The Tax Institute

4 October 2022

Christopher Ryan
Tax Counsel Network
Australian Taxation Office

By email: christopher.ryan@ato.gov.au

Dear Mr Ryan

Practical compliance guideline for section 100A: Additional draft green zone examples

The Tax Institute welcomes the opportunity to make a submission to the Australian Taxation Office (**ATO**) in relation to the proposed updates to PCG 2022/D1 *Section 100A reimbursement agreements – ATO compliance approach* (**draft PCG**) contained in the document titled 'Practical compliance guideline for section 100A: Additional draft green zone examples' (**updated guidance**).

It is pleasing to see that the ATO has listened to and reflected on the feedback received during the earlier consultation on the draft PCG. In particular, the proposed additional green zone examples and removal of the blue zone indicate that the ATO has responded to some of our concerns. However, we note that there remain a number of matters of significant concern that were raised in our earlier submission which are still to be addressed by the ATO. We would be happy to work with the ATO to resolve these outstanding matters.

The Tax Institute broadly supports the inclusion of further examples in the draft PCG that will help taxpayers and tax practitioners better understand the perceived risk of their arrangements by the ATO. Clear examples that are based on underlying principles will provide clarity and certainty for taxpayers, likely assisting in greater voluntary self-compliance and identification of potential risks. We consider that the proposed examples in the updated guidance will assist with this objective. However, further modifications and additions to the draft PCG and proposed examples are suggested to improve clarity for taxpayers.

In particular, we consider that the proposed time lag for satisfying trust entitlements would benefit from being categorised as a safe harbour from an ATO compliance perspective. This will provide clearer guidance about the intended operation of the time lag. The proposed time lag should also have an easily identifiable start date to remove potential confusion about its scope and application.

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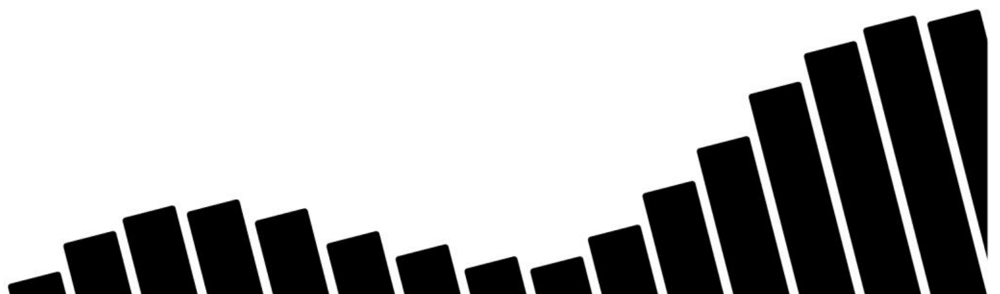

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The current scope of the green zone for distributions to loss entities requires further clarification in the draft PCG and proposed examples to ensure that it accurately reflects common market transactions and provides maximum guidance to taxpayers. In particular, the requirement for the loss beneficiary to continue to be solvent may be difficult for a taxpayer to demonstrate in practice, especially when related party loans are involved.

Some of the proposed examples could also benefit from minor clarifications to more accurately reflect commercial practices faced by practitioners each day and provide taxpayers and tax practitioners with greater certainty. For instance, the proposed example for testamentary trusts would benefit from further detail. The way in which it is currently drafted may not help taxpayers and tax practitioners in identifying aspects of an arrangement that may have a higher risk profile.

The Tax Institute supports the removal of the blue risk zone and considers that its removal will simplify the draft PCG for taxpayers and tax practitioners.

Our detailed response is contained in **Appendix A**. We would be grateful for the opportunity to review the draft PCG on a confidential basis once it has been updated to incorporate the feedback received from this consultation.

