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### DIVISION 7A, DISTRIBUTABLE SURPLUS AND THE MEANING OF 'NET ASSETS'

Clients that operate through companies are well aware of the application of Division 7A that can treat loans, certain payments and the forgiveness of debt from private companies as deemed unfranked dividends.

What may not be understood is that the amount of the deemed dividend is capped by the private company's "distributable surplus".

Working out a company's distributable surplus is therefore a vital element of Division 7A as the extent to which a deemed dividend is assessable is limited to the distributable surplus amount. That is, if a company has a nil distributable surplus for a year, any deemed dividend that may arise due to the operation of Division 7A is reduced to nil.

The distributable surplus formula contains a number of components, notably the 'net assets' amount. This amount is defined as the amount by which the company's assets exceed its legal obligations and certain provisions.

As a starting point, the value of a company's net assets for the purposes of distributable surplus calculation is the accounting value as shown in the company's financial statements. However, the Commissioner has the power to substitute a value deemed appropriate where there is a significant undervaluation or overvaluation of the company's assets or provisions. This is particularly relevant for two classes of assets.

In TD 2009/5, the ATO states that its power to adjust the value of the company's assets is extended to assets not shown in the company's accounting records. For example, a private company may have substantial internally generated goodwill, the value of which is not shown in the accounting records of the company because accounting standards do not permit it. In this case, the ATO states that it is appropriate to substitute the real value of assets and include the value of the goodwill.

Another example mentioned in TD 2009/5 is where a private company operates from business premises owned by the company. Since the purchase, the value of its premises has substantially increased due to the burgeoning property market. However, the value of the premises are recorded in the company's accounts using the historical cost model in accordance with accounting standards. In this case, the ATO states that it is appropriate to substitute the real value of assets and include a market value for the premises as the cost model used in the company's accounts would lead to the overall assets of the company being significantly understated.

Once it is determined that a company has a distributable surplus, any deemed dividend will be limited to this amount.

If you would like to discuss the above matters further, please contact Andrew Lowry or Leonard Tebbutt on 08 9444 9711.

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## 2023 TRUST DISTRIBUTIONS – REDUCING THE RISK

You might recall the ATO published guidance in December 2022 essentially seeking to apply an anti-avoidance provision, section 100A (a section introduced in the late 1970's), to certain distributions from a trust that were made under what is termed a "reimbursement agreement", whereby the benefit of that distribution was meant for someone other than the beneficiary.

Targeted distributions included:

- Unpaid distributions to adult children (or grandparents);
- Distributions to beneficiaries with tax losses;
- Distributions to adult children that are offset against expenses incurred for those children before they turned 18;
- Distributions to beneficiaries that were gifted or assigned to others; and
- Distributions to non-resident beneficiaries that remain unpaid.

The tax consequence of applying section 100A is that the trustee is assessed on the distribution rather than the beneficiary, and the trustee is taxed at a flat rate of 47%. As you can appreciate, this got the attention of trustees, beneficiaries and their accountants across the country.

### *Reduction of Risk3*

It is our view that the ATO's primary concern with respect to unpaid distributions from a trust is where another party, primarily the parents or controllers of the trust, obtains the lasting benefit of these distributions and not the actual beneficiaries. Whilst the ATO has flagged even a temporary or short term benefit as being potentially at risk of section 100A, it is clear from their "Red Zone" scenarios and examples that the highest risks are where the beneficiaries ***never*** receive their distributions.

The ATO classified certain transactions and situations as being in either a ***Red Zone***, or high risk zone, or a ***Green Zone***, or safe zone.

As a result, it is our view that for those trust distributions that cannot be paid to beneficiaries in the short term, the following two actions, could be undertaken by the trustee to move the Trust lower down the ATO risk spectrum, noting though that none of these either individually or collectively will permanently move the trustee into the ATO's preferred "Green Zone".

**1. Accounting Treatment**

Record distributions to beneficiaries (especially adult children) in the financial accounts separately and on a year by year basis. This will enable unpaid distributions that are retained by the trustee to be identified and remain within the ATO's "safe" Green Zone for at least 2 years from the distribution year.

Continue recording the pre 30 June 2022 unpaid distributions as one liability for each beneficiary and ensure that any payments made in the 2023 and 2024 years to beneficiaries are recorded against the pre 2022 amounts. Again, this will ensure that the 2022 unpaid distribution (and subsequent years) can take advantage of the 2 year Green Zone through until 30 June 2024.

