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IN THIS ISSUE

DEALING WITH FAMILY TRUST ELECTIONS AND INTERPOSED ENTITY ELECTIONS WHEN THEY CLOSE THE LOOP TOO TIGHTLY

Discretionary Trusts offer a great structure for clients to tax effectively flow income and capital throughout their family group. There may be a number of factors which require a trust to make a Family Trust Election.

These include:

1. The trust loss measures;
2. The company loss tracing measures;
3. The franking credit trading measures;
4. The trustee beneficiary reporting rules; and
5. The Small Business Restructure Rollover.

Whilst making a Family Trust Election (FTE) does enable a trust to navigate the above measures more effectively, it does significantly restrict the way in which capital can flow outside of the Family Group as defined by reference to the chosen "Test Individual", usually one of the parents.

Where an entity is not automatically included within the Family Group, then an Interposed Entity Election can be made, which is an election to make an entity (company, partnership or trust) a member of the Family Group of the individual specified in a Family Trust Election.

Family Trust Distributions Tax is a tax imposed on a family trust (or an entity that has made an IEE) where a distribution is made to a person or entity that is outside of the Test Individual's family group.

This can cause major headaches for families especially where FTE's or IEE's have been incorrectly made in the past and thus caused entities which may have been in the same family group to now sit outside the family group. This can cause unexpected tax consequences for loans and distributions where they would not have been subject to tax had they been made to an entity or individuals within the family group.

Where you have a number of different trusts in your group, the first step is to identify all FTE's and IEE's and determine whether these create multiple Family Groups within the same Family for FTE purposes. If this has occurred it is really important to ensure that the movement of funds does not inadvertently trigger a distribution between these family groups. The best way to ensure this does not occur is to ensure that any transfers of capital between the two family groups are made via the individual beneficiaries who would form part of both family groups.

For example, Jack and Arnold are brothers who each have family trusts where they have nominated themselves as the test individual. Any transfers directly between Jack's Trust and Arnold's trust will potentially be subject to FTDT. However, a transfer from Jack's Trust to Arnold (who is a member of Jack's family group) and then from Arnold into his trust (also in his family group) would not be subject to FTDT as the transfers in both entities are effectively via an individual within both of their family groups.

It is therefore important that if multiple family groups exist within your family structures how to manage capital flows between them. Having problematic FTEs or IEEs do not on their own cause unexpected tax liabilities, rather they can seek to place unexpected tax liabilities on the flow of funds between these entities.

If you have any questions in relations to Family Trust Elections or Interposed Entity Elections, please contact Andrew Lowry or Leonard Tebbutt on 08 9444 9711.

Market Valuation – Dealing at Arm's Length

Question - 'What's the value?'
Answer – 'How long is a piece of string'

Starting point – key terms

'Market value' is not defined in the legislation, it is the ordinary meaning that is used, that is, the price that a willing but not anxious buyer would have to pay to a willing but not anxious seller for the item.

Albeit not defined, don't let that make you think it has little importance. On the contrary to be blunt, market value is referred to extensively throughout the Tax Acts. One of the many key areas is in regard to the maximum net asset value test ('MNAV test') for the purposes of the CGT Small Business Concessions.

Intertwined within the 'non-defined' term of Market Value is whether or not the parties have dealt with each other at arm's length.

Unlike market value, dealing at arm's length is defined. Subsection 995-1(1) of the ITAA 1997 states that in determining whether parties deal at arm's length, you must consider any connection between them and any other relevant circumstance.

A party is not dealing with another at arm's length if one party does not act independently and is under the control or influence over the other party in connection with the dealings.

Where the Commissioner disagrees with the market value applied and is of the view that the parties have not dealt at arm's length, the Commissioner may apply the Market Value Substitution ('MVS') Rule.

Under the MVS Rule, the market value of a CGT asset is substituted as the capital proceeds of a CGT asset if the actual proceeds are more or less than the market value of the asset and the asset was disposed of in a non-arm's length dealing.

A recent AAT case reiterated the complexity around arm's length determinations and market valuations.

