The Tax Institute

2 May 2022

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Cc: Justin Dearness, Tax Counsel Network, Australian Taxation Office
Christopher Ryan, Tax Counsel Network, Australian Taxation Office

Dear Mr Glindemann

Draft Taxation Determination TD 2022/D1 | Income tax: Division 7A: when will an unpaid present entitlement or amount held on sub-trust become the provision of 'financial accommodation'?

The Tax Institute welcomes the opportunity to make a submission to the Australian Taxation Office (**ATO**) in relation to draft Taxation Determination TD 2022/D1 *Income tax: Division 7A: when will an unpaid present entitlement or amount held on sub-trust become the provision of 'financial accommodation'?* (**draft TD**).

In the development of this submission, we have closely consulted with our National Small and Medium Enterprises Technical Committee and National Taxation of Individuals Committee to prepare a considered response which represents the views of the broader membership of The Tax Institute.

Given that the draft TD will effectively replace Taxation Ruling TR 2010/3: *Income tax: Division 7A loans: trust entitlements* (**TR 2010/3**), and Law Administration Practice Statement PS LA 2010/4: *Division 7A: trust entitlements* (**PS LA 2010/4**), it is important to ensure that taxpayers will still have access to the relevant information and be able to effectively transition from the existing guidance to the new guidance. In particular, this will involve ensuring that any safe harbours or existing concessions — particularly, the treatment of pre-16 December 2009 unpaid present entitlements (**UPEs**) and the availability of the sub-trust options set out in PS LA 2010/4 until maturity for existing arrangements — continue to be in place, otherwise taxpayers will risk being unfairly targeted for following and applying historical ATO guidance.

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It is also important for the ATO to ensure that no new concepts or changes in position are introduced without the appropriate supporting guidance and explanation for such changes. Further, any interactional issues, such as those with Subdivisions EA and EB of Part III of the *Income Tax Assessment Act 1936* (**ITAA 1936**), should be addressed in ATO guidance.

We would be pleased to continue to work with the ATO on further development of the draft TD to ensure it provides the most useful advice and guidance for taxpayers and their advisers.

Our detailed response is contained in **Appendix A**.

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 TD provides the most effective and practical advice for taxpayers and their advisers. All legislative references are to the ITAA 1936 unless otherwise stated.

Timing concerns

TR 2010/3 and PS LA 2010/4 have provided certainty about when a UPE is deemed to be a Division 7A loan under section 109D(3). TR 2010/3 and PS LA 2010/4 both state that if a UPE is not fully repaid by the lodgment date of the trust's income tax return for the income year in which the UPE arose, it is deemed to be the provision of financial accommodation and, therefore, the making of a Division 7A loan in the year in which the UPE arose.

Feedback from our members indicates that this approach was relatively simple, understood, easy to apply and has been applied for more than a decade by taxpayers and tax practitioners.

The approach currently proposed in the draft TD, whereby the Division 7A loan is taken to be made in either:

- the income year in which the present entitlement arises (where the amount of the corporate beneficiary's present entitlement is expressed in the trustee resolution as a fixed amount from the trust income); or
- the year in which the corporate beneficiary can demand immediate payment of an amount from the trustee once the trust income is calculated, typically after the end of the income year in which the present entitlement arises (where the present entitlement is expressed in the trustee resolution as a proportion or percentage of the trust income),

creates unnecessary complexity and uncertainty.

The approach currently proposed will likely result in uncertainties and disputes around timing based on an assumption as to when the company is taken to have knowledge of its entitlement. However, this assumption is not reflective of commercial practices and may not align with the intent underpinning the timing distinction above.

Feedback from our members makes it clear that, in practice, trustees' resolutions to distribute a fixed amount from the income of a trust estate (**trust income**) may still result in the final amount of the present entitlement remaining unknown until the trust income is calculated and the financial accounts and tax returns are prepared, well into the year following the income year in which the present entitlement arose.

It is not uncommon that choices by the trustee are required to be made in the course of determining the trust income. This, combined with common accounting practices, can often result in the trust ultimately having either more or less distributable income than the fixed amount specified in the trustee resolution. Trustees commonly resolve to distribute the first $X amount to the corporate beneficiary, uncertain of whether this amount of distributable income will even be available. There could also be trust liabilities or expenses that reduce the trust income but which are not identified until after the end of the income year.

Further, feedback from our members suggests that it does not necessarily follow that the amount of a present entitlement cannot be known until the trust income is calculated where the entitlement is expressed as a proportion or percentage of the trust income. For example, if the only income of the trust is a dividend, and the corporate beneficiary is made presently entitled to 100% of the trust income, the amount of the present entitlement will be known when the entitlement arises. See also the discussion below on this point.

