The Tax Institute

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Cc: Peter Glindermann, Tax Counsel Network, Australian Taxation Office
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Dear Mr Ryan

Practical Compliance Guideline PCG 2022/D1: *Section 100A reimbursement agreements – ATO compliance approach* and TA 2022/1: *Parents benefitting from the trust entitlements of their children over 18 years of age*

The Tax Institute welcomes the opportunity to make a submission to the Australian Taxation Office (**ATO**) in relation to the draft Practical Compliance Guideline PCG 2022/D1 *Section 100A reimbursement agreements – ATO compliance approach* (**draft PCG**). In addition, although the ATO has not established a consultation process for Taxpayer Alert TA 2022/1 *Parents benefitting from the trust entitlements of their children over 18 years of age* (**TA**), we would like to take the opportunity to also provide comments on this guidance as the TA raises significant concerns for tax professionals.

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 that represents the views of the broader membership of The Tax Institute.

We are concerned that, fundamentally, the draft PCG has not achieved its purpose of clarifying how the ATO intends to apply its compliance resources to potential cases that may trigger the application of section 100A of the *Income Tax Assessment Act 1936* (**ITAA 1936**). Although the draft PCG purports to set out different risk zones, we do not consider that taxpayers are provided with enough guidance to clearly identify the features of arrangements that the ATO considers to be high risk or understand the impact of the ATO's compliance approach. We consider that significant clarification is required throughout the draft PCG to ensure that it provides taxpayers with sufficient guidance.

Our members have provided feedback that they have significant concerns that the ATO's proposed approach in the draft PCG will result in oppressive and unfair outcomes for taxpayers and tax professionals. Our members have concerns that that ATO guidance on the application of section 100A to trust arrangements has historically been lacking, resulting in taxpayers and tax professionals being required to self-assess without appropriate guidance and support.

Some of the examples provided in the PCG are not what many practitioners may consider to be egregious. Feedback from our members indicates that the Commissioner has not consistently, or at all, as a matter of practice, ultimately challenged those factual scenarios, including in the time since the Commissioner issued his website guidance in July 2014. As a result, previously unchallenged behaviour is now deemed high risk under the draft PCG.

We support the ATO's approach conveyed before the Senate[1] since the release of the draft PCG to apply the draft PCG only on a prospective basis, and consider that this position should be made clearer in the final PCG. Applying the draft PCG retrospectively could unfairly penalise taxpayers and tax professionals who have followed the historical, limited guidance in good faith. Rather than a retrospective application, we consider that the ATO should adopt an educational approach, ensuring taxpayers and tax professionals understand how to apply section 100A and assist them in becoming compliant with the requirements of the legislation going forward. This should be supported by continuing education and information regarding those facts and circumstances that the ATO considers to be high risk.

Our members have also expressed concerns about how the ATO has set out its approach in the TA of referring to the Tax Practitioners Board (**TPB**) registered tax agents who are considered to be involved in the promotion of arrangements. The current wording could be interpreted to mean that a majority of tax agents could end up being referred to the TPB for merely providing advice on an arrangement based on previous ATO guidance on section 100A. We also support the ATO's subsequent representations that their intention is not to refer agents who provided ordinary advice services in relation to this arrangement in exchange for an advisory fee[2] and consider that this should be made clearer in the TA.

We would be pleased to continue to work with the ATO on the further development of, and necessary changes to, the draft PCG and TA to ensure they provide 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.

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1 Evidence to Economics Legislation Committee, Parliament of Australia, Canberra, 6 April 2022 (ATO Second Commissioner, Jeremy Hirschhorn), available on Hansard.

2 Ibid.

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 PCG and TA provide the most effective and practical advice for taxpayers and their advisers. Our comments broadly follow the layout of the draft PCG and TA. All legislative references are to the ITAA 1936 unless otherwise indicated.