The Moloney case [Moloney and FCT (2024) AATA 1483]

The AAT had to consider whether the MNAV test was satisfied. If the taxpayer was able to satisfy the MNAV test, the taxpayer would be entitled to the CGT Small Business concessions to reduce the net capital gain to nil.

The key issue being, were the parties dealing at arm's length and was the value of the business (and the shares of the new related company that acquired the business) determined by the parties (being $3.5M), the true market value?

The Commissioner's view being that the parties were not dealing at arm's length and the market value of the business was higher than the capital proceeds. As such he sought to apply the MVS rule. In Deputy President Molloy's view, the taxpayers did not deal at arm's length given the vendor and acquirer were controlled by the same parties. The focus then shifted to determine the market value of the business.

The taxpayers obtained a new independent valuation which came in at a midpoint of $3M compared to the ATO's independent valuation of $7M.

The AAT considered both valuations, noting that both approaches used the same valuation methodology, being a multiple of maintainable EBITDA. Throughout the audit and AAT proceedings, numerous re-workings of the valuation were prepared, this merely proved the existence of the gap between both the ATO and the taxpayer's valuations.

Taking into account the valuations and all assumptions, Deputy President Molloy sided with the taxpayer's valuation adjusting for several other factors to determine that the valuation should be $3,352,500.

The result being the taxpayers could utilise the CGT concessions.

Takeaway

Determining the market valuation of an asset in a transaction has always and will continue to be a point of contention.

This case proved that two independent valuers using the same methodology can arrive at two very different valuations. Perhaps the only certainty in a valuation is that another valuation can, and will likely be, different. However, it is imperative that taxpayers undertaking these transactions obtain a truly independent valuation to support the transaction's sale price.

Supporting documentation and the process undertaken in obtaining a valuation will be key in supporting a particular view.

If you have any questions in relation to any comments made above, please contact Andrew Lowry or Leonard Tebbutt on 08 9444 9711.

VOLUNTARY DISCLOSURE DURING REVIEW OR AUDIT – WHY, WHEN & HOW

Why lodge a Voluntary Disclosure?

The purpose of making a voluntary disclosure is to correct a misstatement in a lodgement submitted to the ATO. So why would you want to lodge a voluntary disclosure to the ATO?

The main benefit is that if administrative penalties are imposed, they could potentially be reduced by up to 80% depending on when the disclosure is made. Greater penalty reductions generally apply to disclosures that are made before the ATO notifies you of a review or audit. Where the amount voluntarily disclosed is less than $1,000, the ATO can reduce any administrative penalty to nil.

Additionally, making a Voluntary Disclosure may stand you in good stead and provide grounds for when you apply to seek a remission of any general interest charge and administrative penalties and, depending on the circumstance, by lodging the Disclosure, there may be a strong argument that the tax was not avoided by way of evasion.

Importantly, the ATO have stated that

"*You also don't need to admit there is a liability or that you were incorrect in your original statement when you make a voluntary disclosure.*"

The ATO would not apply a false or misleading statement penalty if you have taken reasonable care (and can demonstrate this), even though the information is incorrect.

When should the Voluntary Disclosure be lodged?

Voluntary disclosures should generally be made before the ATO gives notice to you of a review or audit however, there are still benefits to lodging a Voluntary Disclosure once a review or audit has commenced. Where the Commissioner has notified you that an examination is to be made of a taxpayers' affairs, lodging a Voluntary Disclosure (in the approved form) ***after*** the notification can reduce the base penalty amount (BPA) by 20%. In this instance, the Disclosure must notify the Commissioner about the shortfall, or the false or misleading nature of the statement and in doing so, it can be reasonably estimated to have saved the Commissioner a significant amount of time or significant resources in the examination.

How do you lodge a Voluntary Disclosure?

If a review or audit has commenced, it is best to notify the ATO case officer of your intention to make a Disclosure on the specific matter and provide an estimated time frame as to when this will be completed. In this instance, the Disclosure should be submitted to the tax officer conducting the review or audit.

