CPA Australia Ltd
ABN 64 008 392 452

Level 20, 28 Freshwater Place
Southbank VIC 3006 Australia

GPO Box 2820 Melbourne
VIC 3001 Australia

P 1300 737 373
Outside Aust +613 9606 9677

cpaaustralia.com.au

Assistant Commissioner Christopher Ryan
Private Wealth
ATO

Email: **christopher.ryan@ato.gov.au**

6 October 2022

Dear Chris,

Section 100A – additional consultation on PCG examples

Following our discussion on 14 September and receipt of the additional consultation materials from the ATO on 16 September, CPA Australia uploaded the information to our **website** and notified our members and tax professionals via our newsletters, including Tax News and the Divisional Newsletters, a LinkedIn post and a live webinar on 5 October.

The response from the profession has been limited. The observations provided to us are:

- The new green zone examples are vanilla arrangements and clearly targeted at specific scenarios to provide certainty for those taxpayers (e.g., farmers, trustees of testamentary trusts)
- There remains a lack of clarity about the ATO's compliance approach when arrangements diverge even slightly from the green zone scenarios, and what level of rationale and documentation will be sufficient to satisfy the ATO
- It is positive to have a loss scenario as this provides a counterpoint to the red zone loss example. However, as the examples are simple arrangements, uncertainty remains in relation to arrangements that sit outside the green zone boundary
- The two-year period is seen as a "bright line" test with concerns raised about longer-term arrangements which are prevalent in the private wealth market. Beneficiaries may often leave their entitlements unpaid on complying sub-trust terms for a variety of reasons, including ordinary family dealings, so advisors are seeking greater clarity on how the ATO will risk assess unpaid present entitlements (UPEs) more than two years old
- There remain ongoing concerns about the retrospective application of section 100A and the ineffectiveness of relying on the 2014 Guidelines. Reiterating the ATO's approach to retrospectivity and transparency about the involvement of the GAAR Panel and SES sign-off in any retrospective application would be beneficial.

Written comments received by CPA Australia are included in the Attachment.

If you have any queries, contact me on +61 3 9606 9666 or **elinor.kasapidis@cpaaustralia.com.au**.

Yours sincerely,

Elinor Kasapidis
Senior Manager Tax Policy
Policy and Advocacy

CPA AUSTRALIA

Comments received on additional draft green zone examples

Introductory comments

It is difficult to comment on or assess the merits of the proposed new green zone examples in isolation, in the absence of knowing what else the ATO may be proposing to change in the PCG, in particular:

- the key issue of retrospectivity, which is referred to below; and
- what might be broadly proposed in terms of possible changes to green zone 3 (the retention of funds scenario).

We reiterate our concerns that the retention of funds scenario in the green zone is defined far too narrowly. We have included a brief summary of our submissions in this regard at Annexure A.

In the absence of knowing what the ATO may be contemplating more generally for the PCG (other than the proposed abolition of the blue zone and the inclusion of more examples for the green zone and red zone, as referred to in the document), the following comments are provided in relation to the additional draft green zone examples on the basis of the existing draft PCG 2022/D1.

Comments on new proposed examples

New proposed green scenarios 3A and 3B

Our main comment on these scenarios is that they add very little by way of clarification to the existing green zone scenario 3. They are simply examples of what would seem to readily satisfy the existing criteria.

They do nothing to address the fundamental problems we see with the conditions for eligibility of green zone 3, as outlined above.

Examples regarding time lag of payment of entitlements

The two examples relating to the time lag between the creation of the income entitlement and payment of the entitlement on pages 7 and 8 of the document, and also the comments made in the second bullet point underneath point 4 on page 1, indicate that the Commissioner's (draft) view is essentially that distributions of income to beneficiaries that are paid out within a two year time frame would essentially fall within the green zone.

It is suggested that these examples will be of little comfort to taxpayers if the implication is that any UPEs that are outstanding for more than two years fall into the red zone, with the Commissioner looking to apply section 100A to such arrangements, unless such arrangements otherwise fall within the green zone. As noted above, we believe that the green zone, as it is currently defined in the draft PCG, is very narrow.

It is particularly relevant to comment on the retrospectivity aspect of the Commissioner's proposed approach in this context. In the various submissions made to the Commissioner in relation to PCG 2022/D1 one of the most important issues for taxpayers and practitioners is the need to ensure that a change to administrative practice, as significant as what is being proposed, will only be applied prospectively.

It is suggested that the overwhelming majority of family trusts would have existing UPEs that have been outstanding for more than two years. Such beneficiaries will include individuals, trusts and even companies (which may have been content to leave their entitlements unpaid, but on complying sub-trust terms pursuant to PS LA 2010/4). Given the narrowness of the green zone, as currently expressed, this means that many existing UPEs will fall outside the safety of the green zone (unfairly, in our view).

If the ATO's view is that UPEs now need to be discharged within a two-year period or be faced with the risk of a section 100A challenge, it is submitted that:

- the ATO should make this quite clear – rather than merely stating that UPEs discharged within a two-year period will fall within the green zone. The ATO needs to clarify to taxpayers the likely consequences of UPEs not being discharged within this period, rather than leaving the reader to form their own conclusion
- this change in administration is so significant that it underlines the critical need for the Commissioner's approach to section 100A to be made prospective and not retrospective.

