7 July 2010

Ms Joanne Casburn
Australian Taxation Office
PO Box 9977
Upper Mount Gravatt QLD 4122

Dear Joanne

The Institute of Chartered Accountants in Australia, CPA Australia, the Taxation Institute of Australia, the National Institute of Accountants, the Law Council of Australia and Taxpayers Australia (the Joint Bodies) welcome the opportunity to provide comments in respect of the Draft Practice Statement PSLA 3362 (PSLA 3362) released by the Australian Taxation Office (ATO) on 2 June 2010.

Our representations have been compiled based on discussions and feedback from various members including those who attended the Division 7A working group meeting held on 17 June 2010. We have set out our detailed comments in the attached submission.

In the meantime, should you wish to further discuss any aspect of this submission, please contact Yasser El-Ansary, Tax Counsel of the Institute of Chartered Accountants on (02) 9290 5623; Mark Morris, Senior Tax Counsel of CPA Australia on (03) 9606 9680; Tony Greco, Senior Tax Adviser of the National Institute of Accountants on (03) 8665 3134; Angie Ananda, Tax Counsel of the Taxation Institute of Australia on (02) 8223 0010; Roger Timms, Head of Tax and Superannuation of Taxpayers Australia on (03) 8851 4505 or Gerry Bean, Partner of DLA Phillips Fox representing the Law Council of Australia on (03) 9274 5661.

Yours sincerely

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Joint submission
Draft Practice Statement PSLA 3362: Division 7A: Trust entitlements

All legislative references are to the *Income Tax Assessment Act 1936* unless otherwise stated.

General comments

1. The Joint Bodies reiterate the view, previously made in our submission on Draft Taxation Ruling TR 2009/D8*: Income tax: Division 7A loans: trust entitlements* (the Draft Ruling) which is now Taxation Ruling TR 2010/3 (the Ruling), that the Ruling contradicts the underlying policy intent of Division 7A and, in particular, Subdivision EA. Furthermore, the Joint Bodies do not agree with the retrospectivity of the ATO's views in Section two of the Ruling in relation to loans arising from implied loan agreements and the exercise of the trustee's power to pay or apply trust funds for the benefit of a beneficiary - especially, in view of the criteria to determine retrospectivity of new ATO views in Recommendation 2 of the Inspector-General of Taxation's report ,'*Review into delayed or changed Australian Taxation Office views on significant issues'*.

2. However, the Joint Bodies acknowledge the ATO's efforts in proposing the administrative concession in respect of unpaid present entitlements (UPEs) made by a trustee of a trust to a private company beneficiary under PSLA 3362. Many issues requiring practical clarification were raised in our submission on the Draft Ruling which have been addressed to some extent in PSLA 3362.

   However, the administrative guidance provided in PSLA 3362 in relation to 'deemed loans' under Section three of the Ruling, particularly in respect of the requirement to show that the benefits from the use of funds flow back from the main trust to the sub-trust under Option 1 or Option 2, is prescriptive and will be complicated to apply in practice. Accordingly, much of the comments provided below are directed at ensuring that tax practitioners and their clients can practically comply with the requirements of Options 1 and 2 even though the administrative guidance provided is essentially, in our opinion, without legal basis.

3. There are various statements in PSLA 3362 and the Ruling which are not legally binding but which contain the Commissioner of Taxation's interpretation of the relevant provisions of Division 7A. The Joint Bodies submit that, at a minimum, statements concerning the interaction of the ATO's views in the Ruling and the provisions of Subdivision EA should be included in the legally binding section of the Ruling or in a separate binding taxation ruling on UPEs and their potential treatment under both section 109D and Subdivision EA.

