News Bulletin

Accountants &
Business Advisors

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KAIAS PHILLIPS
129 Station St. Fairfield
Phone: 9489 5888
www.kaiasphillips.com.au

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ATO ALERT TA 2021/2 FOREIGN 'GIFTS' AND 'LOANS' MAY BE TAXED AT 47%

The ATO recently released Taxpayer Alert TA 2021/2 *'Disguising undeclared foreign income as gifts or loans*'.

The alert highlights the ATO's focus on families that are potentially attempting to avoid or evade tax on foreign income by treating payments to Australian residents as loans or gifts from a foreign related party.

The ATO is working with AUSTRAC and foreign tax authorities to identify cash transfers to Australia that could potentially fit this fact pattern.

There have been an increasing number of ATO reviews/audits for families that have received foreign cash transfers, and it is increasingly becoming a question of when, not if, the ATO will query the transactions.

It appears that the ATO is taking the position that the amounts should be treated as income (and taxable at rates of up to 47%!) unless the recipient can provide sufficient documentation to support a loan or gift designation.

The Alert provides that a payment may be treated as a genuine gift or loan where:

- the characterisation of the transaction as a gift or loan is supported by appropriate documentation.
- the parties' behaviour is consistent with that characterisation; and
- the monies provided are sourced from funds genuinely independent of the taxpayer.

The ATO will not limit their review to the transfer of funds into Australia, but will look to confirm the original source of the funds (e.g. a foreign company or trust), and intermediary transfers, and their ultimate recipient in Australia. It is important that these factors be considered prior to the commencement of any transfers, and have evidence on hand to support a gift or loan designation.

ATO - CRACKDOWN ON FAMILY TRUST DISTRIBUTIONS

On 22 February 2022, the Australian Taxation Office (ATO) released a package of new guidance material in the form of TR 2022/D1 and PCG 2022/D1 that directly target how trusts distribute income.

This ATO new guidance outlines the ATO's view of the operation of section 100A of the Income Tax Assessment Act (ITAA 1936).

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 new guidance, which sets out its proposed compliance approach in relation to beneficiary entitlements conferred on or after 1 July 2022, is an expansion of the boundaries and scope of S.100A, and suggests that the ATO is now willing to adopt a more aggressive approach and use section 100A to attack a wider range of arrangements.

Generally, these arrangements involve trust distributions to low taxed family members or family companies where the benefit of the distribution is diverted away from the beneficiary to another family member that would otherwise pay a higher rate of tax if it was distributed directly to them.

The ATO's new more aggressive approach to trust distributions will likely impact many discretionary trust distributions and some common family trusts arrangements, and will result in many family groups paying higher taxes.

Section 100A of the ITAA 1936

Section 100A was enacted to prevent what is commonly called "trust stripping". At its simplest, it involves arrangements whereby trust income is diverted to third parties and away from the truly intended beneficiaries.

For S.100A to apply, there must be a "reimbursement agreement" that involves a beneficiary entitlement to trust tax net income, the providing of money, property or a benefit to a person and a purpose of a party to the agreement of reducing a person's income tax.

If S.100A applies, a deeming rule operates such that the beneficiary will not be considered presently entitled to the diverted income, but instead the trustee is liable to tax at the top marginal tax rate.

There are some important exceptions to S.100A, including where income of the trust is distributed to minor beneficiaries and where the 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.

ATO S.100A Guidance – Low, Medium & High-Risk Scenarios

The ATO's guidance sets out four 'risk zones' – referred to as:

- *White (low risk)*
- *Green (low risk)*
- *Blue (medium risk)*
- *Red (high risk).*

The White zone captures arrangements entered prior to 1 July 2014, and the Commissioner will not apply new compliance resources to review these arrangements.

Arrangements falling under the Green zone are placed in the low risk category and the ATO will be unlikely to review such arrangements. For example, 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.