The Tax Institute is the leading forum for the tax community in Australia. We are committed to shaping the future of the tax profession and the continuous improvement of the tax system for the benefit of all. In this regard, The Tax Institute seeks to influence tax and revenue policy at the highest level with a view to achieving a better Australian tax system for all. Please refer to **Appendix B** for more about The Tax Institute.

If you would like to discuss any of the above, please contact our Senior Advocate, Robyn Jacobson, on (03) 9603 2008.

Yours faithfully,

Jerome Tse

President

APPENDIX A

We have set out below our detailed comments and observations for your consideration to ensure that the draft PCG and updated guidance on section 100A of the *Income Tax Assessment Act 1936* (Cth) (**ITAA 1936**) provides the most effective and practical advice for taxpayers and their advisers. All legislative references are to the ITAA 1936 unless otherwise indicated.

Introduction to the ATO guidance

The Introduction to the updated guidance (**Introduction**) provides context for this consultation and the proposed new examples for inclusion in the draft PCG. The Introduction contains guidance that does not appear elsewhere in the updated guidance or in the examples, for example:

- the solvency conditions applying to loss beneficiaries — not mentioned in new green zone scenario 3B; and
- the two-year time lag for arrangements to remain within the green zone — not mentioned in either of the new green zone examples dealing with time lags.

It is not clear how or whether the guidance in the Introduction will be incorporated into the draft PCG or the proposed new examples. We recommend that the guidance under point 4 of the Introduction should be included as part of the ATO's compliance approach in the draft PCG and possibly in any examples that refer to this guidance.

Removal of blue zone

The Tax Institute supports the removal of the blue risk zone. This approach will simplify the interpretation of the draft PCG and allow taxpayers and tax practitioners to better understand the risks associated with their current arrangements. Given the fact specific nature of section 100A, we also support the greater use of examples to demonstrate high risk features of an arrangement. However, it is important for the draft PCG to note that any examples contained within are for illustrative purposes and are not risk assessment templates that require strict adherence by taxpayers.

Loss beneficiaries

It is pleasing that the proposed updates to the draft PCG allow distributions to loss beneficiaries to fall within the green zone in some circumstances. However, we consider that the draft PCG would be improved with some further clarifications.

Same family group

We note that the first bullet under point 4 in the Introduction states:

> a loss trust or company beneficiary(s) are presently entitled to trust income and those beneficiaries are members of the same family group (as defined in the tax law) as the distributing trust …

We welcome the addition of this arrangement to the green zone but suggest that the draft PCG should clarify the conditions in which arrangements involving distributions to loss beneficiaries fall within the green zone. We consider that the ATO should provide a specific legislative reference regarding the source of the term ‘family group’.

Use of the loss beneficiary’s entitlement

Proposed new scenario 3B (discussed further below) involves a distribution to a loss beneficiary where the funds are retained by the trustee for working capital purposes. The arrangement is managed under a complying Division 7A loan agreement and is therefore considered to fall within the green zone.

In contrast, the current wording in paragraph 42 of the draft PCG appears to indicate that any distributions to a loss beneficiary will fall within the red zone unless the entire economic benefit of the entitlement is utilised by the beneficiary. Proposed new scenario 3B illustrates that arrangements where the beneficiary does not utilise the funds representing their distribution do not always fall into the red zone. We are of the view that the ATO should reconsider whether the blanket statement in paragraph 42 should be revised to more accurately reflect the ATO’s position.

We also question the wording ‘particularly if the loss beneficiary(s) use the trust entitlement to fund an equity distribution.’ The draft PCG should more clearly state the circumstances in which distributions to loss beneficiaries fall within the green zone, particularly if they are using the funds representing the trust entitlement to make an income or a capital distribution to their stakeholders (that is, their beneficiaries or shareholders).