   We are concerned that the current non-legally binding status of those statements, in particular the final Practice Statement, leaves affected trusts exposed to potential double taxation in the event a UPE is caught by both section 109D and Subdivision EA (especially in view of the ATO's statement under paragraph 38 of the Ruling, that the setting aside of the UPE amount on a sub-trust in accordance with PSLA 3362 will not discharge the UPE). If a UPE matter is disputed in the courts, the ATO is not precluded from arguing a view that could result in double taxation. Furthermore, if the ATO's view in the Ruling is proven to be wrong, there would be inadequate protection for trustees and beneficiaries (as well as tax practitioners).

4. As *Tax Laws Amendment (2010 Measures No.2) Act 2010* received Royal Assent on 28 June 2010, we recommend that the ATO provide its views on how the various relevant amendments concerning Subdivision EA interact with the views expressed in the Ruling (e.g. where there are UPEs between two trusts under section 109XG). Further, these views should be contained in a legally binding statement either in another taxation ruling or as an addendum to the Ruling. Should this not occur, PSLA 3362 should include practical examples on how these amendments practically interact with the Ruling where appropriate. In our view the amendments concerning the application of Subdivision EA would be either wholly or largely redundant given the ATO's views expressed in the Ruling.

5. Given many trusts in the small and medium enterprise sector will be affected by the Ruling and the finalised Practice Statement, we anticipate many of the affected entities would be applying to

the Commissioner to exercise his discretion under section 109RB. This would potentially greatly increase the compliance burden of tax practitioners as, commonly, a client may have many trusts within their group structure, and the application of the discretion would have to be made in respect of each trust and affected entity. This would in turn lead to greater pressure being imposed on the ATO's resources as each of these applications would have to be separately considered and a decision reached as to whether the discretion can be exercised.

Accordingly, we submit that a further draft practice statement be issued to provide guidance on the potential application of the discretion under section 109RB in these circumstances which should set out criteria under which taxpayers can take self corrective action in respect of any loans subject to Section two of the Ruling. In preparing such a practice statement we stress that the analysis underlying Section two loans is highly technical and most taxpayers, as well as many tax practitioners, may not have understood the implications of their recording of transactions in the past.

Specific Comments

1. Section two loans

1.1 Relying on financial accounts for evidence of a loan

Broadly, the ATO provides under PSLA 3362 that a Section two loan would be made where:

- in respect of an implied loan agreement, the UPE of the corporate beneficiary is recorded in the financial accounts of the private company and trust as a loan; and
- in respect of the trustee exercising a power under the trust deed to pay or apply trusts funds for the benefit of a beneficiary, the UPE is recorded as a loan in the financial accounts of the trust.

Further clarification is required as to whether the reference to 'financial accounts' in this regard includes unaudited financial accounts (many small business entities are not required to have audited financial accounts) and general ledgers.

We recommend that the ATO should interpret the term 'financial accounts' after 16 December 2009 to be mean the finalised accounts (audited or unaudited) of the trust and the private company as this will provide tax practitioners with more definitive guidance and cut compliance costs.

Secondly, prior year financial accounts for both trusts and companies may incorrectly refer to a beneficiary's UPE as a beneficiary loan. Typically such errors have arisen as a function of accounting software packages used and the subsequent administrative practices of accountants to imprecisely record a trust distribution of a beneficiary as a credit to a loan account in the name of the beneficiary. In many circumstances, such a misdescription may have been inadvertent as there was no intention of the company beneficiary or trustee to convert an UPE into a loan.

We recommend PSLA 3362 specifically address how the ATO will deal with the issue of imprecise accounting because of the limitations imposed by prior year accounting software packages as we believe it would be inequitable for the ATO to treat such UPEs as loans since accountants would have been just following long standing practice and advising their clients to follow suit because of the relevant configuration of particular accounting packages. In these circumstances, where a review of the trust's financial accounts (or any other relevant documentation) reveals that the only source of the credits to the loan account was from trust distributions the ATO could consider these amounts as UPEs which would then be potentially subject to Section three of the Ruling.