For Voluntary Disclosures submitted whilst the taxpayer is under a review or audit, the ATO have recently issued *NAT 75342 Voluntary Disclosure Form – If you're under review or audit.*

You can use this form to make a disclosure or, submit a written statement that contains all of the relevant information to notify the Commissioner about the shortfall or misstatement.

Importantly, to be considered for penalty remission, the Disclosure must disclose the shortfall or misstatement to the Commissioner and you must ensure that all necessary facts and circumstances on the matter are provided in order to demonstrate that the Disclosure has saved the Commissioner a significant amount of time or significant resources in the review or audit.

We generally treat the Disclosure as a statement of facts and provide an explanation on the error or omission with details of what should have been disclosed and where possible, provide an estimated quantitative tax impact of the mistake.

It is imperative that in making the Disclosure the submission includes sufficient details for the Commissioner to work out the amount of the tax adjustment. Failure to provide sufficient information to do so, will mean that the ATO will not consider the document a Voluntary Disclosure.

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

Personal Services Businesses falling foul of Part IVA

The ATO has long had a focus on entities who generate income from the personal exertion of individuals. The Personal Services Income (PSI) rules were introduced to ensure that where an entity did not meet the conditions of being a Personal Services Business (PSB), the PSI earned by the entity would be attributed to the individual who generated that income.

This has also led to the assumption by some, that if the entity meets the condition of being a PSB, the entity can then deal with its income as it sees fit. While the statutory PSI rules do not require any income to be attributed directly to the relevant individual, where the income is not applied for the benefit of the individual, the ATO may seek to apply the Part IVA General Anti Avoidance Rules.

The ATO is of the view that Part IVA may apply where the arrangement was entered into for the purposes of splitting, diverting, or retaining the income in order to obtain a tax benefit.

The ATO has recently issued a Draft Practical Completion Guide 2024/D2 that provides indicators of what it considers to be low risk and high-risk arrangements for entities that qualify as a PSB, which are summarised below:

<u>Low Risk Arrangements</u>

- The entity distributes the net PSI of the individual to that individual, who is taxed at marginal rates.
- The entity pays remuneration to the individual that substantially equivalent to the value of their personal services.
- The entity pays a market value wage to an associate for providing bona fide services relating to earning the PSI.
- Where there is a timing difference between the entity earning the PSI and the entity distributing the PSI to the individual. The timing difference needs to either be arising for reasons outside of the control of the parties or explainable for reasons unrelated to tax.
- The entity makes superannuation contributions for the individual.
- Where there is a temporary retention of profits in order to purchase an asset. There must be a clear commercial purpose for purchasing the asset.

<u>High Risk Arrangements</u>

- The entity distributes the PSI to another entity where it is taxed at a lower rate than if the individual had earned the income in their own name.
- The entity pays remuneration to the individual that is less than the equivalent to the value of their personal services.
- The entity does not distribute any income to the individual.
- All or some of the PSI is split with an associate of the individual, which results in an overall lower tax liability.
- The entity pays an above market value wage to an associate for providing bona fide services relating to earning the PSI.
- Some or all of the PSI is retained by the entity, even if the entity lent the funds to the individual under a Division 7A loan arrangement.

The PCG provides 13 examples that explore the above type of arrangements further.

The PCG also outlines the ATO’s expectation regarding record keeping. While noting that there can be a general informality between an individual and the entity, the ATO still has the expectation that sufficient records are retained in order to explain why the entity entered into the arrangement to provide the individual’s services (as opposed to the individual providing the services directly), and why the entity has chosen to deal with the PSI the way it has.

Notwithstanding that contemporaneous and substantive records may be kept, the ATO can still apply Part IVA to the arrangement.

Whilst the PCG doesn’t necessarily tell us anything new, it does combine the ATO’s views on how and where the profits of PSB’s should be taxed and unsurprisingly that is in the hands of the individual that derived the PSI.

If you have any questions on your client’s treatment of their PSI, please contact Andrew Lowry or Leonard Tebbutt on 08 9444 9711.