In the 2025 year, payments will need to be applied against the 2022 unpaid distribution as well as the remaining pre 2022 balances and these unpaid distributions will no longer be considered as being within the Green Zone.

**2. Make Payments for Beneficiaries from the Trust**

In order to ensure that you are able to correctly record and allocate payments made by the trustee to Beneficiaries you should, wherever possible, make those payments from the Trust, with a reference that will enable your accountant to correctly allocate the payments against the Beneficiaries pre 2022 unpaid distribution.

Where the payment is made by the parents, perhaps via a personal credit card, ensure the Trust reimburses the parents as soon as possible, again with the necessary reference to identify the nature of the payment and for whose benefit it was paid.

Whilst the ATO has not exhaustively identified what payments can be applied against a beneficiary's unpaid distributions, the following types of payments should be acceptable:

- The beneficiaries personal tax liability;
- University or TAFE fees;
- Assistance with the purchase of a car or other asset owned by the beneficiary;
- Assistance with larger, irregular personal expenses such as a wedding, travel or housing;
- Payments or assistance with regular personal expenses of the Adult beneficiary such as insurances, car expenses, rental expenses etc.
- Reasonable board and lodging.

The regular and recurrent repayment of the unpaid distributions to Beneficiaries adds to the position that these Beneficiaries have and will benefit from these distributions and that there is no agreement that they will not benefit.

The clear line drawn by the ATO is in respect to "parental expenses" being expenses incurred on behalf of a beneficiary under the age of 18 years. The ATO will in no way accept that these payments (in particular, private school fees) can be applied against the unpaid distributions of a now adult child beneficiary.

We expect some significant compliance action from the ATO in coming years on the application of section 100A, so actions that can reduce your Trustee clients' risk in this regard should be considered.

If you would like to discuss the above matters further, please contact Andrew Lowry or Leonard Tebbutt on 08 9444 9711.

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## TR 2023/1: Residency Tests For Individuals Released

Tax on an individual's worldwide income is dependent on their Australian tax residency. Determining tax residency of an individual is complex and based on a largely subjective interpretation by the Commissioner and the courts' application of the statutory tests for residency of individuals as set out in the Tax Act.

On 7 June 2023, the ATO released TR 2023/1 to provide updated guidance on how the Commissioner would apply the residency tests for individuals. The ruling replaces and consolidates prior residency rulings (namely: TR 98/17, IT 2650, and IT 2681) and contains 18 examples of the application of the residency rules. TR 2023/1 also seeks to incorporate the interpretation of the law in recent case law.

Residency for tax purposes is a question of fact based on an individual's connection to Australia. The first three tests relevant to individual taxpayers are the ordinary concepts test, the domicile test and the 183-day test. The fourth test, the Commonwealth superannuation fund test, is relevant only to select government employees.

The Ruling also explains that residency is about your connection to Australia. An individual is a resident if they meet **any one** of the tests. This means that we must consider all applicable tests before concluding an individual is a non-resident.

Importantly, the Ruling states that "..*residency under the first 3 tests is determined by considering all of your relevant facts and circumstances…. Because of this,* ***there are no 'bright-line rules or any single factor that can be said to be paramount."***

TR 2023/1 states that the period of physical presence or length of time in Australia is an important factor, but it is not a determinative factor. It is the individual's intention, purpose or reason for being in Australia that helps to determine whether they are a resident.

The Ruling is silent on the former Government's May 2021 Budget's announcement to propose new residency rules based on a two-tier test recommended by the Board of Taxation. The primary test proposed was a 'bright line test' where a person physically present in Australia for 183 days or more was considered an Australian tax resident without the need to consider other factors.

It would appear that the Commissioner, in stating that there are "no bright line rules" in TR 2023/1 is asserting the importance of considering the nature, duration and quality of a person's physical presence and an intention to treat Australia as home in determining residency.

Factors considered relevant in determining association with Australia **in addition** to an individual's period of physical presence in Australia are:

- intention or purpose of presence;
- behaviour while in Australia;
- family, and business or employment ties
- maintenance and location of assets, and
- social and living arrangements.

The Ruling provides eighteen examples applying these factors to assist in assessing an individual's Australian tax residency position and the broad 2 year 'rule of thumb' assists in determining when a length of overseas stay is substantial for the purpose of considering whether a taxpayer's permanent place of abode is overseas.