1.2 Additional practice statements to provide practical relief

In relation to UPEs misdescribed as loans in the financial accounts, the ATO could issue a separate practice statement allowing taxpayers:

- to review their financial accounts to determine whether the amounts recorded as 'loans' correctly describe the nature of the relationship between the parties; and
- to document the correct nature of relationships between parties where the amounts are mistakenly recorded as loans in previous financial accounts, general ledgers and journals.

Furthermore, where the relationship between parties is correctly recorded as a loan, the ATO could allow such taxpayers to take corrective action in respect of such prior year loans by putting in place complying Division 7A loan agreements and pay any outstanding minimum yearly repayments under section 109N.

1.3 Where a UPE has been forgiven

Paragraph 23 of PSLA 3362 states the ATO may consider that a Section two loan has arisen where a UPE has been forgiven. Further clarification is required as to how the UPE is 'forgiven' and the reason why the 'forgiven' UPE may be a Section two loan.

2. Section three deemed loans

2.1 How is the UPE amount from the sub-trust invested in a specific investment?

To prevent a debate as to whether a trustee invested the sub-trust's UPE amount in a specific asset, or simply failed to invest the sub-trust's funds, further guidance should be provided in PSLA 3362 on how the trustee can disclose how it invested the funds to acquire a specific asset or a part of a specific asset. To illustrate the issue, the trustee of the sub-trust may have chosen to invest the funds in a capital asset with a view to holding the asset for long term capital growth and therefore the sub-trust may not be earning any periodic returns from the investment. It may also not be clear from the financial accounts of the main trust or private company that the UPE has been invested in a specific investment.

The ATO's further guidance should also clarify whether, in satisfying paragraph 44 of PSLA 3362, a trustee of a sub-trust can purchase a proportionate interest in an existing asset of the main trust, and whether the UPE could be set-off against the purchase price of the proportionate interest in the asset. The ability to invest in an existing asset of the main trust would be a practical compliance measure as the main trust may not, at the time, need to acquire a new asset for its business.

2.2 When does the investment by the sub-trust begin?

Further guidance is required regarding when the sub-trust's investment begins under Options 1 and 2. Although paragraph 58 of PSLA 3362 indicates that the parties have until the day on which the Section three deemed loan would have otherwise arisen (that is, the last day of the income year after the income year in which the distribution is taken to have been made) to establish the sub-trust arrangement, the ATO needs to clarify whether the investment starts on the day the decision is made to invest the sub-trust's funds or whether the investment is deemed to start on the day the trustee of the main trust resolved to make the relevant distribution to the company beneficiary (which is in relation to the prior income year).

The ATO should also clarify when the main trust should start paying the annual return on the investment to the sub-trust. Although Example 5 indicates that the annual return is calculated for the income year after the income year to which the UPE relates, the timing to start paying the return needs to be set out clearly in the body of PSLA 3362. (We understand from the Division 7A Working Party meeting that Example 5 may be predicated on the return being made in a year earlier than is required.)

2.3 What is the character of the returns from the investment to the sub-trust?

PSLA 3362 does not seem to address the character of the agreed returns from the investment to the sub-trust.

We understand from the Division 7A Working Party meeting on 17 June 2010, that it is the intention of the ATO to treat the investment under Option 1 as being similar to an investment in a debt interest.

Therefore, to the extent the funds are used by the main trust in the course of a business that is carried on with the purpose of producing assessable income, the part of the return representing the interest component would appear to be tax deductible to the main trust and assessable to the company. This characterisation must be clarified in the final Practice

Statement which should specifically confirm that interest will be deductible to the main trust under Taxation Ruling TR 2005/12.

Especially in view of obiter comments in Hasmid Investments Pty Ltd & Ors v FC of T 2001 ATC 2150 (Hasmid's case), we request the ATO also provide a view that the obiter comments contained in Hasmid's case would not preclude a deduction for returns paid by the main trust to the sub-trust. While Hasmid's case was not decided on the point of interest deductibility (as the distributions where taken to be sham) the following comment made at paragraph 23 of that case mentions that the interest may not be deductible where a return is paid from a main trust to a sub-trust.

