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2 May 2022

Dear Justin, Chris and Peter

Trust reimbursement agreements and unpaid present entitlements – draft guidance

CPA Australia is Australia's leading professional accounting body and one of the largest in the world. We represent the diverse interests of more than 170,000 members in over 100 countries and regions. We make this submission on behalf of our members and in the broader public interest.

The ATO's release of draft guidance on the ATO's interpretation of reimbursement agreements[1] under section 100A of the *Income Tax Assessment Act (**ITAA**) 1936* (**section 100A**) and the treatment of unpaid present entitlements under Division 7A of the *ITAA 1936*[2] (**Division 7A**) has generated a significant response from the tax profession.

Responses cover a range of issues from the time taken to produce the guidance, the changed interpretation and ATO approach, the impacts on clients and their advisers, the potential for serious penalties, the lack of practicality of the Practical Compliance Guidelines (**PCGs**) and, in the case of Division 7A, whether the change should have been enacted through legislation as announced by the Treasurer rather than by the ATO progressing it administratively.

For many practitioners, the draft guidance has prompted proper consideration of section 100A for the first time in decades. Throughout much of the profession, section 100A was perceived to be only relevant to the egregious trust stripping arrangements of the type that prompted the legislation in 1978. In many advisors' minds, the application of section 100A to small family groups and commonly used arrangements was inconceivable. The ATO's 2014 **Trust taxation – reimbursement agreement** guidance (**the 2014 guidance**) provided some indication of the ATO's concerns at the time. However, our members have indicated that awareness of this product was not widespread and have suggested it had limited impact even at the time of release. While the ATO continued to mention section 100A at selected events and had disclosed it was undertaking confidential consultation on guidance products, there was no widespread knowledge across the profession of what was to come. No taxpayer alerts had been issued throughout the intervening years, nor was the issue mentioned by the ATO in its annual messaging on focus areas or its now-retired Compliance Program. Similarly, while a change to the treatment of unpaid present entitlements

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[1] The draft guidance products are:
- **Draft Taxation Ruling TR 2022/D1 Income tax: section 100A reimbursement agreements** (**TR 2022/D1**)
- **Draft Practical Compliance Guideline PCG 2022/D1 Section 100A reimbursement agreements - ATO compliance approach** (**PCG 2022/D1**)
- **Taxpayer Alert TA 2022/1 Parents benefitting from the trust entitlements of their children over 18 years of age** (**TA 2022/1**)

[2] The draft guidance product is **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'?** (**TD 2022/D1**)

(**UPEs**) was anticipated, it was expected to be done through the legislative process with targeted amendments to Division 7A[3].

As a result, the response from the profession was swift and vocal when the draft guidance was issued in February. Taken collectively, the draft guidance has been seen to target regular arrangements used by the hundreds of thousands of small family trusts through which many businesses are owned and operated, and which are standard structures established by tax advisors. For many tax advisors, it was the first notice from the ATO that such arrangements may be subject to scrutiny, and they are now commencing their own reviews and risk assessments of their clients' arrangements.

What has become apparent through this process, is that the draft guidance has significantly increased uncertainty within the small business market. Examples include tax advisors seeking to determine the new interpretative scope of certain terms (e.g., ordinary family dealings), the potential outcomes from ATO compliance activities, the need for improved documentation, and the response expected of them by the ATO for blue zone arrangements.

We note that since the release of the draft guidance, the ATO has publicly clarified its stance on retrospectivity, in particular the **statements** made by acting Commissioner Jeremy Hirschhorn at the Senate Economics Legislation Committee on 6 April 2022, and corresponding **media release** issued by the Assistant Treasurer. These messages are critical in reassuring taxpayers and their advisors about the ATO's focus on future compliance (rather than past years), and to enable the focus to shift to education and support.

As the feedback from public consultation is considered and the guidance is finalised, we encourage the ATO to address, as much as possible, the areas of concern and levels of uncertainty being expressed by the tax profession.

