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How the Guardian case shines a light on reimbursement agreements

TAX

In a seminal decision about how s100A applies to trust distributions, the Federal Court rejected the ATO's position.

By John Jeffreys•08 February 2023•9 minute read

On 24 January, the Full Federal Court handed down its much anticipated decision in Commissioner of Taxation v Guardian AIT Pty Ltd as trustee for Australian Investment Trust [2023] FCAFC 3. It will become a seminal decision in the interpretation of both section 100A ITAA 1936 and Part IVA ITAA 1936.

When applicable, s100A results in the trustee of a trust being assessed on a distribution that was made to a beneficiary of the trust at the highest marginal tax rate on every dollar of the distribution. In addition, the ATO could apply penalties. This can result in a significant tax increase for a family group.

In the Guardian case, the ATO lost its argument regarding s100A due to the absence of a "reimbursement agreement". However, it did win its Part IVA argument in relation to one year of income. This article focuses on the implications for s100A.

Reimbursement agreement

S100A requires a reimbursement agreement before it can apply. This is because the present entitlement of the beneficiary must arise out of the reimbursement agreement. Put another way, a reimbursement agreement must exist prior to the trustee signing the distribution of income minute for a particular financial year.

In the Guardian case, the court held that this did not occur. The reasons for this decision are instructive and important for accountants. This aspect of the decision is a "must know" for accountants with trust clients.

What the Commissioner argued

The Commissioner argued before the court that Guardian AIT, as the trustee of the Australian Investment Trust, reached an understanding with Mr Springer (who ultimately controlled the trust) that in the 2013 income year and future income years:

- The Australian Investment Trust would benefit from the amount to which AIT Corporate Services Pty Ltd was made presently entitled by the trust (the shares in this company were owned by the trust); and
- Mr Springer would ultimately benefit from the amount to which AIT Corporate Services was made presently entitled by that company paying a fully franked dividend to the trust and the trust making Mr Springer presently entitled to that fully franked distribution. (Mr Springer was a non-resident resulting in no further Australian tax).

There are important practical lessons to be learned from understanding why the Commissioner argued that there was a reimbursement agreement and why the court did not agree with that position.

In putting the argument that there was a reimbursement agreement, the Commissioner submitted that the parties to that agreement or understanding were Guardian AIT (as trustee) and Mr Springer. The Commissioner placed much reliance on correspondence from Pitcher Partners (Mr Springer's accountant) to make his argument. The Commissioner contended that there existed within Pitcher Partners an understanding that a dividend would be paid by AIT Corporate Services to its trust shareholder and that this understanding could properly be imputed to Mr Springer because of his existing practice of following the advice of Pitcher Partners.

The Commissioner put the point of view that it was decided that AIT Corporate Services would pay a dividend to the Australian Investment Trust that was sourced out of the distribution that that trust had made to AIT Corporate Services.

To support this argument, the Commissioner referred to correspondence from Pitcher Partners to Mr Springer which set out various options for dealing with the unpaid present entitlement between the Australian Investment Trust and AIT Corporate Services. One of the options mentioned was the payment of a dividend by the company to the trust to clear the unpaid present entitlement. The Commissioner argued that this was a direction or recommendation given to Mr Springer in order to ensure this was done.

Also, the Commissioner made much of the past practice whereby distributions had been made from the trust to corporate beneficiaries within the group. Following this, the corporate beneficiary paid a dividend to the trust which was ultimately distributed to Mr Springer while he was a non-resident.

The Commissioner's argument was that the combined effect of the recommendation and the consideration of the past practices of the group meant that there was a reimbursement agreement. The court rejected this argument.

Why the court rejected the Commissioner's arguments

The court expressly disagreed with the proposition by the Commissioner that the agreement to pay the dividend could be inferred from the actions of the parties prior to the making of the distribution decision by the trustee. The court held that any such recommendation or advice from Pitcher Partners was not communicated to Mr Springer on or before the date on which the trustee made its distribution of income decision for the year ended 30 June 2013.

The Commissioner tried to argue that the position adopted by the advisers, Pitcher Partners, should be treated as a reimbursement agreement. The court rejected this proposition.

