29 April 2022

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

Re: Draft Practical Compliance Guideline ('PCG') 2022/D1
Section 100A reimbursements – ATO compliance approach

Dear Christopher,

The National Tax & Accountants' Association ('NTAA') previously made a submission in relation to the retrospective nature of the proposed compliance guidelines in PCG 2022/D1. We welcome the opportunity to now make a further submission with respect to these guidelines.

The NTAA's reach as a professional association extends to over 10,000 member firms. Our interaction with the tax agent community includes involvement in the professional development of our members, along with the provision of technical support through our National Hotline Service.

As a result, the NTAA is uniquely positioned to comment on the proposed compliance guidelines and we are pleased to offer suggestions and raise concerns with a view to enhancing the practicality of the guidelines.

Our concerns

As a compliance tool, the 'traffic light' approach in PCG 2022/D1 is very effective. However, we are concerned that the compliance guidelines only contain a limited number of scenarios that fall into the green (LOW-risk) zone. Furthermore, of the scenarios presented, the features appear to be too narrowly defined, which could detract from the practicality of the guidelines.

It is argued that, if the ATO were to expand the green zone scenarios (see suggestions below), this would provide taxpayers with the ability to structure their affairs, and deal with the distribution of trust income, with a greater level of confidence. If done appropriately, such an approach should continue to only outline arrangements that would most likely fall outside the ambit of S.100A of the ITAA 1936 ('S.100A').

Green zone scenarios – distributions to members of beneficiary's family and ordinary family or commercial dealings

The following comments relate to green zone arrangements that involve trust distributions made to members of a beneficiary's family and ordinary family or commercial dealings (paragraphs 17 – 19 of PCG 2022/D1).

- Paragraph 17 – There is currently uncertainty as to the scope of paragraph 17. For instance, the following requires clarification:
  - Once a payment is mixed with spouse's funds (e.g., in a joint bank account), can the funds representing the distribution be used in any way or must the funds **also** be used for joint family purposes to fall within the green zone?

- What is the meaning of 'joint family purposes' for the purposes of the compliance guidelines?

  The use of the word, 'joint', in conjunction with the associated example (refer to Example 5 from paragraph 73) indicates the meaning of 'joint' in this context requires that the "funds are subsequently used for purposes which benefit both of them [Mum and Dad] and their children". We believe that this is overly restrictive. Under this approach, for a trust distribution to fall within the low risk zone (i.e., Green Zone) it would be necessary to ensure the funds representing the distribution are wholly enjoyed by both parents and/or their dependants, although it seems this classification would not be available if the funds were used exclusively by one spouse (if the spouse was not a dependant – see comment below in relation to the definition of dependant for the purposes of the guidelines).

  It may be preferable if the word 'joint' were omitted, such that the guidelines refer to using funds for "family purposes", which could be defined to cover family expenses that benefit Mum and/or Dad and/or their dependent children and/or their independent children if they live as part of the same family unit.

- What is the meaning of a "dependant" for the purposes of the compliance guidelines? Can it be assumed that a person is always a dependant of their spouse?

  If so, would that then mean that, if a trust distribution is made to Mrs X, Mrs X can loan or gift the funds representing the distribution to Mr X for the funds to be used for any purposes (i.e., on the basis the funds are being used to benefit a 'dependant' of Mrs X (her spouse)).

- Paragraph 19 – A trust distribution to a parent that is gifted to an adult child to pay for a deposit on a home (refer to Example 3, paragraph 114 of draft Taxation Ruling ('TR') 2022/D1) or that is loaned to the child under a non-commercial agreement to help them move out of home (refer to Example 6, paragraph 124 of TR 2022/D1) falls into the green zone. This is because the gifting arrangement is "able to be explained as achieving ordinary familial objects" and "a genuine interest-free loan from parent to child because of their family relationship is explicable as an arrangement entered into in the course of ordinary dealing".

  It would be useful for the ATO to provide further examples of what other gifts and non-commercial loans could be explained by ordinary familial or commercial objects. For example, if may be argued that the provision of a non-commercial loan or a gift from parent to child (because of the family relationship) to assist them to start up a business, or to travel or buy a car would also fall under the ordinary dealings exception.