> *23. … Even if the alleged distributions had been valid, the unremitted amounts would not be loans but amounts held by the trustee under separate trusts for each individual. There is no evidence that such amounts were invested so as to produce any part of the subsequent income of the trust so as to provide any further entitlement to income and, effectively, reduce that income. Consequently, there can be no allowable deductions in the 1987 and 1988 years for alleged ``interest''*

The ATO also discussed the nature of an investment under Option 2 at the Division 7A Working Party meeting in which the sub-trust is similar to a co-investor in the main trust's assets. We understand it is not envisaged that the main trust would need to execute a resolution to to distribute the sub-trust's agreed return on its investment. Instead we understand there would be a sharing of net (accounting) income of the main trust which would be apportioned between the sub-trust and the main trust according to the share of assets acquired from the UPE funds set aside and the main trust's other assets.

Further clarification of such treatment will be required in the final Practice Statement which should expressly deal with how this return is reflected in the financial accounts, income tax return and working papers of both the trustee of the trust and the company. Also, where the amount is a share of a loss, guidance is required as to whether that loss can be reflected in the company's tax return (or whether it is accumulated in the sub-trust under Division 6).

If the sub-trust is a co-investor in the main trust's assets, we note Example 5 will need to be revisited as the funds invested by Tin Pty Ltd would not be included in Gross assets of Green Discretionary Trust. In addition, this treatment seems to be in conflict with clause 3 of the Green Deed (and that may be the preferred description in the example is Gross assets used by the Green Discretionary Trust). The description of gross commercial assets in the denominator of the formula under Option 2 would need to be reconsidered as well.

2.4 Option 1

2.4.1 Use of funds invested by the sub-trust

We note that Option 1 in PSLA 3362 does not require the invested funds to be used for any particular purpose. Also, the ATO has indicated that there is no requirement for the funds to be used for an income producing purpose in order to apply Option 1. We recommend that this be clarified in the final Practice Statement (as well as confirming that the Practice Statement is generally applicable regardless of whether there is any use of the assets in the main trust to fund incidental private outgoings as canvassed at the Division 7A Working Group meeting on this issue).

2.4.2 Review period

For completeness, the final Practice Statement should also refer to the limited amendment period in section 171A for nil liability returns for the 2003-2004 income year, or earlier years, as some of these returns would have an amendment period of six years rather than standard four years. In addition, such a finalised Practice Statement should refer to the Commissioner's administrative practice of limiting his period of review for trustees (as they are not issued with notice of assessments) to

four years after the later of the due date or actual date of lodgement of the trust's tax return. The Commissioner's administrative practice is found on the ATO's website at: http://www.ato.gov.au/taxprofessionals/content.asp?doc=/content/00142229.htm.

2.5 Option 2

2.5.1 What is included in 'Gross commercial assets of the main trust'?

The annual return formula for Option 2 contains the component 'Gross commercial assets of the main trust'. Further clarification is required as to what assets are included in the 'gross assets of the main trust according to the financial statements for the relevant year'. For example, the final Practice Statement needs to expressly address whether intangible assets such as internally generated goodwill are included in the 'Gross commercial assets of the main trust' especially where such goodwill is unbooked.

Broadly, as currently drafted such gross assets may include the business assets of the trust as set out in its 'financial statements' for the relevant income year. Such assets will not include any unbooked internally generated goodwill which could lead to an understatement in the amount of the trust's gross assets. As a corollary this could lead to an overstatement in the amount of gross assets comprising assets acquired through the funding of UPEs and hence an overstatement of any agreed return. The implications of this approach should be expressly set out in the final Practice Statement.