Draft Practical Compliance Guideline: PCG 2022/D1

Identification of risk profiles

One of the fundamental purposes of practical compliance guidelines is to provide taxpayers with useful guidance to better understand the ATO's risk assessment and compliance approach on a particular issue. We note that this view is supported by ATO guidance which states:[3]

> Practical compliance guidelines will transparently communicate the ATO's assessment of risk in relation to tax law compliance issues and consequential resource allocation intentions.
>
> Practical compliance guidelines are the identifiable, coherent, principal source of the type of broad compliance guidance described above in respect of significant law administration issues.

In this regard, we consider that the draft PCG does not provide taxpayers with the necessary guidance to better understand the ATO's views of the risks. The various factors identified in the draft PCG that result in an arrangement falling into any of the risk factors are unlikely to be determined without some level of examination by the ATO. As a result, it is not clear how a taxpayer's risk profile is capable of being determined without the Commissioner applying resources to consider the broad and potentially vague qualitative factors noted in the draft PCG. In turn, we consider that this creates increased cost for the ATO with minimal benefit as well as significant uncertainty for taxpayers because, practically, compliance resources will likely need to be applied to determine if a taxpayer falls into the white and green risk zones.

[3] Practical Compliance Guideline PCG 2016/1: *Practical Compliance Guidelines: purpose, nature and role in ATO's public advice and guidance*, paragraphs 8 and 9.

Use of value judgments

Section 100A was introduced as an anti-avoidance provision to overcome 'arrangements and other income derived by trusts to escape tax completely.'[4] Further, arrangements or understandings entered into in the course of ordinary family or commercial dealing are specifically excluded from the definition of an arrangement.[5]

In this regard, we note that, throughout the draft PCG, numerous value judgments are made regarding matters that, prima facie, are solely matters concerning a family's dealings. In practice, family units and family dealings are based on several factors including relationships between family members, financial circumstances, cultural influences and various other personal or socio-economic factors. Further, we consider that the notion of 'ordinary family dealing' is difficult to define and apply as a comparative test, as every family is unique and their specific arrangements and dealings are therefore unique to them. It is particularly confusing for taxpayers when the Commissioner states that a dealing is not ordinary just because it is commonplace.[6]

As a result, we do not consider it appropriate for the Commissioner to be making determinations based on these value judgments when determining a taxpayer's liability to taxation. It should not be up to the ATO to determine how a family ordinarily deals with each other. In doing so, there is a significant risk that individual case teams will apply their own values to a taxpayer's circumstances, resulting in decisions that are unfair, incorrect or insensitive to the taxpayer's situation. These value judgments have the effect of making the ATO the arbiter of what is 'ordinary' for family dealings. This could leave the ATO open to inadvertently making discriminatory decisions based on prejudices and cultural insensitivities.

We consider that these value judgements should be removed from the draft PCG. Alternatively, the Commissioner should be transparent about the underlying assumptions that are used when making determinations about the family dealings, ensuring taxpayers understand the Commissioner's perspective, and supporting a consistent application of section 100A.

We consider that the ATO should provide an express statement explaining the Commissioner's understanding of the policy objective and intended impact of section 100A. In particular, it would be useful for the ATO to articulate, in their view, the types of arrangements and dealings that section 100A was not designed to address, including specific examples of ordinary family and commercial dealings. This would allow taxpayers to better understand the ATO's overall stance on section 100A and better ascertain their own risk profile. It would also be useful for the ATO to better articulate the types of arrangements and dealings that, in their view, the exception in section 100A for 'ordinary family or commercial dealing' was designed to exclude from the operation of the provision.

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4 Explanatory Memorandum to the *Income Tax Assessment Amendment Bill (No. 5) 1978*, page 5. This Bill was enacted as the *Income Tax Assessment Amendment Act 1979*, Act No. 12 of 1979.