- Paragraph 19 – It is relatively common for grandparents to pay for, or contribute to, the cost of their grandchildren's school fees. In fact, we are aware that in some private schools based in Victoria, that grandparents are responsible for paying over 25% of the fees that relate to children attending the school. It would be useful for the ATO to provide a green zone arrangement that covers this scenario. For example, if a trust distributed to a grandparent (where the grandparent was the 'controller' of the trust) and the funds representing the distribution were used, or partly used, to pay their grandchild's school fees, it would seem this would be explained by ordinary familial objects and, thus, could constitute a green zone arrangement.

  In addition, we would also suggest that an example is submitted in which a grandparent pays for the school fees of their grandchild, in circumstances where the grandparent has sufficient independent wealth to pay for the private school fees (i.e., the trust distribution is not the source of funds to pay for the private school fees).

Green zone scenarios – retention of funds by the trustee

The following comments relate to green zone arrangements that allow a trustee to retain a trust distribution made to an individual or corporate beneficiary (paragraphs 20 – 22 of PCG 2022/D1).

(a) The 'use of funds condition' (refer to paragraph 21(b)).

- Paragraph 21(b) states: "The 'use of funds condition' means that the trustee, as permitted by the trust deed, **uses the funds** (in its capacity as trustee)…" [Emphasis added]

In many cases, a trustee may retain and hold funds representing a trust distribution in a reserve fund for working capital or for the acquisition of investment assets, etc. The funds may be held in a reserve account for some time prior to actually applying the funds for the stated purpose. It would be useful for the ATO to clarify whether or not holding funds in this way, for a period of time, would satisfy the "uses the funds" aspect of this paragraph.

- Paragraph 21(b)(i) – Does the reference to working capital extend to using the funds representing an unpaid present entitlement to repay a loan owed to another beneficiary or to pay an outstanding unpaid present entitlement (i.e., where it could be said that the loan or unpaid present entitlement was previously retained for working capital or investment purposes)? It is argued that such an arrangement should fall into the green zone.

- Paragraph 21(b)(ii) – If a trustee uses retained funds to acquire a depreciating asset for the business (e.g., car) that is used by arm's length employees, does that fall under working capital (presumably this would not meet the definition of 'investment asset')? It may be useful for the ATO to define the meaning of 'working capital' and 'investment asset' for the purposes of the compliance guidelines.

- Paragraph 21(b)(iii) – The requirements that must be satisfied in order to satisfy the 'use of funds condition' where the funds are lent by a trustee to an associate seem unduly restrictive and place too heavy a burden on trustees and beneficiaries.

  It is noted that, if a trust distribution made to a parent is lent or gifted, by the parent, to their child to allow them to pay a home deposit, this falls into the green zone. In contrast, if the distribution remains unpaid and is lent by the trustee to the child for the same purpose, it falls into the blue zone. As much as possible, consistency between like arrangements would be preferable (and in this case, it is argued both should be in the green zone).

  In any case, it is argued that if a trustee lends funds to an associate on terms that satisfy S.109N, this should be sufficient to satisfy the 'use of funds condition', regardless of how the funds are used. As the trustee derives interest on the loan, this arrangement is akin to an investment asset. The ATO accepts the acquisition of an investment asset by a trustee satisfies the 'use of funds condition', and this is not dissimilar to an investment asset in the form of a loan. Furthermore, the provision of a loan to an associate would likely constitute an ordinary commercial dealing, which would fall outside the ambit of S.100A.

  If a trustee lends retained funds to an associate, there are potentially three different parties involved: the presently entitled beneficiary, the trustee and the associate. Whilst they may all be related, it cannot be assumed that each party will act in accordance with the wishes of the other parties. In order to manage the S.100A risk, the trustee must ensure the associate uses the funds in the requisite way and that they continue to do so whilst the loan is on foot. This is a burden (particularly bearing in mind that the associate carries no risk with respect to S.100A), which would be removed if the trustee only had to ensure the loan was held on S.109N terms.

  The NTAA view such a change as being mutually beneficial and it could be argued that taxpayers would be more willing to change behaviour to fit within the green zone, if falling into the green zone was achievable.

  It is noted that, if such a change was made, paragraph 21(c) would need to be modified so that it only applied to paragraphs 21(b)(i) and (ii).

- Paragraph 21(b)(iii) and (c) – It would be useful for the ATO to clarify the definition of 'associate' for the purposes of the compliance guidelines.

