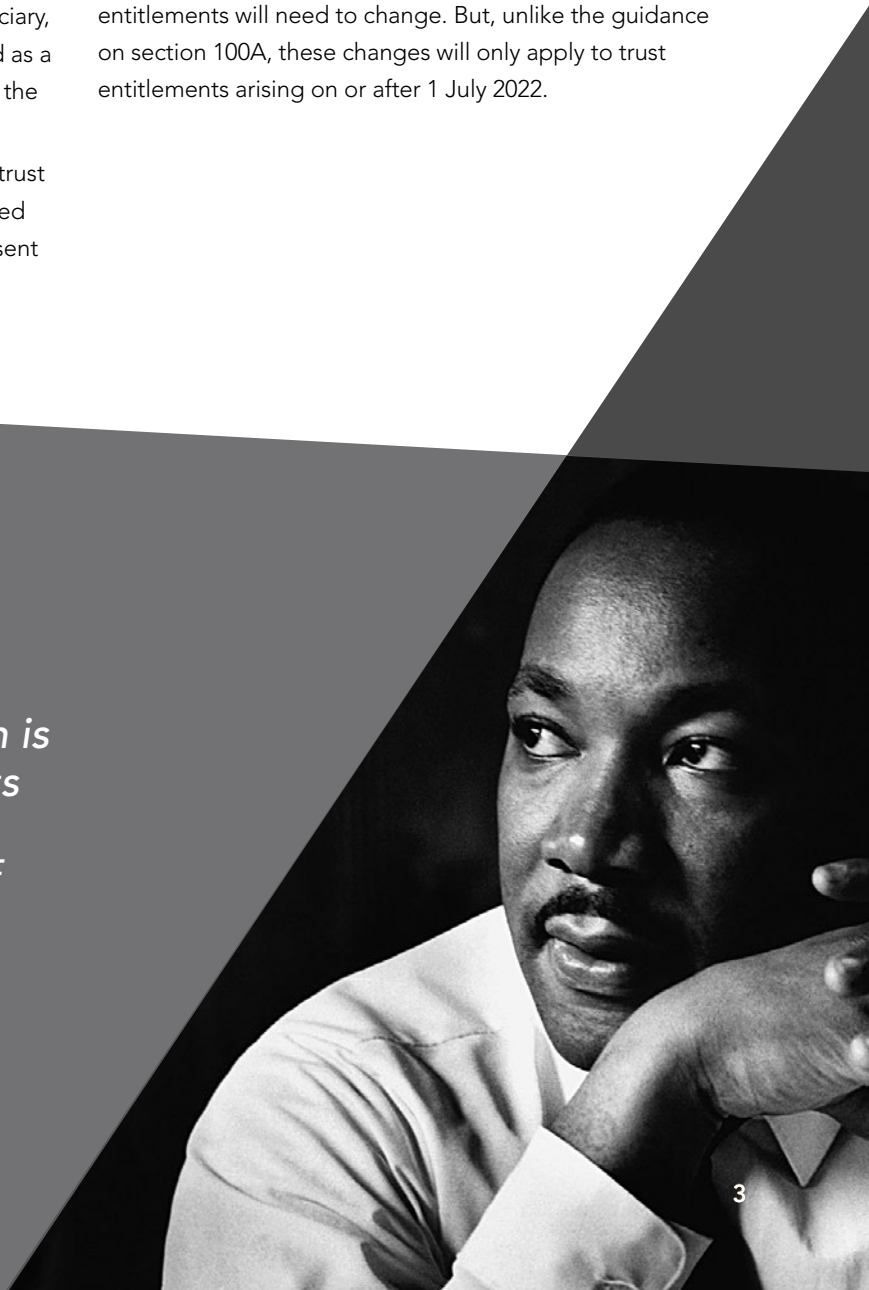
The ATO's views on "sub-trust arrangements" has also been updated. Basically, the ATO is suggesting that sub-trust arrangements will no longer be effective in preventing an unpaid trust distribution from being treated as a loan for Division 7A purposes if the funds are used by the trust, shareholder of the company or any of their related parties.

The new guidance represents a significant departure from the ATO's previous position in some ways. The upshot is that in some circumstances, the management of unpaid entitlements will need to change. But, unlike the guidance on section 100A, these changes will only apply to trust entitlements arising on or after 1 July 2022.

QUOTE OF THE MONTH

"The ultimate measure of a man is not where he stands in moments of comfort and convenience, but where he stands at times of challenge and controversy."

Martin Luther King, Jr.



IMMEDIATE DEDUCTIONS EXTENDED

Temporary full expensing enables your business to fully expense the cost of:

- new depreciable assets
- improvements to existing eligible assets, and
- second hand assets

in the first year of use.

Introduced in the 2020-21 Budget and now extended until 30 June 2023, this measure enables an asset's cost to be fully deductible upfront rather than being claimed over the asset's life, regardless of the cost of the asset. Legislation passed by Parliament last month extends the rules to cover assets that are first used or installed ready for use by 30 June 2023.

Some expenses are excluded including improvements to land or buildings that are not treated as plant or as separate depreciating assets in their own right. Expenditure on these improvements would still normally be claimed at 2.5% or 4% per year.

For companies it is important to note that the loss carry back rules have not as yet been extended to 30 June 2023 – we're still waiting for the relevant legislation to be passed. If a company claims large deductions for depreciating assets in a particular income year and this puts the company into a loss position then the tax loss can generally only be carried forward to future years. However, the loss carry back rules allow some companies to apply current year losses against taxable profits in prior years and claim a refund of the tax that has been paid. At this stage the loss carry back rules are due to expire at the end of the 2022 income year, but we are hopeful that the rules will be extended to cover the 2023 income year as well.