5 Ibid, page 36 and subsection 100A(13).

6 Paragraph 79 of TR 2022/D1.

White zone

Paragraph 13 – Arrangements that continue before and after 1 July 2014

We note that paragraph 13 of the Draft PCG states:

> We will not commence any new compliance activities to consider the application of section 100A for income years ended before 1 July 2014, unless it is outside the green zone and:
>
> - we are otherwise considering your income tax affairs for those years
> - **you have entered into an arrangement that continues before and after that date, or**
> - the trust and beneficiary tax returns that were required to be lodged for those years were not lodged before 1 July 2017.
>
> *(Our emphasis added)*

We consider that it is unclear from this paragraph what is meant by the phrase 'continuing before and after'. Prima facie, it appears that the phrase is referring to arrangements that were entered into prior to 1 July 2014 and were still in effect after that date. For example, it is unclear whether a present entitlement arising in the 2013–14 or an earlier income year, that remains unpaid today, would be treated by the ATO as an arrangement that continues after 1 July 2014, or whether something more would be needed to occur after 1 July 2014 to make the arrangement 'continue' after that date.

We consider that this particular phrase should be reworded to ensure that the scope of arrangements covered by the white zone is clear to taxpayers.

Subparagraph 21(b)(ii) – 'Investment assets'

Subparagraph 21(b)(ii) of the draft PCG uses the phrase 'investment assets' in its description of how funds are used. We note that the term 'investment assets' is not a defined term in the tax law and is not frequently used or understood in practice.

We recommend that the ATO should provide greater detail regarding what constitutes 'investment assets' to enable taxpayers to better understand how this condition applies in the context of the draft PCG.

Paragraph 21(c) – Associates

Paragraph 21(c) of the draft PCG provides that a trustee will not satisfy the use of funds condition:

> … if any associate of the trust benefits … from that use of funds (for example, being able to use a trust asset for less than market value consideration).

Feedback from our members suggests that an associate of a trust would usually benefit from reinvestment by the trust, usually through future income and from capital growth in assets that have been invested into. We consider these transactions fall within the scope of an ordinary commercial dealing, that is, undertaken with the objective of growing the trust's assets and not with a tax reduction purpose.

It would be useful for the ATO to consider whether paragraph 21(c) is too broadly expressed and may therefore capture unintended arrangements. We consider that it would be helpful for the ATO to provide greater explanation and clarification on this point. In particular, the ATO should specify the types of arrangements and assets that create areas of concern to allow taxpayers to understand the types of transactions with associates that may be deemed at higher risk.

Green zone

Subparagraph 21(b)(iii) – Obligation to enter into Division 7A compliant loan agreements

We consider that subparagraph 21(b)(iii) of the draft PCG should not impose an obligation on taxpayers to enter into loans that comply with section 109N of the ITAA 1936 in situations not involving a private company. For example, if the UPE is owed to an individual, there is no corporate beneficiary that has an UPE with that trust and the trust lends funds to an associate, no Division 7A implications would arise.

In these instances, we consider that the trustee should be able to lend on terms that are considered commercial but without necessarily meeting the stricter requirements of section 109N. It would be inappropriate and beyond the scope of the legislation to require that a loan in these circumstances must comply with Division 7A in the absence of a corporate beneficiary that is presently entitled to share of trust income that remains unpaid.

We further note that Division 7A compliant loans may not actually represent a commercially viable dealing in many cases. Often, the Division 7A benchmark interest rate is not reflective of commercial rates offered in the market. Further, specific circumstances may require a rate that differs from the Division 7A benchmark interest rate. For example, a personal loan may attract a far higher interest rate than the Division 7A benchmark interest rate. We therefore recommend that the ATO reconsiders this aspect of the draft PCG and suggest the reference to section 109N be removed.

Blue zone

We note that the examples in the green zone address only beneficiaries that are individuals or private companies. We do not consider it appropriate that all distributions to trustee beneficiaries automatically fall into the blue zone. We note that while subsections 100A(3A) and (3B) prevent section 100A from applying to such distributions, section 100A may still apply to the extent that the trust-to-trust distribution is sheltered by losses and does not flow through to another beneficiary. We therefore consider that characterising all trust-to-trust distributions as falling into the blue zone imposes unnecessary compliance burdens on taxpayers and poorly applies the ATO's limited compliance resources.

The extensive and robust provisions in Schedule 2F to the ITAA 1936 prescribe how a trust can recoup its losses and set out various pathways and choices, including making family trust elections and interposed entity elections, to avoid the imposition of family trust distributions tax. These provisions, which post-date the introduction of section 100A by more than 15 years, have greatly impeded the ability to shelter trust-to-trust distributions with losses.