Moreover, the approach currently proposed in the draft TD may encourage tax planning behaviour. For example, some taxpayers may make use of the wording in the draft TD to attempt to obtain more than a 12-month benefit, provided they can show that knowledge of the amount of the present entitlement did not exist until more than one year after the income year in which the present entitlement arose. For example, taxpayers may contend that it took until after June 2023 to finalise the tax calculations and determine the trust income for the 2021–22 income year, which, according to the draft TD, would result in the provision of financial accommodation in the 2023–24 income year rather than the 2021–22 income year.

Alternatively, some taxpayers may reverse engineer the way in which present entitlements are expressed in trustee resolutions to deliberately state them as a percentage or proportion of the trust income instead of a fixed amount. On the approach currently proposed in the draft TD, this would enable them to delay the income year in which the financial accommodation is taken to have been provided. For example, if a trust has knowledge that it will likely receive income from only one source (e.g. dividend income), the trustee may resolve to make a corporate beneficiary presently entitled to 100% of the trust income. In this scenario, despite the trustee practically knowing the amount of the distributable amount by the end of the financial year in which the present entitlement arises, the corporate beneficiary may claim that the amount was unknown until the trust income was determined and the tax calculations were finalised after the end of that income year.

For all these reasons, we consider that the draft TD should take a uniform and practical approach that addresses these practical difficulties and removes any tax planning incentives. This could be achieved if an approach consistent with that set out in PS LA 2010/4 is adopted. That is, the default position should be that the financial accommodation is taken to be provided by the trustee in the income year following that in which the present entitlement arises. This approach is well understood and has been accepted by taxpayers since 2009. It would also remove the perception that the Commissioner has changed his position on the matter and avoid the need to assume or impute knowledge between entities (see further below). We suggest that all instances where the draft TD seeks to depart from any of the well understood and accepted concepts set out in in PS LA 2010/4 should be clearly noted.

Further, we consider that the ATO should amend the draft TD to explicitly state that staged or tiered resolutions[1] will not necessarily give rise to immediate knowledge of the amount of the corporate entity's present entitlement. As noted above, there are several reasons why the amount may be unknown despite the present entitlement being expressed in the trustee resolution as a fixed amount from the trust income.

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1 Usually expressed as the First $X of the trust income to be distributed to one beneficiary, the Next $X of the trust income to another beneficiary, and the Balance of the trust income to a further beneficiary.

Knowledge and imputed knowledge

Paragraph 10 of the draft TD introduces the concept of 'knowledge,' and indicates instances where knowledge may be imputed between the parties. 'Knowledge' and 'imputed knowledge' is a topic on which the ATO has not previously provided guidance. Accordingly, we consider that the community likely has a lack of understanding around what these concepts mean and how to apply them in practice.

Some examples where the concept of imputed knowledge is relevant include:

- Different individuals in directorship roles;
- Where Spouse A controls the corporate beneficiary while Spouse B controls the trust; and
- Instances where the shareholder(s) of the corporate beneficiary is not the same person(s) as the trustee or the shareholder(s) of the corporate trustee.

If the Commissioner were to maintain the proposed approach of the differing treatment of distributions described above, necessitating an application of the new concept of knowledge and imputed knowledge, we consider that the ATO should provide detailed guidance, supported by practical examples, about what constitutes 'knowledge' and when this knowledge can be imputed between the related parties. Without this detailed guidance, we consider it unreasonable for the ATO to impute knowledge apart from instances where the same individual(s) signed both sets of financial accounts (that is, for the trust and the corporate beneficiary).

Concepts in older guidance products

We note that TR 2010/3 and PS LA 2010/4 contain several concepts as outlined below that will continue to be relevant and useful beyond when the draft TD is finalised and takes effect. We consider that the key concepts from TR 2010/3 and PS LA 2010/4 should be retained where relevant, noting that this may need to be included in separate ATO guidance products.

Alternatively, the draft TD could include a detailed side-by-side comparison of the differences between the approaches in the draft TD and those in TR 2010/3 and PS LA 2010/4. We consider that such comparisons could be set out in a table that should also note the reasons for any changes in the ATO's position.

When financial accommodation is taken to be provided

TD 2010/3 contains detailed guidance outlining when financial accommodation is taken to be provided by the trustee. This enables taxpayers to better understand and apply the law. In contrast, we are of the view that the draft TD does not contain sufficient information on this point. Once TR 2010/3 is withdrawn, we consider that taxpayers will find it unnecessarily difficult to find information on this topic. We consider that the draft TD, or another ATO guidance product, should contain this information.