As mentioned above, the vast majority of private trusts will have UPEs that have been outstanding for more than 2 years, which the ATO would be aware of from the reviews undertaken on family groups. Moreover, save for scenarios involving the UPEs owing to company beneficiaries that are affected by Division 7A, we are not aware of any evidence that ATO officers in the field were, or are, taking issue with the tenure of UPEs. Taxpayers and advisers would therefore be quite justified in regarding this as a significant shift in an ATO interpretation.

By prospective, we mean that the ATO position reflected in the final tax ruling and PCG should be applied prospectively from either the date of finalisation, or from the date that the draft pronouncements were first released, save for the possible exception of specifically identified aggressive arrangements (for example, the 'circular flow of funds' example 9 in Draft TR 2022/D1). We do not regard as reasonable or convincing, the Commissioner's reported assertions that there is no retrospectivity, in that the ATO will be adhering to the 2014 website guidance. The 2014 guidance was vague, lacking in specificity, did not have the authority, status or rigour associated with a public ruling, was routinely not enforced in the field by ATO officers and itself was retrospective in nature. In relation to delayed payment of UPEs in particular, there is virtually nothing in the 2014 guidance that would give an indication of the ATO seeking to apply section 100A to UPEs remaining on foot for in excess of 2 years.

As much as tax practitioners may strongly disagree with the Commissioner's proposed approach to section 100A, much of the angst arises due to the perception that the ATO is now significantly changing its interpretation of a provision that has been in force for 44 years, with retrospective implications on existing arrangements. Much of this angst would dissipate if the Commissioner would confirm that the views expressed would only be applied prospectively.

Testamentary trust example

It is presumed that this example is seeking to illustrate satisfaction of the retention of funds criteria in the green zone. This example is not controversial of itself, so it is doubtful that it adds much in terms of understanding the various conditions. Perhaps the example is being included, in conjunction with the preceding two examples, to indicate scenarios where an outstanding UPE beyond two years would fall within the green zone. The concerns we have about this issue are outlined in the preceding paragraphs.

Further comments

1. The narrowness and rigidity of the 'use of funds condition' referred to in paragraph 20 and explained in paragraph 21(b) of the Draft PCG. In particular:
    - the requirement that any loans to associates made by the relevant trust be placed on section 109N terms, the implication being that section 109N terms represent the sole benchmark of commerciality. We consider that, provided that a commercial interest rate is derived on such loans, this should be sufficient for this element to be satisfied; and
    - the further requirement that, where funds are loaned by the relevant trust to another associate, the use of funds test must also be satisfied by the associate borrower. It is considered that this is onerous, excessive and, in our view, irrelevant to the question of whether the funds have been applied to income earning purposes by the focal trust. We believe that this element should be removed from the paragraph 26 conditions.
2. The exclusionary factors in relation to the green zone outlined in paragraph 26 of the Draft PCG are both too far reaching and ambiguous, which has the combined effect of inappropriately narrowing down the scope of the 'use of funds' safe harbour and creating uncertainty. The main concerns in this regard are as follows:
    - the fifth exclusion relating to the discharge of a UPE by payments sourced by beneficiaries needs to be significantly amended, in relation to the following:
        - Arrangements involving the payment of a dividend by a corporate beneficiary: numerous submissions will have been made to the Commissioner that this exclusion needs to be significantly restricted to ensure that dividends payable by company beneficiaries that are used to meet Division 7A obligations are not inappropriately impeded (noting that we have no issue with the Commissioner challenging arrangements with circular flows of funds similar to those outlined in example 9 of TR 2022/D1). See illustration at foot of this paper.

- Arrangements whereby a beneficiary that is a unitholder reinvests their entitlement into units: we understand that numerous submissions have been made on this item, which seems quite inappropriate for a range of reasons that will have been covered off in detail in various submissions; and

- the last exclusionary factor referred to in paragraph 26 (features that may be explicable by a tax avoidance motive) is unworkably broad and vague. We consider that this factor needs to be reviewed and either removed or made more specific and practically workable.

Illustration: dividends from company beneficiary applied to meet Division 7A obligations

- Family Trust X, Family Trust Y and Company Z are all controlled by the same person. The two trusts are discretionary trusts.
- Family Trust Y holds all the shares in Company Z.
- Family Trust X generates income and taxable income.
- Family Trust X has distributed income to Company Z. The resultant UPE is discharged and replaced with a Division 7A complying loan.
- The loan requires minimum yearly repayments. To meet these repayments, Company Z declares a franked dividend to Family Trust Y, its shareholder.
- Family Trust Y distributes that franked income to the controller of the group who is on the top marginal income tax rate.
- The controller of the group then applies the dividends to lend to Trust X which then, in turn uses the funds to meet is repayment requirements on the Division 7A loan.

Arrangements like these are very common and, it is strongly submitted, should be specifically catered for in the green zone.