Overall, whilst the incorporation of recent Federal Court decisions recognizing globalisation and flexible working arrangements is welcomed, a lack of certainty and clarity in law remains. The subjective interpretation of the domicile test and the 183-day test still hinges on the Commissioner being satisfied that all of an individual's facts and circumstances support their residency status.

If you would like to discuss the above matters further, please contact Andrew Lowry or Leonard Tebbutt on 08 9444 9711.

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## MANAGING RISKS IN ALLOCATING PROFESSIONAL SERVICES FIRM PROFITS – PART 2

In our first article we discussed how the ATO are again taking aim at how Professional Services Firms allocate their profits to the owners (Principals) with the announcement late last year that they will start contacting Professional Service Firms to "assist" them in managing those risks.

The ATO issued PCG 2021/4 outlining the ATO's compliance approach in regards to how profits are allocated within Professional Service Firms. The PCG was to apply from 1 July 2022, so the 2023 tax year will be the first year the ATO expects to formally apply its guidelines. However, where an existing firm can satisfy the ATO's former "suspended" guidelines, they will continue to apply through to 30 June 2024.

The PCG only applies to Professional Service Firms, which they define to mean "knowledge-based services" including accounting, architecture, engineering, financial services, law, medicine and management consulting.

The object of the PCG is to determine the Firm's risk level and as such, the level of engagement the Firm can expect from the ATO.

The ATO expects that the Principals/owners of Professional Service Firms will annually assess their eligibility to apply the PCG to determine their risk level.

The eligibility question is dealt with by two Gateways that the ATO expects Firms to satisfy in order to be able to use the PCG's risk matrix. We dealt with those Gateways in our first article. Where a Professional Services Firm has determined that it has satisfied the two Gateways, it can then undertake its 2023 Risk Assessment, using either the first two, or all three of the Risk Assessment Factors.

The **first factor** deals with the Principal's share of their profit entitlement from the Firm. This factor effectively requires a determination of all income derived from the Firm to which the Principal is entitled (based on their profit or equity share). This is by way of:

- Salary;
- Superannuation;
- Allowances;
- Fringe Benefits;
- Non-cash benefits;
- Dividends, including franking credits from ordinary and class shares; and
- Any trust distributions from the Firm or a related business, such as a Service Trust.

Once this figure is determined, you then need to identify what amount of all of the above profit entitlements (including superannuation) are returned in the "hands" of the Principal.

In order to stay within the ATO's Low or Moderate Risk zones, between 50% and 75% of the Principal's profit entitlement must be returned in their hands or in their own name.

The **second factor** deals with the total effective tax rate for all income the Principal is entitled to receive for that year.

This next factor looks at aggregating the tax rate applied to essentially all of the income in the first factor to determine the average tax rate applied across the Principal and all other entities that receive part of this income.

This includes the tax rate of family members that receive either dividends or trust distributions, the tax rate of the Principal, the tax rate of a superannuation fund, and the FBT rate applied to the Firm where taxable fringe benefits are part of the Principal's remuneration.

The ATO's guidelines demonstrate how you can use the higher tax rate where the Principal or other taxpayers derive other non-Firm income to treat the Firm income as being taxed at the highest effective tax rate.

Using the ATO's Risk Zones, for a Principal to qualify as either Low or Moderate Risk, the aggregate tax rate needs to be between 25% and 35% across the Principal and related taxpayers who receive a share of Firm income.

Professional Firm Principals need to aggregate their scores from the first two factors and then determine which risk zone they are in, Low, Moderate or High.

Those that fall within the High Risk zones may be subject to ATO compliance action and we are aware of the ATO beginning to undertake reviews across the professional services industry to understand how Firms and Principals are distributing their income.

The **third factor**, which is optional and, in our view, would only be used to lower a High risk rating after the first two factors, looks at the remuneration returned by the Principal as a percentage of the commercial benchmark for the Principal's services.

In our experience this factor is particularly difficult to apply and should only be used in circumstances where a comparable commercial benchmark exists for remuneration of the specific Principal.

For Firms and Principals that can show that they still satisfy the ATO's original, but now suspended guidelines, these new ATO guidelines will only apply from 1 July 2024, however for new Firms and those that do not satisfy the old guidelines, these guidelines apply from 1 July 2022. Accordingly, they will need to be considered in finalising the Principal's 2023 remuneration and Firm profit distributions.

If you would like to discuss the above matters further, please contact Andrew Lowry or Leonard Tebbutt on 08 9444 9711.