We consider it crucial that the draft PCG provides a green zone for, and sets out the circumstances that will determine, those low risk situations involving distributions to loss trusts, particularly those that have made family trust elections.

This should be supported with examples involving both a retention of funds by the trustee and no retention of funds by the trustee. We consider this important as the income injection test[7] and family trust election regime[8] facilitate the making of such distributions between family trusts. In these instances we consider that section 100A should apply only in exceptional circumstances where the income injection test otherwise does not apply to deny a tax deduction to the loss trust.

Feedback from our members suggests that, in practice, private groups often make these types of trust-to-trust distributions, where the relevant entities have generally made family trust elections or interposed entity elections. Expanding the green risk zone to cover certain low-risk trust-to-trust arrangements that comply with the trust loss provisions in Schedule 2F to the ITAA 1936, especially where the use of funds condition is satisfied, will ensure that taxpayers participating in such arrangements understand that the ATO accepts these can be characterised as green zone arrangements.

We consider that the draft PCG could be modified to provide clearer guidance on the impacts of an arrangement falling into the blue risk zone. We understand that the intention of the blue zone is to highlight circumstances where the ATO **may**[9] request further information to better understand the arrangement. However, the current wording of the draft PCG suggests that an arrangement in the blue zone **will**[10] likely lead to a review by the ATO.

While the draft PCG advises that 'an arrangement … within the blue zone does not mean that section 100A applies to the arrangement'[10], the current wording does not address the likelihood that section 100A may apply to an arrangement that falls within the blue zone. We consider that the current wording in paragraph 27 of the draft PCG should be changed to ensure consistency between paragraphs 24 and 27 by replacing 'will' with 'may' in paragraph 27, use more overt statements that clarify the likelihood of section 100A applying to an arrangement that falls within the blue zone and help taxpayers better distinguish between the blue and red zones.

We also consider that the blue risk zone should be renamed to amber or yellow, maintaining consistency with other medium risk zones in practical compliance guidelines.[11] We understand that blue zones in practical compliance guidelines are generally used to represent a low to moderate risk.[12]

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7 Division 270 of Schedule 2F to the ITAA 1936.

8 Subdivision 272-D of Schedule 2F to the ITAA 1936.

9 See paragraph 24 of PCG 2022/D1.

10 See paragraph 27 of PCG 2022/D1.

11 Refer to PCG 2021/4: *Allocation of professional firm profits – ATO compliance approach*; PCG 2019/1: *Transfer pricing issues related to inbound distribution arrangements*; and PCG 2020/1*: Transfer pricing issues related to projects involving the use in Australian waters of non-resident owned mobile offshore drilling units – ATO compliance approach*.

12 Refer to PCG 2017/1: *ATO compliance approach to transfer pricing issues related to centralised operating models involving procurement, marketing, sales and distribution functions*; and PCG 2020/7: *ATO compliance approach to the arm's length debt test*.

Paragraph 26 factors

Paragraph 26 of the draft PCG lists a number of features that will result in an arrangement involving the retention of funds by the trustee falling outside the green zone. The second and third dot points state that such arrangements include situations where the beneficiary:

- makes a gift of their trust entitlement or an associated amount receivable from the trust (for example, if the unpaid present entitlement (**UPE**) was converted into a loan); or
- disclaims their entitlement or forgives or releases the trustee from its obligation to pay their trust entitlement or an associated amount receivable from the trust.

We recommend that the ATO prefaces these two points with the requirement that the provision of benefits and creation of the beneficiaries' entitlements must be preceded by a reimbursement agreement for section 100A to apply.

The first dot point states that such arrangements include situations where 'the arrangement is a red zone arrangement'. Given paragraph 25 says that 'arrangements that do not fall within the white zone, green zone or the red zone are in the blue zone', and paragraph 26 falls within a section of the draft PCG describing blue zone arrangements, it follows that arrangements in the blue zone must necessarily fall outside the red zone. We therefore recommend that the ATO clarify whether the first dot point should instead state:

> The arrangement is not a red zone arrangement …

We note that the fifth dot point describes that blue zone arrangements include instances where:

> A beneficiary's trust entitlement is satisfied by payments that are sourced from that beneficiary, or a beneficiary's trust entitlement has been made subject to a loan agreement and the repayments of that loan are sourced from payments or loans from that beneficiary.

