accountantsdaily BULLETIN

Three ways to solve all your s100A problems

TAX

The ATO's approach to trust distributions was the biggest tax issue of 2022, but there are some clear ways through the confusion.

By John Jeffreys•13 January 2023•11 minute read

The ATO's draft guidance on section 100A released in February and then the finalisation of those views in TR 2022/4 and PCG 2022/2 in December was one of the most important tax issues that public practice accountants have faced for years.

In my view the implications of the ATO's stance on the operation of s100A is more significant than the reach of Division 7A and the ATO's changed views on unpaid present entitlements owed to private companies that were made known about 12 years ago.

Unless the government decides to change the way in which trust income is assessed for tax purposes, accountants will forever need to be concerned about how the ATO could potentially use s100A to attack even the most commonplace trust arrangements. The finalised ATO documents only serve to heighten that concern.

While we now know a good deal more about how the ATO thinks s100A could apply, the majority of trust arrangements will fall outside the green zone and red zone as discussed in PCG 2022/2. This means accountants will be dealing with the risk and uncertainty of advising clients without knowing whether the ATO finds the arrangement acceptable or not.

The proof will be in the pudding. Here I mean "the pudding" of how ATO auditors deal with the ATO documents in practice. Very senior officers of the ATO have tried to calm the waters by saying that the ATO thinks there will only be a few situations where the ATO will try to apply s100A. The indication from these officers is that the ATO documents are only there to catch a very small number of egregious situations. I do hope that will be so.

However, after thinking in some depth as to the implications of the ATO documents, I find it difficult to come to this view. It seems to me that there are a wide variety of normal trust arrangements that either do not come within the green zone or are excluded from it under paragraph 32 of PCG 2022/2.

Not an academic exercise

The problem for accountants is that this is not just some nice academic, intellectual discussion that can be had over a glass of wine. Accountants must make real decisions for real client situations about what will be put (or not put) in trust distribution minutes and tax returns. These decisions mean real money to real people. Accountants and tax advisers are placed in a difficult position because they will need to make decisions about these uncertain situations. The s100A “buck” will truly stop with accountants.

The ATO might say, “If you are in doubt, just ask the ATO for a ruling”, but this will often be impractical. First, if the ATO were serious in saying this it would be flooded by private ruling requests, and we already know that the ATO is struggling to respond to such requests in a timely manner.

Further, decisions about trust distributions are frequently made in the last weeks of June each year. The trust distribution minute must be signed before the stroke of midnight on 30 June for most trusts. There is no time to ask the ATO a complicated s100A question and then receive a response by 30 June. This just won’t happen.

And, of course, asking for a private ruling request after the trust distribution minute has been signed is fraught with difficulty. You can’t change the contents of the minute and the taxpayer must send the request for a private ruling to the ATO with the implied starting point that there is a s100A issue — that’s why the ATO’s opinion is being sought in the first place. Accordingly, obtaining private binding rulings from the ATO is not something that many tax advisers will recommend to their clients.

How to solve the problem

But, having said all the above, clients still need a solution to the problem. I now set out what I consider are the three ways to solve the s100A problem.

1. **Pay the beneficiary**

If the beneficiary is paid their entitlement within two years of being made presently entitled to the amount and the beneficiary spends the money on themselves, you can be reasonably certain that the ATO will not try to apply s100A.

The two-year concept derives from the PCG. It is not a concept found in the law. I consider that we may now speak of the “two-year rule” that has been created by the ATO in this PCG. Broadly, if a beneficiary is paid their entitlement within two years of being made presently entitled, it would seem that the ATO, in most situations, will not apply s100A.

This is not to say a trustee cannot have an unpaid present entitlement that endures for more than two years, but the PCG requires other conditions to be met in that case, which I will not discuss here.

I also say that the beneficiary must spend the entitlement on themselves. More particularly, the beneficiary must not gift their entitlement to anyone. If the beneficiary does gift their entitlement, in whole or in part, and they do not meet the narrow requirements of green zone scenario 1, the arrangement will be excluded from the green zone. So, to be sure, the beneficiary should not gift their entitlement if the trustee wants to be assured of no s100A caused assessment. (How the trustee can control this or even know about what the beneficiary has done with their entitlement is an intriguing issue, to put it mildly).

2. **Go green**

The second way to stop the ATO attacking a trust arrangement (on its face) under s100A is to keep arrangements within the green zone scenarios as discussed in the ATO documents. Basically, this is the “swim between the flags” method.

This requires accountants and tax advisers to be very familiar with the green zone scenarios and examples in the ATO documents. It also means being very familiar with what can exclude arrangements from the green zone as described in paragraph 32 of the PCG.