Our submission covers the following key issues raised during the public consultation process:

- Concerns about retrospectivity and the difficulty in advising clients in relation to past distributions
- Clarity about the ATO's approach to promoter penalties and referrals to the Tax Practitioners Board
- Practical challenges when determining risk zones and the potential for clients to fall into higher risk zones when it is unlikely that section 100A could be applied
- The uncertainty created in relation to blue zone arrangements where many common arrangements fall
- The unlimited amendment period available to the Commissioner under section 100A and the need for legislative change to align with other anti-avoidance rules such as Part IVA of the *ITAA 1936* (Part IVA).

Detailed comments encompassing feedback from our members are contained in the Attachment.

If you have any queries about this submission, contact Elinor Kasapidis, Senior Manager Tax Policy on 0466 675 194 or **elinor.kasapidis@cpaaustralia.com.au**.

Yours sincerely,

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[3] The changes were first announced in the 2016-17 Federal Budget. These were then deferred in 2020 to an undefined date and have now lapsed due to the election being called.

Reimbursement agreements – TR 2022/D1, PCG 2022/D1, TA 2022/1

1. Retrospectivity

There has been substantial concern regarding the potential retrospective application of section 100A given the unlimited period of review. As noted, while public statements by the ATO have since alleviated some of the anxiety, there remains confusion about the ATO's approach to past years, particularly the period 1 July 2014 to 30 June 2022.

The concern is that there is no constraint on the ATO re-opening tax returns back to 2014-15 in the event of an audit. Many practitioners are anticipating that section 100A will become a standard consideration in review and audit processes, and that without a clear 'line in the sand', ATO staff may look to adjust earlier years as part of compliance activities[4] even though taxpayers and advisors were barely aware of the potentially broad application of section 100A at the time.

The ATO has confirmed the administrative position in the 2014 guidance will apply up to 30 June 2022 in instances where the 2014 position was more favourable to the taxpayer than the position in the draft guidance. We reiterate the fact that awareness of this guidance has been relatively low and that the ATO did not reinforce its views or seek to actively educate taxpayers and their advisors over the following years.

Until February 2022, tax advisors were of the belief that they were taking reasonable care, particularly in ensuring that the ordinary family or commercial dealing exception was satisfied, and therefore were providing their advice competently. Given this situation, we challenge the ATO's implication (as reflected in its proposed approach) that tax advisors should have been aware of the ATO's view and should have been considering section 100A risk since at least 2014. Therefore, we also challenge the ATO's view that no additional protection beyond the 2014 guidance should be afforded to tax advisors and their clients.

In reality, after assessing their clients' arrangements, tax advisors are now finding that many of their clients' arrangements are not covered by the 2014 guidance. This means that many advisors will be discussing blue zone arrangements and section 100A risk with their clients for the first time since establishing the structure. These discussions will not only cover post-1 July 2022 distributions but will necessarily also cover the potential options in relation to past years.

We accept that the ATO does not wish to remove the option of retrospective application of section 100A to red zone cases, however, consideration should be given to extending protection to blue zone arrangements in place between 1 July 2014 and 30 June 2022[5]. This will recognise the general lack of guidance available until this year, provide certainty for past years and enable advisors and their clients to focus on any changes required from 1 July 2022.

We also recommend that the ATO reinforce the message that returns that are now past the period of review will not be re-opened, except in cases of fraud or evasion. This will reduce the number of past-year returns being contemplated by advisors and provide clear assurance for returns lodged prior to 1 July 2017.

[4] As described in paragraph 27 of PCG 2022/D1. We understand this to mean that the ATO will not initiate compliance activities specifically in relation to section 100A risks for blue zone arrangements. However, should a taxpayer be selected for compliance activity for any other reason, then the ATO will review arrangements for section 100A (where relevant) and can, if it so chooses, to amend returns back to 2014-15.
[5] Or at least 30 June 2021 if it could be reasonably be expected that advisors and their clients could practically adjust distributions for the year ended 30 June 2022 in accordance with PCG 2022/D1.