However, the draft PCG does not explain why the ATO is concerned by dividends and set-offs. Feedback from our members indicates that these types of arrangements are frequently used and understood to be commercial in nature. We consider that it would be helpful for the ATO to expand on and detail the underlying concerns to ensure that taxpayers understand the ATO's perspective of the risks and factors that will enliven section 100A. See below for further detail on this point.

In addition, the final dot point appears to be a catch-all criterion to capture any arrangement that may broadly be related to a tax reduction purpose. As the final dot point appears to allow the ATO to direct compliance resources that it perceives to evoke a tax reduction purpose, we are concerned that it may serve to deem arrangements that do not bear any of the aforementioned features in paragraph 26 into the blue zone. We consider that this point should be replaced or updated to better reflect features that would prevent an arrangement from being classified in the green zone. If no descriptive features are present, we recommend deleting the final dot point. This will provide greater certainty for taxpayers and tax practitioners when applying the draft PCG.

Satisfactions of loans through dividends and set-off arrangements

Based on the experiences of our members, The Tax Institute understands that Division 7A loans can be repaid by way of a dividend (paid by the lender company) and set-off. Such transactions may include tripartite arrangements where the shareholder of the company is not the borrower under the loan but some other trust.

We note that the draft PCG suggests these arrangements will be in the blue zone rather than in the green zone where the corporate beneficiary's entitlement has been lent back to the trust by way of a complying Division 7A loan.

We recommend that the ATO should provide a green zone rating for basic arrangements that involve repayments of loans through dividend and set-off, and are being managed on complying Division 7A loan terms, as these arrangements are often not undertaken with the intention of reducing liability to taxation. This greater transparency would ensure that taxpayers are aware of the circumstances and reasons when they are likely to be placed into a higher risk zone.

Red zone

Paragraph 30 clarification

The Tax Institute considers that it is currently unclear whether the two dot points in this paragraph should be read with an 'and' or an 'or' separating them. We recommend amending paragraph 30 of the draft PCG to insert the appropriate connector.

Paragraph 31

Paragraph 31 of the draft PCG sets out features that place arrangements into the red zone, where they involve an individual adult beneficiary being made presently entitled to trust income. The third dot point includes arrangements where '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 feedback from our members, we understand that, in practice, funds representing the beneficiary's UPE may be used to repay a parent's credit entitlement. In other words, one lender to the trust is effectively replaced by another lender. We recommend that the ATO incorporate further guidance into the draft PGG to better explain the risk profile of these kinds of arrangements and provide taxpayers with greater certainty about the ATO's approach to these arrangements.

Testamentary trusts

Paragraph 32 of the draft PCG provides that Examples 7 and 8 in Appendix 1 cover those types of arrangements that may be considered high risk. We note that arrangements involving life tenancies in testamentary trusts and estates will likely be caught by these sections of the draft PCG, despite the fact that they are often not established with a tax reduction purpose.

Further, many testamentary trusts involve distributions to minor beneficiaries, who are under a legal disability. This fact alone prevents section 100A from applying due to the operation of subparagraphs 100A(1)(a) and 100A(2)(a). We therefore consider that the draft PCG should provide specific guidance for arrangements involving testamentary trusts, including how section 100A could apply to arrangements involving testamentary trusts, and provide greater clarity about how they could be impacted by the draft PCG.

Paragraph 40

Paragraph 40 of the draft PCG provides that an arrangement will not be contrived if a difference occurs merely due to franking credits. We note that there are several other instances where differences may inadvertently arise for similar reasons. These include differences due to foreign income tax offsets (**FITOs**), tax deferred amounts and tax-free amounts. We consider that this paragraph should be updated to also include these, and any other relevant, factors.