The court said that even if there was an understanding within Pitcher Partners that a dividend would be paid, this does not mean that understanding could be imputed to Mr Springer.

In reaching this decision, it is noteworthy that the court found evidence that the proposed payment by the corporate beneficiary to its shareholder (Guardian AIT as trustee for the Australian Investment Trust) was not “wholly conjectural”. That is, there was evidence to suggest that a dividend might be paid. However, this was not enough for the court to conclude that a reimbursement agreement existed.

Other comments by the court

The court stated these principles in relation to having a reimbursement agreement:

- An agreement need not be enforceable for the purposes of s100A. However, the understanding must nevertheless reflect a common intention or consensus existing between at least two parties. A plan drawn up or conceived by one person alone cannot be an arrangement or agreement.
- If there is an arrangement where monies are proposed to be paid by a beneficiary (as in the Guardian case), it would be expected that the beneficiary would be a party to the reimbursement agreement.
- For an arrangement or understanding to exist, it must be adopted in the sense that it must be assented to, whether expressly or impliedly. Consent, in this context, requires a consensus between two or more parties.
- An arrangement whereby a person would act in accordance with the wishes of another is capable of being an agreement within the meaning of s100A. By contrast, an expectation that an arrangement will be entered after the creation of the present entitlement is not sufficient for the purposes of s100A.

Why this is important

It is clear from the decision of the court that for there to be a reimbursement agreement, there needs to be a good deal more than inferences and conjecture. There needs to be a clear consensus arrived at between two minds. In my view, the ATO tax ruling TR 2022/4 needs to be amended to make this point much clearer.

I consider that the ATO has not given anywhere near enough emphasis on the requirement that a reimbursement agreement must exist prior to a beneficiary being made presently entitled in its products on s100A. The ATO has caused the profession to focus on what has happened with the money to which a beneficiary has been presently entitled and then inferred that a reimbursement agreement was in existence due to the way in which a beneficiary's entitlement has been dealt with. This approach is not technically correct, and it significantly downplays whether a reimbursement agreement exists in the first place.

It is clear from the Guardian case that what is necessary for a reimbursement agreement to exist is more substantial than what the ATO argued in the case and what has been said by the ATO in its products that relate to s100A.

The decision of the Full Federal Court in the Guardian case should be cause for the ATO to rethink its approach and amend TR 2022/4 and PCG 2022/2 so that they are not so strongly focused on concluding that s100A applies due to the way in which beneficiaries' entitlements have been dealt with.

The beneficiary payment issue

I am particularly concerned about the ATO's approach to the situation where a beneficiary receives their entitlement but then does not spend the entitlement on themselves or save the amount for their own benefit. This includes gifting of the entitlement, using the entitlement to purchase goods or services for another person or, as in the Guardian case, the payment of a dividend.

The ATO makes it clear that such practices could indicate a reimbursement agreement. Further, if you engage in these practices, only in limited circumstances will a taxpayer be able to fall within the "green zone" in accordance with PCG 2022/2. (See paragraph 32(b) and green zone scenario 1 in PCG 2022/2). Added to this is the ATO requirement that "you" should have a "clear understanding as to why a beneficiary has chosen to deal with their entitlement in the way they have …" (paragraph 49 PCG 2022/2).

This has both technical and practical difficulties.

The Guardian case makes it clear that if a beneficiary is to pay away their entitlement, they need to be a party to the reimbursement agreement. The ATO rulings do not mention this.

Also, due to the ATO's approach on this issue, "you" are supposed to keep track of the reasons why a beneficiary chose to deal with their entitlement. How are "you" supposed to know that? Are beneficiaries now required to document their reasons for why they applied their entitlement in a certain way? Are trustees and their advisers now required (by the ATO) to question beneficiaries as to how they have used their entitlement? What compels the beneficiary to disclose that information? How does the beneficiary know which dollar in their bank account constitutes their beneficiary's entitlement? How do they know which dollar in their bank account has been spent on which purpose?

The approach of the ATO to beneficiaries not applying a present entitlement to their own benefit borders on the absurd. Following the Guardian case, it is now in addition to being impractical, technically unarguable in many circumstances.

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