Feedback from our members indicates that the proposed condition requiring that the loss beneficiary continue to be solvent will likely be difficult to demonstrate in practice or may involve the loss beneficiary having liabilities owing to related parties that are unlikely to be called up. For example, a loss beneficiary may not be solvent when considering only their financial position on a balance sheet basis, either before or after the distribution. However, all the beneficiary’s creditors may be related parties who are not calling for repayment of their inter-entity loans, thereby ensuring the ongoing operations and liquidity of the beneficiary. We consider that the primary focus should instead be on whether the use by the loss beneficiary of the distribution to repay related party creditors is an arrangement to which section 100A applies.

New green zone examples for proposed time lag

The updated guidance proposes to introduce an additional green zone example whereby the time lag between when a beneficiary becomes entitled to trust income and that entitlement being satisfied does not exceed two years. The Tax Institute broadly supports this approach as it provides certainty and clarity for taxpayers and tax practitioners.

However, we consider that the time lag should be framed as a safe harbour, provided other features that indicate a higher risk zone are not present. Factors that indicate a higher risk zone could include gifting or on-lending, or some other transaction that constitutes a reimbursement agreement, after the entitlement has been satisfied. This will ensure that the proposed time lag is effective in providing taxpayers with guidance and certainty on their arrangement.

We understand that the proposed time lag is an ATO administrative approach rather than a feature prescribed in the legislation. We consider that the draft PCG should expressly state that the ATO is not prescribing a two-year period within which trust entitlements of beneficiaries must be satisfied. As currently worded, there is a risk that taxpayers and tax practitioners may construe the proposed time lag to mean that beneficiaries' trust entitlements must be satisfied within a two-year period or the arrangement will automatically fall within section 100A.

We therefore recommend that the draft PCG make it clear that a safe harbour will exist where the trust entitlement is satisfied within two years, and that an arrangement where the entitlement is not satisfied within two years does not fall within the scope of the safe harbour (however, there may be other factors that result in the arrangement still falling within the green zone). In this latter case, the arrangement does not automatically fall within section 100A, and the ATO may make further enquiry to better understand the arrangement.

Arrangements outside the two-year period

We also consider that the updates to the draft PCG should provide clarity that an arrangement involving the satisfaction of a trust entitlement after two years of itself should not cause the arrangement to fall within the red zone. This will require a consideration of all the taxpayer's circumstances.

By way of example, an arrangement based on the proposed green zone example (Tortoise Trust) should still fall within the green zone, even if the arrangement continues for more than two years. The draft PCG should clearly state this interaction to avoid confusion or misunderstandings about the application and scope of the proposed time lag.

Starting point needed for time lag

The proposed time lag will need an easily identifiable starting point to ensure there is clarity, consistency and certainty for taxpayers. The two-year period could start immediately after the end of the income year in which the present entitlement arises, or the date of lodgment of the tax return for the beneficiary for that year (being the time at which it is clear that the beneficiary has acknowledged their present entitlement).

While some may prefer the two-year period to start when the trust entitlement is known by the beneficiary, The Tax Institute prefers the first option. It will generally be easier and more consistent for taxpayers and tax practitioners to start the two-year period from the end of the income year in which the trust entitlement arises. This will ensure that a universal two-year period would apply to all affected taxpayers rather than the start of the period being dependent on when the tax return is lodged or the beneficiary acknowledges their present entitlement.

New green zone scenario 3A

We note that proposed scenario 3A (McDonald Family Trust) is similar in facts and outcome to existing example 2 in the draft PCG. The primary difference appears to be the different industries in which the relevant business operates. We consider that further explanation of any differences in the underlying intent of the beneficiaries, or use of the beneficiaries' entitlements, should be further expanded upon to ensure they are correctly interpreted and differences identified. This will also assist in understanding the utility that proposed scenario 3A brings to the draft PCG.

New green zone scenario 3B

Paragraph 22 of the updated guidance states:

> ... the trustee of Black Trust and Red Pty Ltd subsequently enter into a loan agreement ... that meets the requirements of section 109N of the ITAA 1936.