Paragraph 42

We consider that the draft PCG should provide greater clarity on arrangements where a beneficiary with losses uses the funds to repay loans that were originally taken out to fund the losses. In these instances, we do not consider that any section 100A issues will arise provided the lender is an unrelated lender dealing at arm's length terms.

Even in instances where the funds were borrowed from a related lender, we consider that section 100A may not necessarily apply in every situation. We consider that the draft PCG should include further guidance and clarity on the consequences of this distinction.

Red zone scenario 5

Scenario 5 of the draft PCG appears to suggest that that any distribution to a loss company or trust, would be covered by section 100A. We note that an entity within a group may be in a loss situation for a number of commercial reasons. Further, provided the trust deed allows it, trustees are entitled to make distributions to eligible entities under the trust deed and no risk should arise provided the entity receives the distribution.

As a result, we do not consider that section 100A applies in all situations where a distribution is made to a loss making entity. We recommend that the draft PCG should be updated to further specify and highlight the circumstances when distributions to loss entities are considered to be high risk.

Examples in draft PCG

Example 6 and adult students

Both Example 6 from the draft PCG and Example 3 from the TA contain a fact pattern involving the trust entitlement of an adult beneficiary who has incurred or incurs university or tuition fees. Both of these examples are considered low risk because the present entitlement was created before the obligation to pay the fees was incurred by the student, and the trust amounts were either paid directly to the beneficiary or applied on their behalf and at their direction to meet the cost of their fees.

We consider that both Example 6 from the draft PCG and Example 3 from the TA should clarify that the source of the funding to pay the university or tuition fees of an adult beneficiary should not change the outcome and such arrangements should continue to be treated as low risk. Where a beneficiary becomes liable for the fees and sources the funds to meet the cost of those fees either from a third-party deposit-taking institution or from their parents, then later directs the trust to repay the bank or their parents out of their trust entitlement, the beneficiary has received the benefit of that distribution by directing that their debt be repaid from their trust entitlement. In either case, the source of the funds to meet the cost of the fees does not change the tax outcome.

Example 7 and evidentiary requirements

Example 7 of the draft PCG, and the TA, appear to be drafted under the assumption that parents will routinely force upon their children a binding obligation to repay costs incurred in raising them. However, we do not consider this underlying assumption to be an accurate representation of the wide range of circumstances prevalent in the community.

Realistically, instances of children providing financial support to their parents in consideration of the fact their parents provided them financial support while raising them can be impacted by a wide range of cultural and socio-economic factors. As noted above, we do not consider it appropriate for the ATO to apply value judgments and determine what is, or is not, an ordinary family dealing in these circumstances.

These obligations and provisions can significantly impact the outcome of whether a matter is an ordinary family dealing. Consideration should be given to whether the draft PCG should be updated to provide the ATO's view on legal obligations.

We consider a clearer distinction is needed in the draft PCG between an adult child who volunteers financial assistance to their parents and a minor who is forced, or otherwise coerced, to agree to an arrangement at an age where they legally, or otherwise, are not capable of doing so.

Further, the draft PCG and TA should note the evidence that the ATO will accept in these instances to explain the taxpayers' positions. We note that the ability to evidence these familial arrangements is a significant concern for taxpayers. While it is possible for an adult child to enter into a formal agreement to express their desire to financially assist their parents, there are concerns that this may be viewed by the ATO as an allegedly contrived circumstance. However, we also note that a lack of a formal agreement may be adversely viewed by the ATO, potentially indicating a lack of evidence to support the taxpayer's position.

We consider that the draft PCG should clearly state and adopt a consistent position on evidentiary requirements that will apply for all taxpayers. It would be useful for the ATO to provide some examples of what would constitute an ordinary and uncoerced family dealing.

Example 10 and red zone Scenario 4

Paragraph 39 of the draft PCG (Scenario 4) broadly states that arrangements will be in the red zone if the difference between the trust's net income and the beneficiary's entitlement is the result of a contrivance. Paragraph 40 of the draft PCG states that where the difference is merely due to franking credits, it will not be taken to be as a result of a contrivance. We also note that paragraph 117 of the draft PCG and paragraph 139 of draft Taxation Ruling TR 2022/D1: *Section 100A: reimbursement agreements* include facts in the examples whereby the meaning of trust income under the trust deed is amended as part of the arrangement to generate a favourable tax outcome.