2. Promoter penalties and referrals to the Tax Practitioners Board

Paragraph 29 of TA 2022/1 refers to promoter penalties and referrals of practitioners to the Tax Practitioners Board for breaches of the *Tax Agent Services Act 2009* (**TASA**). This wording was taken by many in the profession to suggest that the ATO was actively seeking to identify and penalise advisors. Many advisors also felt that it insinuated that those who included adult children in trust distributions were, in some way, promoters.

Quite clearly, promoter penalties are not intended for practitioners who act in good faith, believe they are acting within existing guidelines or have reasonably arguable positions, are providing tax advice and compliance services for a few and are not rewarded for marketing or encouragement. This has been confirmed by the acting Commissioner's comments at the Senate Economics Legislation Committee, namely that "ordinary advice services for an advisory fee are not subject to the promoter penalty provisions"[6]. It would be helpful for words to that effect to be included in the finalised guidance to provide assurance about the ATO's approach to advisors.

3. Application of the PCG

PCGs remain a challenge for advisors to practically implement as they are not interpretive guidance but should still be considered when providing advice to clients. The extent to which PCGs are relevant to issues such as the application of penalties, the availability of the penalty safe harbour provisions, the interpretation of the TASA Code of Conduct, professional indemnity insurance or civil remedy by clients remains unclear.

To the extent that PCGs seek to provide certainty for a sufficiently large number of low-risk arrangements, while clearly signalling the ATO's areas of focus, PCG 2022/D1 goes only part way to achieving such an outcome. The ATO **asserts** that, "The vast majority of small businesses operating through a trust will not be affected by this public advice and guidance."

However, feedback from our members has indicated that the settings for the green zone result in only a limited number of arrangements satisfying the requirements. Due to the various permutations and combinations of trust arrangements, there is generally a high likelihood that an arrangement will contain at least one of the factors that triggers the blue zone rating (refer next section for further detail).

For those arrangements found to be in the red zone and where taxpayers are considering amending prior year returns, we suggest that, to encourage disclosures, the ATO consider a voluntary disclosure process which includes the full remission of penalties. It remains unclear as to the manner in which the ATO will approach such cases, and whether a voluntary disclosure may be in their best interests.

In terms of implementation, the application of the risk assessment process in PCG 2022/D1 is comparatively more onerous for advisors than that required for other PCGs that contain clear quantitative benchmarks[7] given the dependence of section 100A on the facts and circumstances of each case. Advisors and tax practices continue to face workload challenges as they work through the COVID-driven backlog compounded by staff and skills shortages. Further, many smaller practitioners have limited expertise in section 100A and are not necessarily able to access specialist legal advice in relation to their clients' arrangements.

We therefore recommend that the ATO support advisors servicing the Private Wealth and Small Business markets to establish a clear understanding of the guidance, including PCG 2022/D1, and assist advisors to quickly identify and resolve any issues prior to the 2022-23 distributions being made.

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[6] P. 24, **Hansard**, Senate Economics Legislation Committee, Estimates, 6 April 2022
[7] Examples include the effective tax rate in *Practical Compliance Guideline PCG 2021/4 Allocation of professional firm profits - ATO compliance approach* and interest rates on loans in *Practical Compliance Guideline PCG 2017/2 Simplified transfer pricing record-keeping options*

Given the significant impact of this draft guidance and the strong response from the profession, we also recommend that the ATO undertake a review of PCG 2022/D1 in 2024-25 to evaluate its effectiveness in addressing section 100A risks and to determine whether the risk factors and settings should be updated.