- Footnote 10 should appear in the body of the compliance guidelines.

(b) Excluding factors in paragraph 26 (refer to paragraph 20, second dot point).

It would be useful for the ATO to provide further explanation of the following 'excluding factors':

- Paragraph 26, first dot point – This reads: "The arrangement is a red zone arrangement".

  Of particular concern is the red zone arrangement at paragraph 31, dot point 3: "funds that represent the entitlement are made available to the parent or other caregiver of the beneficiary by way of loan or gift."

Based on this red zone arrangement, a trustee is *not* able to retain a trust distribution made to an adult child (who is involved in the management of the business of the trust) where the trustee lends the funds representing the distribution to the child's parents in any circumstance (and remain in the green zone). This is the case even if the loan is on terms that satisfy S.109N and the loaned funds are used as working capital in the parent's business. This is not a green zone arrangement because the arrangement contains an excluding factor, being that funds that represent an entitlement to an adult child are made available to their parent by way of a loan.

To avoid this (presumably unintended) outcome, it is argued that this red zone arrangement should read as follows: "funds that represent the entitlement are made available to the parent or other caregiver of the beneficiary by way of loan or gift (unless it is a loan made by the trustee that satisfies the 'use of funds condition' described in paragraph 21(b)(iii) of this Guideline)".

Either way, it would be useful for the ATO to clarify this in the compliance guidelines.

- Paragraph 26, second dot point – What does "The beneficiary makes a gift of their trust entitlement or an associated amount receivable from the trust (***for example, if the unpaid present entitlement was converted into a loan***)" mean? [Emphasis added]. It would be useful for the ATO to clarify this dot point.

- Paragraph 26, fourth dot point – This reads: "The income of the trust estate is less than the net income as a result of the trustee exercising a power, or the deed being amended, to affect the quantum of income of the trust estate."

  It is very common for there to be a difference between trust income and net (taxable) income (and for the latter to exceed the former) so it is important for the ATO to clarify what is meant by "trustee exercising a power".

  If the trustee exercises a power to characterise income is this problematic? Many trust deeds give the trustee a broad power to determine the income of the trust estate (i.e., generally with a default definition of income in the event the power is not exercised). If the trustee determines trust income pursuant to this power, does this breach paragraph 26 as it would affect the quantum of trust income? If this is the case, it is argued this excluding factor is too restrictive (and, in any case, it would need to be made clearer in the compliance guidelines so taxpayers are able to properly assess their risk under the guidelines).

  We suspect that this qualification is meant to deal with arrangements whereby trustees exercise their power to re-characterise trust income and achieve a favourable outcome. As such, we suggest that a more detailed narrative is provided within the guidelines, along with an example supporting this understanding.

(c) Control of the trust / involvement in the business of the trust (refer to paragraph 20).

- Paragraph 20, dot point 3 – It is necessary to clarify what 'controls the trustee of the trust' means for the purposes of the compliance guidelines.

  For instance, is this similar to the concept of control for the purposes of the small business concessions, which would broadly mean that an entity would control the trustee of a trust if the trustee acts, or could reasonably be expected to act, in accordance with the directions or wishes of the entity? Or perhaps the guidelines intend for taxpayers to simply look at formal titles of control of the trustee or the trustee company (e.g., will the ATO look to who holds the shares in a corporate trustee as a measure of control, as it is the shareholders that have the power to 'hire and fire' the director/s of the company).

  In any event, we suggest further guidance is needed to assist in assessing who 'controls' a trust. To that end, the guidelines could rely upon other concepts contained within the ITAA 1936 or ITAA 1997 for this assistance, in much the same way as the guidelines rely upon the principles contained in S.109N with respect to loans provided by a trust to associates of the trust.

- Paragraph 20, dot point 4 – This condition is extremely restrictive and, it is argued, unnecessarily so. It is common for asset protection reasons for one spouse ('Spouse A') to control the family trust whilst the other ('Spouse B') controls the private company beneficiary. Being different individuals, this would mean a trust distribution from the trust to the private company beneficiary could not be retained by the trustee and remain in the green zone (in any circumstance).