We consider that this level of guidance is insufficient to provide taxpayers with the required level of clarity to assist them in understanding whether their arrangement is a high risk arrangement.

We consider that the draft PCG should be more definitive about when arrangements will not be considered red zone arrangements, particularly where the difference between the trust's net income and the beneficiary's entitlement arises as a result of differences between tax and accounting principles. For example, Taxpayer Alert TA 2016/12: *Trust income reduction arrangements* covers similar arrangements and clearly states that the ATO is not concerned with arrangements where differences arise because 'proper accounting … leads to differences between when and how amounts are recognised for tax purposes.'

We recommend that the draft PCG should similarly carve out all arrangements that arise as a result of differences caused by adherence to proper accounting standards, and not as the result of an exercise of a trustee's power or variation of a trust deed (rather than only making reference to differences arising due to franking credits).

Example 9 — Different treatment of similar investments

Example 9 of the draft PCG appears to suggest that investing in a related unit trust is likely to be flagged at a higher risk compared to investing in an unrelated trust. However, we consider that such investments should carry the same risk rating in instances where they are made at market value as there is no perceived tax or economic benefit between investing in a related or unrelated trust.

As a result, we recommend that the ATO reconsiders whether investments made at market value in a related trust should necessarily attract a red zone rating and provide further clarification on the specific of arrangements that will result in a high risk rating.

Example 11

We consider that Example 11 of the draft PCG is not representative of realistic commercial practices and should be modified to deal with more practical examples of distributions to loss entities within a private group. We consider it to be highly unlikely for a controller of a trust to come across a previously unknown entity who coincidentally happens to have tax losses and proceeds to make a distribution to that unknown entity.

In many cases, the trust will have a valid family trust election in place and family trust distributions tax would be triggered on such a distribution. As a result, the appropriate amount of taxation as intended by the legislation will likely have already been paid. We therefore recommend that Example 11 be amended to cover more realistic and practical situations.

Further, when one or more of these beneficiaries are loss-making due to financial, commercial or operational issues, distributions to such entities should not automatically trigger section 100A in the absence of other facts alluding to a tax reduction purpose. As noted above, an entity may have losses for a variety of valid reasons.

We also note that, although the examples have been simplified for ease of illustration, further details are required in the example indicating the reasons why the arrangements are considered to be high risk. In particular, we consider that the draft PCG should clarify that such arrangements with the specified features will be in the red zone in the absence of further facts explaining their commercial rationale.

Other issues

ATO's allocation of compliance resources

There has been minimal or contradictory historical guidance issued by the ATO in relation to section 100A on which taxpayers could rely. Case law on section 100A has also historically been limited to and applied only in egregious circumstances, likely setting an expectation and understanding that section 100A was limited to those types of circumstances. Further, some arrangements that were permitted, either directly though rulings or indirectly through no further actions during audits, may now be considered to be high risk. We also note that, for historical reasons, extensive records for trust distributions were not maintained or kept, or required by the ATO.

Accordingly, The Tax Institute supports the ATO's subsequent representations before the Senate to apply the draft PCG on a prospective basis.[13] We consider that making this position clear in the final PCG will provide greater certainty and comfort for the community.

Question the need for inclusion of risk zones in the PCG

The draft PCG plays an important role in conveying the ATO's preliminary position on the transitional approach that is intended to be adopted for pre-1 July 2014 and pre-1 July 2022 arrangements. The most valuable part of the draft PCG is in the transitional approach explained at paragraphs 13 and 47.

However, as stated in our opening remarks, the draft PCG has not achieved its purpose of clarifying how the ATO intends to apply its compliance resources to potential cases that may trigger the application of section 100A.

The Tax Institute's view is that, aside from some recommended clarification on terminology and updating the ATO's intended position on compliance action, our primary concerns relate to the existence and design of the risk zone framework.