Specific issues

- Further guidance on trust-to-trust distributions would be beneficial. Green zone scenario 3 only covers distributions to individuals and corporate beneficiaries, not trust beneficiaries. As private groups often distribute between trusts, the final PCG should address the situation where there has been trustee retention of funds in such circumstances.
- The inclusion of a green zone example involving distributions to loss beneficiaries would be helpful to understand the ATO's parameters in relation to loss entities.
- Paragraph 40 of PCG 2022/D1 states that the ATO will not treat an arrangement as being the result of a contrivance if the difference between taxable income and distributable income is merely due to franking credits. We suggest that this paragraph be updated to include the wording contained in ***Taxpayer Alert TA 2016/12 Trust income reduction arrangements*** which states that the ATO is not concerned where the differences result from amounts not traditionally regarded as trust income (e.g. capital gains) as well as a result of proper accounting.
- By using the term 'associate', paragraph 21(b)(iii) of PCG 2022/D1 appears to create a requirement for taxpayers to enter into section 109N loan arrangements even where no private company is involved. Further clarity is required as to whether this is intended.

4. Uncertainty in relation to blue zone arrangements

Due to the breadth of paragraph 26 of PCG 2022/D1, many arrangements considered by advisors to be at very low or no risk of section 100A are falling into the blue zone. While paragraph 27 seeks to clarify that a blue zone result does not mean that section 100A applies to the arrangement, this provides little assurance for advisors when discussing these outcomes with their clients.

For blue zone arrangements, advisors are likely to be required to undertake a facts and circumstances-based inspection of the arrangement. This will enable an assessment of the likelihood of section 100A being applied by the ATO, and the identification and creation of documentation required to be able to justify the position taken. This can be a costly undertaking, particularly for lower net worth and small business clients, which may be disproportionate to the actual level of risk where their arrangements sit only marginally outside the green zone.

One aspect causing great uncertainty is the ATO's view of the scope of the ordinary family or commercial dealing exception. This exception has not had substantial definition by the ATO in the past. Section 100A cases are only now coming before the courts, so there has also been limited judicial clarity. Feedback from our members has reflected concern that the ATO has taken a narrow view of the exception, rather than keeping it sufficiently broad to deal with the many different family situations that exist, the practical way in which family dealings work or the broader definition of family amongst many family groups.

The effect of such uncertainty is yet to be seen as the majority of the impacted return lodgments are not due until May 2024. However, we recommend that the ATO continue to engage with the profession throughout this period to gauge the practical impacts and to support the transition. Consideration should also be given as to whether further guidance should be provided in relation to blue zone arrangements, and the various features which might further increase or decrease the level of section 100A risk associated with the arrangement.

5. Legislative change

During consultation, the design and scope of section 100A has been raised by members as an issue.

Section 100A was introduced to deal with trust stripping and was designed to require a tax reduction purpose, rather than a dominant purpose, having regard to the nature of those schemes being targeted. Unlike the amendment period restrictions that apply under Part IVA, there are no time limits on the Commissioner to apply section 100A.

In view of the notable differences between, and wider scope of, section 100A as compared to Part IVA, it is our view that section 100A was intentionally designed as a tool to target egregious trust stripping arrangements, rather than tax avoidance generally.

The ATO has now clarified its interpretation and intended application of section 100A, which is far broader than many advisors had understood. This has resulted in the provision becoming an extremely powerful and visible tool for the ATO, particularly given the extensive use of trusts in Australia. To provide certainty and protection to taxpayers, we recommend that the Government amend section 100A to include a time limit and dominant purpose requirement to better align with other anti-avoidance provisions such as Part IVA.

6. Scenarios

While we recognise that the ATO cannot provide examples for every situation, the following list of scenarios provided by our members reflect the uncertainty that the draft guidance has created.

Legitimate expenses for adult child

Further to the tuition and board expenses that the ATO finds to be legitimate in Example 3 of TA 2022/1, are the following expenses also acceptable to the ATO?

- Purchase of or contribution to a motor vehicle (or other transport) for the adult child
- Payment of HECS/HELP debts (as distinct from fee-paying courses) and other tertiary education costs
- Payments for or towards travel (e.g., international holiday)
- Contributions to purchase property – either cash for deposits or settlement
- Regular payments to reimburse/subsidise interest payments on mortgage loans for property or share acquisition
- Regular payments to reimburse/subsidise rental payments when living independently of parents.