It is argued that it is appropriate to broaden this test such that 'control' is defined in the guidelines as having the same meaning as the definition used for the purposes of the small business concessions. This would make the guidelines more accessible without compromising the integrity of the document – especially given the restrictions imposed on how trustees must use the funds to remain in the green zone.

As an aside, it is noted that, if the trustee of the trust distributed income directly to Spouse B, the funds representing the distribution could be retained in the trust without issue.

Furthermore, dot point 4 looks at who controls the trust whereas, in contrast, dot point 3 directly above looks at who controls *the trustee of* the trust (with neither being defined). It would be useful for the ATO to adopt like phrasing (unless the difference is intended) and, in either case, for a definition to be provided.

Other comments

The NTAA also wishes to raise a concern with respect to the ATO's S.100A guidance more generally. The NTAA is concerned that action taken by taxpayers to manage their exposure to S.100A may result in adverse tax outcomes for them. It is not unexpected that taxpayers may take action given the release of the compliance guidelines and Taxpayer Alert 2022/1.

Possible 'double taxation' in cases where a trust entitlement is invalidated under S.100A

If S.100A applies to a trust distribution, the beneficiary is deemed to never have been made presently entitled to the trust income for tax purposes. Section 100A does not otherwise disturb the rights between the parties for trust law purposes, which means the beneficiary is still able to demand payment of their entitlement.

If a beneficiary called for payment of their unpaid present entitlement (to which S.100A had been applied) and the trustee pays the entitlement out, the NTAA is concerned this may trigger CGT event C2 for the beneficiary, potentially resulting in the beneficiary paying tax on the distribution (which has also been taxed to the trustee under S.100A).

CGT event C2 (S.104-25 of the ITAA 1997) happens at the time an unpaid present entitlement is discharged (or disclaimed, released, or waived) by a beneficiary. This will prima facie give rise to a capital gain in the beneficiary's hands as the cost base of the entitlement is nil and the capital proceeds is equal to the face value of that part of the entitlement that is paid out.

Ordinarily, a capital gain that arises under CGT event C2 with regard to an unpaid present entitlement would be reduced via the operation of S.118-20 of the ITAA 1997 (which would broadly apply to reduce a capital gain to the extent that an amount in respect of the unpaid present entitlement has been included in the assessable income of the beneficiary as a result of its creation).

However, a problem arises in the context of an unpaid present entitlement that has been invalidated under S.100A because, by reason of the application of S.100A, no amount is included in the beneficiary's assessable income in relation to the distribution (i.e., as S.100A invalidates the distribution for tax purposes). If CGT event C2 does happen when the beneficiary's unpaid present entitlement is paid out (remembering that a S.100A assessment does not disrupt the beneficiary's entitlement to that distribution for trust purposes), then the following outcome arises:

(a) S.118-20 of the ITAA 1997 will not apply to reduce the beneficiary's capital gain from CGT event C2 that arises in relation to the disclaimer; and

(b) the discharge of any amount of the beneficiary's unpaid present entitlement would, therefore, result in a taxable capital gain.

This outcome effectively constitutes double taxation (as the same amount is effectively taxed to the trustee under S.99A(4), and also to the beneficiary under the CGT provisions).

Whilst this appears to be unintended, it does create a real risk of double taxation for trustees and beneficiaries who may take action without appreciating the tax consequences of that action. We strongly recommend that the ATO provide guidance with respect to this issue.

It is noted that the same double taxation issue could also potentially arise:

- If a beneficiary disclaims a trust entitlement to which S.100A has been applied or if a beneficiary disclaims a trust entitlement to which S.100A is later applied. In this case, as no consideration is typically payable upon the release of the unpaid present entitlement, the market value substitution rule will apply to deem the beneficiary to have received market value capital proceeds. The market value of the unpaid present entitlement would prima facie be its face value. Refer to S.116-30(1) and S.116-30(3) of the ITAA 1997.
- If the trustee discharged a portion of a trust distribution prior to it being invalidated under S.100A (e.g., if the trustee paid the tax owing on the distribution on the beneficiary's behalf or paid out a portion of the entitlement to the beneficiary for them to pay the tax owing).

We are very confident that the outcome mentioned above for potential 'double taxation' is not intended. However, as the legislative framework currently stands, we are unable to identify a mechanism that would avoid the double taxation outcomes highlighted above.

Yours faithfully

Geoff Boxer
Chief Executive Officer
NTAA