As currently drafted, the risk zone framework does not readily enable taxpayers to determine their risk profile. This is evident from the extensive confusion across the profession regarding how practitioners will assist practically their clients in identifying their risk zone given the lack of measurable metrics when it comes to the information necessary to determine a taxpayer's risk profile. It is also not clear how the ATO will be able to readily determine a taxpayer's risk profile, without applying compliance resources to this exercise; this undermines the purpose and benefit of a practical compliance guideline. We note that not all PCGs contain a risk zone framework.

We have also received feedback from our members that they fear many of their clients may fall into the red zone, as currently described. This is questioned by the ATO who have conveyed to us that the majority of taxpayers' arrangements should not fall within the red zone. Practically, and in light of the issues identified above, it is our view that the proposed risk zones add more complexity than they are trying to resolve.

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[13] Evidence to Economics Legislation Committee, Parliament of Australia, Canberra, 6 April 2022 (ATO Second Commissioner, Jeremy Hirschhorn), available on Hansard.

It is our recommendation that further consultation should be considered around the merit of establishing a risk zone framework in these circumstances and the appropriateness of how the zones have been defined in the draft PCG. Further consideration should focus on whether greater use can be made of taxpayer alerts, containing practical realistic examples, rather than the risk zone framework to better communicate the ATO's concerns so that taxpayers have a higher level of comfort around their arrangements.

Taxpayer Alert TA 2022/1

Referrals to the Tax Practitioners Board

Our members have shared their concerns that that the ATO's referral of promoters to the TPB may include tax agents who have merely advised on such an arrangement. This interpretation could result in high numbers of tax agents who have advised on family trust arrangements being referred to the TPB.

The Tax Institute supports the ATO's recent statements to the Senate that the ATO does not intend to refer tax agents who provided ordinary advice services in relation to this arrangement in exchange for an advisory fee.[14] We consider that this approach should be made clearer in the TA to reduce confusion and concern by members of the tax profession.

Further, given the breadth of the potential impact, we consider that the ATO should focus on education and ensuring that tax professionals understand the reasons for the ATO's change in position. This approach will ensure that tax practitioners who followed available historical guidance and practice in good faith at the time are not unduly penalised or targeted.

Application to other family members

The TA deals only with adult children beneficiaries. This has led to many practitioners questioning whether section 100A would similarly apply where distributions are made to other close family members, including elderly parents, nieces/nephews, aunts/uncles, cousins etc.

However, this will depend on a range of circumstances personal to the taxpayer. It is also unclear whether the exception for ordinary or commercial dealing applies only to all of a family group's past and current children. For example, it is not clear whether this scope includes only direct children, or if it also includes step-children and adopted children and other types of filial relationships.

To avoid doubt, we consider the TA should be amended to clarify that there is an equal risk of section 100A applying where a distribution is made to any family member or eligible beneficiary who has a lower marginal tax rate. Alternatively, the TA should include a clearer definition of adult children to ensure that taxpayers and tax practitioners understand the exact scope of this exemption.

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[14] Ibid.

Example 1

We note that the TA appears to presume that the present entitlements in the arrangements in question have all been preceded by a reimbursement agreement. However, a reimbursement agreement is a key prerequisite for section 100A to apply. We consider that the TA should detail the facts and considerations that will lead to the existence of a reimbursement agreement. It is not appropriate for the TA to assume that all arrangements will give rise to a relevant reimbursement agreement.

The TA also makes a value judgment that the arrangements in question have not been made for the benefit of the family as a whole. The TA does not consider other potential factors such as an increase in the overall value of the parents' estate assets (that may benefit the family as a whole), focusing solely on the decreasing ongoing principal and interest repayments (that benefit the parents in the short to medium term). As such, we consider that this example should be refined to reflect these types of family objectives.

We also re-iterate our comments above regarding the use of value judgments in the draft PCG and TA. We consider it highly inappropriate for the ATO to assume, through the TA, what fact patterns are considered 'ordinary' in the context of the diverse set of situations that comprise family dealings. We consider that the TA should clearly state the assumptions the ATO has used when determining that the relevant arrangement is not an ordinary dealing.

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.