The Blue zone is a "catch all" zone. It captures anything that is not a White, Green or Red zone arrangement. The PCG notes that the Blue zone captures arrangements whereby a trust entitlement is withheld by the trustee and may otherwise be in the Green zone, but for the fact they exhibit certain risky features.

The Red zone captures the arrangements that are squarely in the Commissioner's sights as being subject to sS.100A.

Red zone arrangements are those where:

- the beneficiaries' respective entitlements appear to be motivated by sheltering the trust's (taxable) net income from higher rates of tax;

  and
- the arrangement involves contrived elements directed at enabling someone other than the presently entitled beneficiary to have use and enjoyment of the economic benefits referable to the trust's net income.

An example of a Red zone scenario is where adult children of the controllers of the Trust receive a present entitlement to trust income but some or all of the economic benefit ends up with others (typically with their parents).

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.

While administrative guidance materials such as PCG 2022/D1 do not have the force of law, Practical Compliance Guidelines outline how the Commissioner will allocate ATO compliance resources according to assessments of risk.

As alluded to previously, S.100A does not apply to arrangements that form part of an 'ordinary family or commercial dealing'. However, what is clear is that the Commissioner appears to be narrowing this exception.

It is therefore important that for those with discretionary trusts 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.

INSTANT ASSET WRITE-OFFS EXTENDED

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

- new depreciable assets
- improvements to existing eligible assets, and
- secondhand 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.

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.

RECENT SUPERANNUARTION LAW CHANGES

A number of superannuation law changes due to commence 1st July 2022 have passed both houses of Parliament and now await the Governor General's final sign off. In summary, these are:

- The $450 per month income threshold for making employer contributions is being abolished
- The 'work test' is being abolished for non-concessional contributions for individuals aged 67 to 75
- The eligible age for making a 'downsizer' contribution is decreasing from 65 to 60
- The maximum amount of voluntary contributions under the First Home Super Saver Scheme increases from $30,000 to $50,000
- Changes to how trustees calculate Exempt Current Pension Income when there are members in both accumulation and pension phase for parts of the year

IMPORTANCE OF GROSS PROFIT TO BUSINESS PROFITABILITY

While there are many factors that affect the profitability of a business, a key factor is what is left after you subtract from your sales the costs of selling your product (cost of goods sold) or delivering your service (cost of sales).

While it is critical to keep an eye on all costs, in almost every business model the largest percentage of costs is tied up in the company's cost of goods sold. Because of this, even small changes in margin can have significant impacts.

For example, where sales of a business are $1M and the gross profit is $350K, which, giving you a gross margin of 35%, so that, after allowing for the goods sold, 35 cents out of every dollar made in sales is "left over" to cover all other operating expenses and profit.

However, if the business is able to increase the gross margin to 40 percent. That 5 percent difference results (assuming none of the other operating costs changed) in extra profit of $50,000 that goes straight to the bottom line, .

Clearly then the Gross Margin of a business is a very important key performance indicator (KPI) to the success of the business. Therefore, it is critical that every business has systems in place to measure and monitor this important KPI.

The starting point is to set a gross profit goal and set up systems that provide accurate and up-to date information, including profit and loss statements that show the numbers in both dollars and percentages, so that both changes caused by sales increases or decreases and changes in the Gross Margin percentage are highlighted.

Other key aspects relevant that may affect the Gross Profit of a business that the reporting systems may throw up include:

- product mix - breaking down the gross margin and identifying which products (or service) are helping you meet the business goals, and which might be getting in the way
- pricing and product strategy. An increase in price goes straight to the bottom line. If an increase in price is not an option due to competitive pressures, then there may be other ways to add value to or customize and thus differentiate your products or services. When you differentiate your products or services, you may then be able to charge a higher price
- Buy better and smarter – streamline the purchasing function and look at ways to reduce the cost of materials through volume discounts, better stock control, avoiding rush orders etc
- Give discount with purpose, not from habit. If you need to discount, do so. But do it strategically by knowing how much more you'll need to sell at the lower price to make up for the discount.

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