I make the prediction that accountants and tax advisers will be surprised at how often the trust arrangements of their clients cannot be brought within the green zone. This is particularly so when regard is had to: [1] the somewhat narrow situations that constitute the green zone and [2] when those arrangements are then excluded from the green zone under paragraph 32 of the PCG.

Accountants and tax advisers should understand that even if arrangements are within the green zone, the ATO is not thereby saying s100A cannot apply. All the ATO is saying is that it will not commit compliance resources to investigating the arrangements. If the arrangements come up in the course of another type of ATO investigation, I am not sure whether the ATO will still consider the possible application of s100A.

3. **Don’t have a “reimbursement agreement”**

This method of avoiding s100A has had little airplay, yet if it can be achieved, it provides the surest method of avoiding the operation of s100A. This is because a condition that is necessary for the application of the provision will not exist.

We have witnessed over the past year the ATO getting the accounting and tax advisory profession to focus on what has happened with trust distributions. This has been done on the unstated assumption that whether a reimbursement agreement exists can be determined by what has actually been done with the distributions to which beneficiaries have been made presently entitled. While this idea cannot be dismissed, there is a fundamental technical issue to which this idea pays scant regard.

It must be kept clearly in mind that s100A (1)(b) and (2)(b) require the present entitlement of the beneficiary to arise out of a reimbursement agreement. Alternatively, the beneficiary’s entitlement must arise by reason of any act, transaction or circumstance that occurred in connection with, or as a result of, a reimbursement agreement.

Put plainly, if there is no reimbursement agreement, s100A can have no application. Understanding this fundamental idea is the royal road to having no s100A problems. In my view, there has been scant discussion of this issue because the ATO’s approach has focused everyone’s attention on what is happening with the beneficiary’s entitlement, on the assumption that a reimbursement agreement already exists. This is not a technically correct approach. One must first decide whether a reimbursement agreement exists and then examine what has happened with the beneficiary’s entitlement to determine whether there is a possibility of s100A applying.

Not having a reimbursement agreement is possible to achieve, but it is in the hands of the trustee of the trust and the trustee's advisers.

An agreement (although very widely defined) still requires the meeting of, at least, two "minds" to agree to do something. If at the time the trustee makes its decision with regard to the distribution of the income of the trust for a financial year there has been no such meeting of two minds, there cannot be a reimbursement agreement — no matter what occurs to the beneficiary's entitlement.

Remember, the beneficiary's entitlement must arise out of a reimbursement agreement. This means the agreement must have occurred prior to the trust distribution minute for the financial year being signed. With some effort, this can be achieved. I won't say that it will always be easy, but it is achievable — and if you can achieve this, you don't have to be concerned about the PCG, green zones, red zones or any other zone or idea. S100A cannot apply.

For most of last year I was encouraging accounting firms to advise their trustee clients to adopt a formal set of documents to assist with the view that no reimbursement agreement had been entered into.

First, it must be the case that prior to the trust minute being signed, the trustee has not entered into any agreement (whether of legal status or not) with anyone as to how the trust's income is to be distributed. This includes no discussions with the family about what is to happen with the trust's income. No discussions over Christmas lunch. No discussions over the family barbecue. No discussions!

In this way, the trustee can testify in court, if need be, that no agreement was entered into prior to the trust distribution decision being made and the trust distribution minute being signed.

Next, once the amount of each beneficiary's entitlement is determined (often some time after year end) the trustee writes to each beneficiary and sets out the details of the distribution that was made to them on (usually) the prior 30 June. The trustee, in this letter, requests the beneficiary to advise the trustee what the beneficiary would like the trustee to do with the beneficiary's entitlement. The beneficiary should be encouraged to take arm's length advice — including from the trustee — about this decision.

The beneficiary then writes back to the trustee and informs the trustee of the beneficiary's wishes, whatever they are. If this is all done genuinely at arm's length and with proper governance procedures, there should be a strong argument that s100A cannot apply. This is because it is demonstrably the case that there was no reimbursement agreement out of which the beneficiaries' entitlements arose.

It is my expectation that lawyers will create sets of pro-forma documents to assist trustees and their advisers to avoid an s100A problem. These documents may not exactly mirror what I have said above, but I do expect they will roughly follow what I have said.

I should make it clear that I am not a lawyer, and these are my suggestions as someone who has a good understanding of s100A. The documents that I suggest should be drafted by a lawyer. Accountants must be on guard against entering into work that they are prevented by law from undertaking.

Final comment

It would be a good idea for Karen Payne, the Inspector General of Taxation and Taxation Ombudsman, to make a note in her diary to investigate how the ATO is actually applying the ATO documents in a couple of years. She should take submissions from all interested parties and analyse this in detail.

This would enable the Australian community to determine whether our fears about the reach of s100A are justified or whether the statements by senior ATO officers that it will only be applied in a limited number of circumstances are correct.

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