Safe harbours

PS LA 2010/4 contains safe harbours in the form of sub-trust investment options 1, 2 and 3. Since 2010, these safe harbours have provided taxpayers with comfort, allowing them to structure their tax affairs in a practical method that is also low risk. The draft TD does not provide similar safe harbours, and leaves taxpayers who have previously relied on them uncertain of the tax consequences of continuing with the same or similar arrangements.

Specifically, it is unclear whether:

- taxpayers can continue managing existing UPEs held on sub-trust under one of these investment options until their maturity date without an adverse Division 7A consequence;
- the option available under PCG 2017/13 — to put in place a 7-year loan on complying Division 7A terms in accordance with section 109N between the sub-trust and the corporate beneficiary prior to the company's lodgment day to provide a further period for the amount to be repaid with periodic payments of both principal and interest — continues to be available for existing sub-trust arrangements.

We consider that the draft TD should continue to provide these safe harbours. If the ATO intends to remove them, we consider that this should be made clear in the ATO guidance, accompanied by:

- the reasons outlining the ATO's change in position (compared to that set out in PS LA 2010/4); and
- a reasonable period of time to allow taxpayers, who relied on any of the safe harbours in PS LA 2010/4 in good faith, to seek advice and re-structure their affairs into those that are appropriate and acceptable to the ATO.

Treatment of pre-16 December 2009 distributions

Paragraph 28 of TR 2010/3 states that:

> Section three of … [TR 2010/3] does not apply to UPEs arising before 16 December 2009.

The draft TD remains silent on the Division 7A status of pre-16 December 2009 UPEs. Given that TR 2010/3 is proposed to be withdrawn once the draft TD takes effect, the status and tax treatment of pre-16 December 2009 UPEs is now uncertain.

We consider it to be inappropriate for the ATO to change their position on UPEs arising before 16 December 2009, especially as the ATO has historically not applied the approach in TR 2010/3 to these UPEs. Further, we note that the Commissioner would be out of time to issue amended assessments deeming dividends pursuant to section 109D on the basis that a pre-16 December 2009 UPE constitutes the provision of financial accommodation.

We consider that the ATO should continue to maintain its previous stance and amend the draft TD to make it clear that the position set out in the TD will not apply to UPEs arising before 16 December 2009.

Treatment of pre-4 December 1997 loans

Division 7A does not generally apply to loans made before 4 December 1997. Based on the law, the ATO has had a long-standing practice of permitting these loans to remain quarantined and making them subject to Division 7A only in certain circumstances (e.g. if the term of the loan is extended or the amount increased pursuant to section 109D(5) or if the loan is forgiven and section 109F applies).[2]

We consider that the draft TD should clearly state that this approach will continue, ensuring that taxpayers have comfort and certainty over their existing arrangements.

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[2] We also note the Commissioner's position in PS LA 2006/2 (GA) regarding the operation of Division 7A in relation to loans that have become statute barred.

Interaction with Subdivisions EA and EB

We note that, if finalised, the view in the draft TD will contain significant overlap with Subdivisions EA and EB (about UPEs). We consider that the extent of the overlap would effectively mean that Subdivisions EA and EB will practically apply only:

- in respect of prior existing UPEs; and
- for arrangements that occur in the period between 30 June and when the company ascertains the amount of their present entitlement (the point at which the UPE is taken to be a loan for tax purposes and therefore Subdivisions EA and EB would cease to apply as the UPE would no longer exist).[3]

We consider that the draft TD should, similar to TR 2010/3, explicitly state that the Commissioner will not seek to apply Subdivisions EA or EB outside of the two instances mentioned above. We consider that this will make the system notably simpler to administer and reduce the compliance burden for taxpayers.

We have also noted below some specific concerns regarding the interaction of the draft TD with Subdivision EA that require further clarification and guidance:

- The draft TD appears to depart from the position in TR 2010/3 by saying at paragraph 12 that where an amount is held on sub-trust for the sole benefit of the corporate beneficiary, the present entitlement to income is paid and there is no UPE. This contrasts with TR 2010/3 that infers that an amount held on sub-trust continues to be a UPE to which Subdivisions EA or EB may potentially apply.
- The draft TD should clarify the possible application, if any, of Subdivision EA or EB where an amount is held on sub-trust for the sole benefit of the corporate beneficiary as — according to the ATO — it is no longer a UPE and also does not constitute the provision of financial accommodation (and is therefore not a loan under section 109D(3)).
- Paragraph 146 of the draft TD is unclear regarding when amounts will not be treated as UPEs for the purposes of Subdivisions EA and EB. The paragraph provides an example of amounts that are 'dealt' with under section 109D. However, this view may not apply in all circumstances, such as where the UPE arose before 16 December 2009.
- Paragraph 147 of the draft TD outlines the limited scope of Subdivision EA as applying to instances where the trust and the corporate beneficiary do not share the same controlling mind. We consider that there may be other circumstances that could fall within the scope of Subdivision EA. In particular, pre-16 December 2009 UPEs or post-15 December 2009 UPEs held on sub-trust in accordance with PS LA 2010/4 may be within the scope of Subdivisions EA or EB in instances where the trust lends money to a shareholder or associate of a shareholder of the corporate beneficiary (**shareholder/associate**). The draft TD should also make reference to Subdivision EB throughout wherever there is a reference to Subdivision EA.

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[3] See paragraph 12 of TD 2022/D1.

- Paragraph 148 suggests that where amounts are set aside by the trustee and held on sub-trust for the exclusive benefit of the corporate beneficiary, the conditions for Subdivision EA to operate are not satisfied because there is no UPE. It is unclear whether this is under an arrangement consistent with that described in Option 3 of PS LA 2010/4. We consider that clarification is needed around whether this arrangement needs to be consistent with Option 3 from PS LA 2010/4 — including the need for the sub-trust to prepare its own accounts showing the investment and prepare its own tax return — and whether the ATO's preliminary view in paragraph 148 applies to sub-trusts made in accordance with Option 1 and Option 2 of PS LA 2010/4.
- We consider that confirmation is required that, under the ATO's preliminary view in the draft TD, a post-15 December 2009 but pre-1 July 2022 UPE held on sub-trust may still result in a Subdivision EA or EB issue where a loan is made by the trust to a shareholder/associate of the corporate beneficiary. However, from 1 July 2022, there is no UPE that can result in Subdivision EA or EB applying, as potentially indicated by paragraph 148 of the draft TD.

Division 7A potentially applying twice

We have concerns that the draft TD may give rise to instances where Division 7A is, effectively, applied twice to a single arrangement. This may occur in instances where the taxpayer creates a sub-trust that mirrors a Division 7A compliant loan, and the funds are used by a shareholder/associate of the corporate beneficiary. Based on paragraph 13, the corporate beneficiary is not taken to provide financial accommodation where the funds are held for the sole purpose of the corporate beneficiary by the sub-trustee. Paragraph 14 goes onto say that where the funds are used by a shareholder/associate of the corporate beneficiary, the corporate beneficiary is taken to have provided financial accommodation to the shareholder/associate.

However, as the funds are no longer held for the sole purpose of the corporate beneficiary, the exclusion from the arrangement being the provision of financial accommodation no longer applies. Accordingly, the arrangement, by extension, must therefore constitute the provision of financial accommodation by the corporate beneficiary in favour of the trustee. This is in addition to the financial accommodation that is taken to the provided by the corporate beneficiary to the shareholder/associate, resulting in two Division 7A loans arising under the same arrangement.

It is unclear how the amount to which the corporate beneficiary is entitled should be treated or characterised, given the ATO's position in paragraph 14.

Underlying assumption about how funds are stored

We note that paragraph 13 of the draft TD states:

> A choice by the private company not to exercise that right does not constitute financial accommodation in favour of the trustee in its capacity as trustee of the sub-trust, because the sub-trust fund is held for private company beneficiary's sole benefit.

We consider that this statement potentially reflects the approach that the draft TD is based on an underlying assumption that a separate bank account is created for the purposes of storing the monies for the purposes of the trustee determining which entities are entitled to or can access the money.

We do not see that there is a principle established in the law that requires the sub-trustee to create a separate sub-account with a third-party deposit-taking institute to validly hold the funds for the corporate beneficiary's sole benefit.

The draft TD does not provide any guidance regarding the evidence required to demonstrate the existence and terms of a 'separate trust'. It is unclear whether the trustee of the sub-trust is required to prepare separate financial statements and a separate tax return and whether a separate Tax File Number (**TFN**) is required to be obtained by the sub-trust. A lack of guidance on this point will cause significant uncertainty for taxpayers and likely result in future disputes regarding appropriate evidence.

Sub-trusts and financial accommodation

Subject to our comments above regarding the underlying assumption about how funds in a sub-trust are stored, we consider that the draft TD contains uncertainty around how the corporate beneficiary provides financial accommodation where there is a sub-trust. We note that paragraphs 14 and 15 of the draft TD state that financial accommodation will be provided by the corporate beneficiary if the funds of the sub-trust are able to be used by the shareholder/associate of the corporate beneficiary.