Retention of funds by the trustee and offsets

While green zone scenario 3 and example 2 of PCG 2022/D1 provide the low-risk parameters for the retention of funds by the trustee for certain purposes, including working capital, there are common arrangements involving adult children (i.e., not a trustee of the trust or employed in management of the business) that fall outside the scope of the two ATO scenarios and may trigger the “beneficiary making a gift of their trust entitlement” feature listed in paragraph 26 of the PCG under the blue zone arrangements.

Our members have reported that, in their experience, in the vast majority of retention or offset cases, distributions to beneficiaries are made on or before 30 June without any reimbursement in mind and no offsets against parents’ loan accounts are contemplated at that time.

What is the ATO’s view on the following two examples, particularly on whether, or not, the “connection” and “benefit to another” requirements or the “ordinary dealing exception” are satisfied?

Retention scenario:

- Distributions made on or before 30 June are retained in the trust and the adult child beneficiaries are aware of the amount and that it is available at call
- The distributions credited are made on the basis that the beneficiaries can call on it at any time and may do so immediately, including shortly after year-end
- Examples include when they get married, move out of the family home or acquire a business
- The parents, who are also the trustees, are aware of the trustee obligation to pay at call and do not, and cannot, know when their adult children may call on the money
- In the event of the death of a parent, the trust funds are distributed consistently with distributions that are owing
- The retention in the family business is almost never part of any understanding, express or implied, at the time of making the distribution, even where the adult children are subsequently comfortable that their funds are retained within the family business until called upon by them
- Annual distributions are made and retained over many years until the adult children make a call, however, this is not connected to or contemplated when making the distributions on 30 June each year
- These amounts are all paid out to the adult beneficiaries at some time.

Offset scenario:

- Offsets generally occur when, on preparing the accounts, usually months after the distribution was made at year end, it is ascertained that the parent's loan account has been overdrawn and gone into debit. This situation exposes the assets of the parents to the liabilities of the business in the event of insolvency of the business
- An arrangement is not contemplated at the time the distributions are done on 30 June, for at that time the loan account position of the parent is not known
- The adult child agrees to a parent's request to loan their credit to the parent for the purpose of the parent's asset protection
- Offsets are done from the adult child's loan account to the parent's loan account
- The adult child is not out of pocket (i.e., it's not a gift) as the parent owes them the money directly. Is the outcome different if this arrangement is repeated over a number of years?

Dividend and set-off arrangements

Paragraph 26 of PCG 2022/D1 states that arrangements involving dividends and set-offs by corporate beneficiaries are not considered green zone arrangements. The satisfaction of Division 7A loans through a dividend and set-off (including via a third entity) is common practice and should be considered an ordinary dealing. If there are particular features of these kinds of arrangements which cause the ATO concern, these should be included in a red zone scenario rather than imposing a broad rule that captures benign arrangements.

Financial accommodation – TD 2022/D1

Member feedback on TD 2022/D1 was broadly receptive of the change, although it was observed that the changes had been expected to be made through legislative changes by Parliament.

One issue is that the view taken in TD 2022/D1, that the timing of the financial accommodation occurs upon knowledge of the beneficiary's entitlement, can create compliance and administrative difficulties. The finalised Taxation Determination should take a uniform view as to timing (similar to paragraph 46 of *Practice Statement Law Administration PS LA 2010/4 Division 7A: trust entitlements*) to avoid disputes between the ATO and taxpayers about when knowledge of an entitlement existed based on which controlling minds were involved with the resolutions and when calculations were performed.

It is also noted that TD 2022/D1 may drive a behavioural shift where taxpayers seeking to provide 'fixed' distributions express these as a percentage in order to obtain the benefit of a 12-month deferral from making annual Division 7A repayments.

Further clarity is also sought as to 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. In particular, the ATO should clarify whether PCG 2017/13 will be extended to UPEs arising on or before 30 June 2022.