



## THE TAX INSTITUTE

12 November 2021

David Stevenson  
Senior Director  
Public Groups & International  
Australian Taxation Office

By email: [PGIPAGUnit@ato.gov.au](mailto:PGIPAGUnit@ato.gov.au)

Dear Mr Stevenson,

### Draft Taxation Determinations

The Tax Institute welcomes the opportunity to make a submission to the Australian Taxation Office (**ATO**) in relation to the following Draft Taxation Determinations (**Draft TDs**):

- TD 2021/D2: Income tax: aggregated turnover — application of the ‘connected with’ concept to partnerships, foreign hybrids and non-entity joint ventures (**TD 2021/D2**);
- TD 2021/D3: Income tax: aggregated turnover — application of the ‘connected with’ concept to corporate limited partnerships (**TD 2021/D3**); and
- TD 2021/D4 Income tax: aggregated turnover — application of the public entity exception to the indirect control test (**TD 2021/D4**).

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

Subdivision 328-C of the *Income Tax Assessment Act 1997* (**ITAA 1997**) was originally introduced as a grouping provision for small business entities. Over recent years, this subdivision has been adapted into various other sections of the tax law, such as the temporary loss carry back and temporary full expensing measures, resulting in the core principles potentially applying to entities with an aggregated turnover of up to (less than) \$5 billion. As a result, there is a greater potential for inconsistent outcomes and ambiguities for taxpayers as the fundamentals of Subdivision 328-C are being applied to circumstances they were not originally designed to operate in.

Accordingly, The Tax Institute welcomes guidance on the application of the various tests and concepts in Subdivision 328-C, such as the ‘connected with’ test located in section 328-125. We consider that the guidance in the Draft TDs should be expanded to include other common circumstances that impact taxpayers, including partnerships with fixed income distributions and discretionary trusts. We note that this additional guidance may be in the form of other guidance products, such as new TDs. This extra guidance is crucial to ensuring that taxpayers can navigate the complexities and consistently apply the concepts to their circumstances.

We note that the 'affiliate' concept, defined in section 328-130, is also used throughout the tax law. Feedback from our members is indicative of concerns held across the profession that there is minimal ATO guidance available on this concept. This is a constant source of confusion and complexity for taxpayers and advisers, who are challenged to apply the provision in practice.

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

We would be pleased to continue to work with the ATO on any amendments to the Draft TDs.

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 Associate Tax Counsel, Abhishek Shekhawat, on 02 8223 0013.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'Peter Godber', with a long horizontal flourish extending to the right.

**Peter Godber**

President

## APPENDIX A

We have set out below detailed comments and observations for your consideration to ensure the Draft TDs provide the most effective and practical guidance for taxpayers.

### Application to partnerships with fixed distribution entitlements

Partnerships with fixed distribution entitlements are common arrangements in businesses, especially in the context of professional practice structures. A consequence of fixed distribution entitlements is that taxpayers may receive a different percentage of the distributions made each year, depending on the profits of the partnership. These arrangements make it practically difficult for taxpayers to calculate the relevant control percentage.

For example, Entities A, B and C carry on a business in partnership together. Under the terms of their partnership agreement, C's annual entitlement to a share of the partnership profits is fixed at \$200,000, with A and B sharing the remainder of the profits in a 70:30 ratio respectively.

If the partnership earned \$400,000 in one year and \$600,000 in the subsequent year, the relevant control percentages for the three entities would be notably different. This is highlighted below.

#### First income year: Partnership profits \$400,000

Entity	Distribution received (\$)	Distribution received (%)
A	\$140,000	35.0%
B	\$60,000	15.0%
C	\$200,000	50.0%

#### Second income year: Partnership profits \$600,000

Entity	Distribution received (\$)	Distribution received (%)
A	\$280,000	46.7%
B	\$120,000	20.0%
C	\$200,000	33.3%

The different amounts that the partners of a partnership receive under a fixed distribution agreement can make it difficult to calculate the appropriate control percentage over the period of time the test requires. We consider that TD 2021/D2 should include further guidance on the impacts of fixed partnership distribution arrangements and provide examples that demonstrate the appropriate steps when calculating the control percentage in these circumstances.

### Application to waterfall profit entitlements

Feedback and insights from our members indicate that there is an increasing number of entities, notably limited liability companies in the United States, that have implemented waterfall profit sharing entitlements in their relevant operating agreements. These profit sharing arrangements typically create a hierarchical order in which the shareholders or partners are entitled to profits, resulting in entities receiving varying distributions each year.

For example, under a basic waterfall arrangement:

Member A is entitled to 100% of the first \$100,000 of profit, then

Member A is entitled to one-seventh of the next \$700,000 of profit and Members B, C, and D are entitled to two-sevenths each of that next \$700,000 of profit, then

All four Members share any profits in excess of \$800,000 equally.