FEDERAL BUDGET 2022-23

The Federal Budget has been brought forward to 29 March 2022. With the pandemic and the war in Ukraine we have seen a lot less commentary this year about what to expect in the Budget. But, as an election budget, we typically expect to see a series of measures designed to boost productivity, many of which are likely to benefit businesses willing to invest in the future. Bolstering the workforce, and measures to increase the participation of women, is also a potential feature as Australia struggles with post pandemic worker shortages. Fiscally, the Budget is likely to be in a better position than expected in previous Budgets so there is more in the Government coffers to spend on initiatives. Look out for our update on the important issues the day after the Budget is released.

ARE YOUR CONTRACTORS REALLY EMPLOYEES?

Two landmark cases before the High Court highlight the problem of identifying whether a worker is an independent contractor or employee for tax and superannuation purposes.

Many business owners assume that if they hire independent contractors they will not be responsible for PAYG withholding, superannuation guarantee, payroll tax and workers compensation obligations. However, each set of rules operates a bit differently and in some cases genuine contractors can be treated as if they were employees. Also, correctly classifying the employment relationship can be difficult and there are significant penalties faced by businesses that get it wrong.

Two cases handed down by the High Court late last month clarify the way the courts determine whether a worker is an employee or an independent contractor. The High Court confirmed that it is necessary to look at the totality of the relationship and use a 'multifactorial approach' in determining whether a worker is an employee. That is, if it walks like a duck and quacks like a duck, it's probably a duck, even if on paper, you call it a chicken.

In CFMMEU v Personnel Contracting and ZG Operations Australia v Jamse, the court placed a significant amount of weight on the terms of the written contract that the parties had entered into. The court took the approach that if the written agreement was not a sham and not in dispute, then the terms of the agreement could be relied on to determine the relationship. However, this does not mean that simply calling a worker an independent contractor in an agreement classifies them as a contractor. In this case, a labour hire contractor was determined to be an employee despite the contract stating he was an independent contractor.

In this case, Personnel Contracting offered the labourer a role with the labour hire company. The labourer, a backpacker with some but limited experience on construction sites, signed an Administrative Services Agreement (ASA) which described him as a "self-employed contractor." The labourer was offered work the next day on a construction site run by a client of Personnel Contracting, performing labouring tasks at the direction of a supervisor employed by the client. The labourer worked on the site for several months before leaving the state. Some months later, he returned and started work at another site of the Personnel Contracting's same client. The question before the court was whether the labourer was an employee.

Overturning a previous decision by the Full Federal Court, the High Court held that despite the contract stating the labourer was an independent contractor, under the terms of the contract, the labourer was required to work as directed by the company and its client. In return, he was entitled to

be paid for the work he performed. In effect, the contract with the client was a "contract of service rather than a contract for services", as such the labourer was an employee.

The second case, ZG Operations Australia v Jamse produced a different result.

In this case, two truck drivers were employed by ZG Operations for nearly 40 years. In the mid-1980's, the company insisted that it would no longer employ the drivers, and would continue to use their services only if they purchased their trucks and entered into contracts to carry goods for the company. The respondents agreed to the new arrangement and Mr Jamsek and Mr Whitby each set up a partnership with their wife. Each partnership executed a written contract with the company for the provision of delivery services, purchased trucks from the company, paid the maintenance and operational costs of those trucks, invoiced the company for its delivery services, and was paid by the company for those services. The income from the work was declared as partnership income for tax purposes and split between each individual and their wife.

Overturning a previous decision in the Full Federal Court, the High Court held that the drivers were not employees of the company.

Consistent with the decision in the Personnel Contracting case, a majority of the court held that where parties have comprehensively committed the terms of their relationship to a written contract (and this is not challenged on the basis that it is a sham or is otherwise ineffective under general law or statute), the characterisation of the relationship must be determined with reference to the rights and obligations of the parties under that contract.

After 1985 or 1986, the contracting parties were the partnerships and the company. The contracts between the partnerships and the company involved the provision by the partnerships of both the use of the trucks owned by the partnerships and the services of a driver to drive those trucks. This relationship was not an employment relationship. In this case the fact that the workers owned and maintained significant assets that were used in carrying out the work carried a significant amount of weight.

For employers struggling to work out if they have correctly classified their contractors as employees, it will be important to review the agreements to ensure that the "rights and obligations of the parties under that contract" are consistent with an independent contracting arrangement. Merely labelling a worker as an independent contractor is not enough if the rights and obligations under the agreement are not consistent with the label. The High Court stated, *"To say that the legal character of a relationship between persons is to be determined by the rights and obligations which are established by the parties' written contract is distinctly not to say that the "label" which the parties may have chosen to describe their relationship is determinative of, or even relevant to, that characterisation."*

A genuine independent contractor who is providing personal services will typically be:

- Autonomous rather than subservient in their decision-making;
- Financially self-reliant rather than economically dependent upon the business of another; and,
- Chasing profit (that is a return on risk) rather than simply a payment for the time, skill and effort provided.

Every business that employs contractors should have a process in place to ensure the correct classification of employment arrangements and review those arrangements over time. Even when a worker is a genuine independent contractor this doesn't necessarily mean that the business won't have at least some employment-like obligations to meet. For example, some contractors are deemed to be employees for superannuation guarantee and payroll tax purposes.