In particular, we consider that the draft TD should clarify:

- from where the funds are effectively 'sourced'; that is, from the sub-trust or the main trust, and whether the distinction matters;
- how this distinction will impact the potential provision of financial accommodation.

Interaction with PCG 2017/13

We consider that the ATO should clearly state how Practical Compliance Guideline PCG 2017/13: *Division 7A – unpaid present entitlements under sub-trust arrangements maturing in the 2017, 2018, 2019, 2020 or 2021 income years* (**PCG 2017/13**) will apply going forward.

We note that the PCG 2017/13 has been extended three times while the ATO has awaited legislative reform targeting Division 7A and UPEs. With the release of the draft TD and subsequent withdrawal of PS LA 2010/4, taxpayers need a clear pathway when managing their sub-trust arrangements. We do not consider it appropriate for taxpayers to wait until very late in each income year for the ATO to potentially update PCG 2017/13 for further guidance limited to that financial year. This piecemeal approach does not provide long-term certainty for taxpayers.

We consider that the ATO should publicly state, well in advance of 30 June 2022, the extension status of PCG 2017/13. That is, confirmation that PCG 2017/13 will either not be extended, or that it will be extended, to all UPEs arising on or before 30 June 2022 that are held on sub-trust and have not been fully repaid on maturity of the 7- or 10-year term. This will enable impacted UPEs to flow through the system and be managed for the extended term as a complying Division 7A loan.

We note that, effectively, a renewal would need to extend to as late as:

- the 2029–30 income year for 30 June 2022 UPEs that are placed on 7-year sub-trust arrangements, pursuant to Option 1 of PS LA 2010/4, during the 2022–23 income year; and

- the 2032–33 income year for 30 June 2022 UPEs that are placed on 10-year sub-trust arrangements, pursuant to Option 2 of PS LA 2010/4, during the 2022–23 income year.

Example 2 in paragraph 36

We consider that paragraph 36, contained in Example 2, of the draft TD should explicitly state whether X Co has provided financial accommodation to any person. We note that paragraph 14 of the draft TD broadly states that financial accommodation will be taken to be provided where the corporate beneficiary consents to the sub-trustee allowing those funds to be used by the company's shareholder/associate. However, it remains unclear whether the user of the funds will not be taken to have been provided with financial accommodation even when they are a third party, such a bank. We note that in Example 2, the sub-trust funds are effectively being lent to the bank.

We consider that Example 2 should make it clear whether the bank has received financial accommodation from the company, or whether no financial accommodation has been provided merely because of the nature of relationship between the bank and the corporate beneficiary. We note that a provision of financial accommodation in this example should not result in a deemed dividend under section 109D as the bank is not otherwise a shareholder/ associate of the corporate beneficiary.

Meaning of 'used'

The term 'used' is contained in the draft TD approximately 13 times. However, this term is not defined or adequately described, creating potential ambiguity for taxpayers and making it difficult for them to understand and apply the draft TD. We note that 'used' is a broad term that can easily change its practical meaning depending on the context in which it is used.

We consider that the term 'used' should be defined in the draft TD. Further, all the examples should specifically note:

- whether the relevant 'use' being described is referring to the sub-trust's funds or those of the main trust;
- how they are being 'used'; and
- from where the funds are being sourced.

This will clarify the operation of the law for taxpayers and enable them to better understand and apply the draft TD.

We note that the draft TD suggests that where amounts are set aside on sub-trust, the use of funds by a shareholder/associate with the corporate beneficiary's knowledge amounts to the provision of financial accommodation by the corporate beneficiary. However, in instances where the asset being 'used' is not cash, but another asset such as property, uncertainty arises whether this 'use' amounts to the provision of financial accommodation or has an alternate impact (for example, a section 109CA 'payment'[4]). It may be arguable that the 'use' of an asset such as a dwelling or a car is the provision of accommodation but not 'financial' accommodation.

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[4] It is noted that the type of payment defined by section 109C, and extended in its meaning by section 109CA (for companies), is much broader than the type of payment to which section 109XA(1) and section 109XB apply (for certain trust amounts).

We consider that the draft TD should provide guidance about the ‘use’ of assets that are not cash, clarifying whether this amounts to a ‘payment’ pursuant to section 109CA, or a ‘loan’ pursuant to section 109D. Further, clarification should also be provided regarding whether the potential payment or loan in these instances is made by the corporate beneficiary or the sub-trust.

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.