Similar to the practical difficulties with fixed partnership distributions mentioned above, taxpayers may receive different percentages of the entity's profits each year. This can create difficulties when taxpayers are attempting to determine their relevant control percentage, especially if they receive distributions on either side of the 40% threshold. We consider that the ATO should include further guidance in TD 2021/D2 on these circumstances, accompanied by practical examples which highlight the appropriate steps required when calculating the control percentage in these circumstances.

### **Application to partnerships without identifiable voting rights**

Example 2 of TD 2021/D3 applies to partnership arrangements where voting interests are readily identifiable. However, we note that ATO guidance products<sup>1</sup> have recognised difficulties in determining voting interests in all partnerships, particularly in relation to some foreign limited partnership arrangements. We consider that TD 2021/D3 should provide further guidance in the form of examples on how taxpayers should apply the 'connected with' principle in instances where the foreign limited partnership agreement does not confer the requisite voting power for partners.

### **Application to trusts**

The application of the 'connected with' test to trusts results in significant complexity, with some aspects of the test being applied differently than it is compared with other entities. We consider that further guidance should be developed that clarifies the operation of this test for trusts, and provides taxpayers with practical examples to better assist them with the mechanical aspects of the control percentage. We have noted below some areas where further guidance would better assist taxpayers.

#### *Discretionary trust distributions*

Subsection 328-145(4) of the ITAA 1997 sets out how to calculate the control percentage for entities that receive distributions from discretionary trusts. The calculation of the control percentage for discretionary trusts is notably different compared with other entities and may cause confusion with general taxation principles. We consider that basic guidance, accompanied by examples, will better highlight the important aspects in the calculation of this test and assist taxpayers better understand and apply the legislation.

Below, we have outlined a basic scenario for consideration as the basis for an example.

Discretionary Trust A made a capital profit on sale of an asset in the 2016–17 income year. The trustee resolved, pursuant to a power in the deed, to treat that capital profit as trust income for the purposes of the deed. The capital profit component of the trust income for the 2016–17 income year was distributed equally between the primary beneficiaries of the trust, Entities X and Y. The remainder of the (ordinary) trust income was distributed to a related company, ABC Pty Ltd.

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<sup>1</sup> For example, see ATO ID 2010/8 (Withdrawn): *Income Tax: Non-Portfolio Dividend exemption to a distribution received by a limited partner from a Corporate Limited Partnership* and TD 2008/24: *Income tax: can section 23AJ of the Income Tax Assessment Act 1936 apply to a dividend when it is paid by a company (not being a Part X Australian resident) to an Australian resident company which receives it in its capacity as a partner in a partnership?*

The shares in ABC Pty Ltd were held wholly by Discretionary Trust B (which did not have any trust income to distribute in the relevant years). In subsequent years, Discretionary Trust A distributed all of its trust income to ABC Pty Ltd.

Noting the reference to income in subsection 328-125(4)(a) is according to general trust law concepts and not general tax concepts,<sup>2</sup> Entities X and Y have had a percentage of Discretionary Trust A's income paid to, or applied on behalf of, each of them. If the distribution percentage was 40% or more, Entities X and Y would be connected with Discretionary Trust A from the 2017–18 to the 2020–21 income years.

The inclusion in TD 2021/D2, or another ATO product, of a scenario similar to the above would better demonstrate the steps when calculating the control percentage for discretionary trusts, while alerting taxpayers and their advisers to key considerations. Namely, it would clarify that:

- The income referred to in subsection 328-125(4) of the ITAA 1997 is income pursuant to the general laws that apply to trusts and not according to ordinary tax concepts; and
- The 'connected with' rule is based on the percentage of trust income or trust capital paid to, or applied for the benefit of, the beneficiary and/or their affiliates in any of the four immediately preceding income years. As a result, a beneficiary who receives a distribution of at least 40% will satisfy the control percentage requirement for discretionary trusts for the subsequent four-year period.

The guidance above would also benefit from examples regarding the application to unit trusts with non-fixed elements.

### **Commissioner's discretion**

Subsection 328-125(6) of the ITAA 1997 provides the Commissioner with the discretion to make a determination that that one entity does not control another if the control percentage is at least 40% and less than 50%. With the continued expansion of the small business entity grouping tests being used for businesses of all sizes, there is a need for clear guidance about how the Commissioner approaches this discretion. We consider that taxpayers will benefit from further guidance that outlines the factors and evidence the ATO will consider when making the relevant determination.

This guidance will assist in reducing compliance costs for taxpayers by allowing them to implement the relevant record-keeping procedures and retain key evidence that will better address potential areas of concerns for the ATO and also relieve the ATO from the burden of responding to private ruling applications that might otherwise be required.

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<sup>2</sup> ATO ID 2012/99: *Income Tax: Capital gains tax – direct small business participation percentage in a trust – meaning of 'distributions of income' and capital*

## **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.