Alternatively, PSLA 3362 currently allows such gross assets to be determined according to their market value. However, there is no guidance as to what documentation will be required to establish such a valuation, or how periodically such valuations must be undertaken. Accordingly, we recommend that the final Practice Statement include further prescriptive guidance on the evidence required in determining the current market value assets. In particular, it should clarify whether the trustee needs to obtain annual market valuations of gross assets, or if the trustee could conduct valuations on a more periodic basis being, say, once every three or five years. The latter approach should encourage increased compliance especially as many practitioners and their clients may be deterred from relying on Option 2 if they were required to incur the costs of annual independent valuations.

2.5.2 The period to repay the principal amount of the investment to the sub-trust

We note that there is no specific reference as to when the trustee of the trust is obliged to repay the principal amount back to the sub-trust under Option 2. We understand that the ATO has indicated that the obligation to repay the investment to the sub-trust would be at call by the trustee of the sub-trust. This issue should be expressly clarified in the final Practice Statement.

2.6 When does the sub-trust have to pay the annual return to the corporate beneficiary?

Based on paragraphs 48, 147, 148 and 149 of PSLA 3362, the trustee of the sub-trust must pay the annual return from its investment in the main trust, in respect of an income year, to the corporate beneficiary before the lodgement date of the corporate beneficiary's tax return for that income year. To provide clarity, the final Practice Statement should clearly state the specific time at which the agreed returns under Options 1 and 2 must be paid from the sub-trust to the corporate beneficiary to ensure that section 109D does not apply.

In addition, clear guidance is required as to whether the payment can be made in any form. For example, a 'payment' may be made in cash, by way of an offset against the corporate beneficiary's liabilities or through journal entries between entities.

2.7 More examples of Section three deemed loans

We recommend that more examples be provided illustrating the use of funds representing the UPE being used to acquire a specific investment as well as an example setting out the application of Option 1 in the finalised Practice Statement. The latter example may be particularly useful as we expect that many taxpayers will practically rely on this option as their default position.

Furthermore, depending on the final meaning of 'Trust Net Income' under Option 2, it would be useful to provide more examples concerning the application of Option 2 especially where accounting net income of the main trust is not the same as its taxable income.

It would also be useful to provide examples of both options for different trust scenarios e.g. scenarios dealing with different meanings of "income" under the trust deed and where the separate income and capital beneficiaries.

3. Outstanding issues

3.1 *Amendments to the Ruling*

In connection with our comments in item 3 under General Comments, we would request, at a minimum, that Example 8 of the Ruling be included in the binding section of the Ruling, in order to provide protection to taxpayers following principles contained in the final Practice Statement. Where this is not possible, we highlight that there is no taxpayer protection against primary tax for following the ATO view in relation to the creation of a sub-trust.

3.2 *Interaction between the Ruling and Subdivision EA retrospectively*

Also in connection with item 3 under General Comments, tax practitioners will need further practical guidance as to how to proceed in respect of prior income years. For example, say a client wants to voluntarily amend their tax returns where the corporate beneficiary has a UPE from a trust caught under Section two of the Ruling for a prior income year being, say the year ended 30 June 2006. In that year, a shareholder of the company also borrowed money from the trust which should have been a deemed dividend under Subdivision EA at that time based on the interpretation of Division 7A at that time. In amending the client's 2006 tax return, guidance is needed as to whether the trust should include the UPE as a deemed dividend from the company so that the beneficiaries of the trust in the 2006 year derive the additional assessable income or whether section 109XB should apply so that the shareholder that borrowed the money bears the additional tax burden.

3.3 Impact of the Ruling on UPEs to non-corporate beneficiaries

Now that the ATO's view on UPEs to corporate beneficiaries has been formalised in the Ruling, it is noted that the same rationale in the Ruling could apply to UPEs to non-corporate beneficiaries. It would be useful if the ATO could provide its view on whether the same rationale would be applied to UPEs to non-corporate beneficiaries.