This wording, together with the other facts in the scenario, suggests that where funds are used for working capital and the amount of the UPE is managed under a Division 7A compliant loan agreement, the arrangement falls within the green zone (in the absence of any high risk features).

We note that new green zone scenario 3B (Black Trust) seems to be based on the 2014 web guidance that discusses the interaction of section 100A and Division 7A. In particular, that guidance expressly stated the ATO's position as follows:

> Where a loan from a beneficiary to a trust is a complying loan under Division 7A (or an unpaid entitlement is held by the trust on terms described in PS LA 2010/4 and the funds retained in the trust are used as working capital, the ATO would consider the arrangement, in the absence of other factors, to be in the course of an ordinary commercial dealing.

The Tax Institute recommends that the draft PCG should clarify whether a loan that is being managed on Division 7A complying terms is considered to be an ordinary commercial dealing and would therefore fall within the green zone. This is inferred by proposed new green zone scenario 3B.

New green zone example for loss beneficiaries

Feedback from our members indicates that private business structures will usually have a combination of loans from both third parties and related parties. As a result, we consider that the proposed new example for green zone scenario 4 (Top Trust) should be updated to include a mixture of related party and third party creditors to whom money is owed. This may be achieved by noting that the loans consist of a bank overdraft and at-call loan from Doctor Evergreen. The inclusion of this fact pattern should not alter the outcome from a section 100A perspective, but it will more accurately represent common loan structures.

We also note that beneficiaries are rarely, if at all, notified of the quantum of their trust entitlement on the same day as that entitlement is ascertained by the trustee. In practice, there is generally a delay between when the trustee ascertains the trust entitlement and informs the beneficiary of that entitlement for various reasons that are not associated with or related to tax avoidance. The accuracy and relevance of the example would be greatly improved if it instead stated that the beneficiary is notified 'within a few weeks.'

New green zone example for testamentary trusts

Feedback from our members indicates that the proposed example concerning the green zone for testamentary trusts concerns a scenario where few practitioners are likely to consider the potential application of section 100A, as the risk of it applying to this arrangement is very low.

For this example to have the utility sought by the ATO, we consider that it should include aspects or features that are more likely to raise concerns but still fall within the green zone. Alternatively, the draft PCG may benefit from further examples which highlight aspects that concern the ATO and would subsequently result in a testamentary trust arrangement falling within one of the higher risk zones.

Updated references

We consider that the draft PCG should include updated references to other related guidance materials. In particular, we consider that Taxation Determination TD 2022/11: *Income tax: Division 7A: when will an unpaid present entitlement or amount held on sub-trust become the provision of 'financial accommodation'?* (**TD 2022/11**) should be included in the list of related guidance. TD 2022/11 contains important information that may be related to the terms under which a complying loan is made for the new example in green zone scenario 3B.

APPENDIX B

About The Tax Institute

The Tax Institute is the leading forum for the tax community in Australia. We are committed to representing our members, shaping the future of the tax profession and continuous improvement of the tax system for the benefit of all, through the advancement of knowledge, member support and advocacy.

Our membership of more than 11,000 includes tax professionals from commerce and industry, academia, government and public practice throughout Australia. Our tax community reach extends to over 40,000 Australian business leaders, tax professionals, government employees and students through the provision of specialist, practical and accurate knowledge and learning.

We are committed to propelling members onto the global stage, with over 7,000 of our members holding the Chartered Tax Adviser designation which represents the internationally recognised mark of expertise.

The Tax Institute was established in 1943 with the aim of improving the position of tax agents, tax law and administration. More than seven decades later, our values, friendships and members' unselfish desire to learn from each other are central to our success.

Australia's tax system has evolved, and The Tax Institute has become increasingly respected, dynamic and responsive, having contributed to shaping the changes that benefit our members and taxpayers today. We are known for our committed volunteers and the altruistic sharing of knowledge. Members are actively involved, ensuring that the technical products and services on offer meet the varied needs of Australia's tax professionals.