4 May 2022

Mr Justin Dearness

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By email to: justin.dearness@ato.gov.au

Dear Justin,

Invitation to comment - TR 2022/D1 - Income tax: section 100A reimbursement agreements

On behalf of the Institute of Public Accountants, we submit our comments on the draft taxation Ruling TR 2022/D1 Income tax: section 100A reimbursement agreements (draft Ruling) about the preliminary view on how the Australia Taxation Office (ATO) could apply this provision.

1. General

We appreciate the opportunity to provide comments and feedback. We make this submission on behalf of our members and in the broader interest of the public. Our members represent small businesses and other taxpayers that routinely use discretionary trust as a preferred vehicle. This submission includes key points raised via member feedback. This draft Ruling has caused extreme concern for our members with an extraordinary number actively reaching out to us on this matter. This is significantly more than any other previous ATO guidance. Members consider this draft Ruling to significantly impact how they conduct their routine client engagements particularly around trust distributions.

This updated guidance has come at a time when our members have been under significant pressure, specifically, managing the financial impacts of the pandemic for their clients through the plethora of government initiatives and continuing with ongoing support, to return their client's business to sustainable levels over the past two years. This draft Ruling has caused additional strain on our already burdened members particularly having to explain to clients the ramifications of the updated guidance on both the past and future situations.

Our members feel blindsided by the publication of this draft ruling. There has not been any prior indication of the narrow interpretation adopted in the draft Ruling, having regard to the limited ATO guidance on S100A that was introduced to deal with “Bottom of the Harbour” type trust stripping arrangements.

Although this clarification on the interpretation of s100A has been in the offing for some time, the lack of formal announcements by the ATO during this period has contributed to this unexpected situation. The ATO has known for years that certain practices, considered legitimate tax planning in a family context, had been widely used. It should have acted earlier, as advisors assumed these practices were tolerated if not entirely acceptable, particularly as it was rarely the subject of any S100A ATO compliance activity. The breath and depth of the current guidance (TR 2022/D1) is in complete contrast to the '2014 Trust taxation – reimbursement agreement (S100A factsheet)' which was the previous ATO guidance in the public domain.

At the heart of our member concerns is that the ATO has now adopted a narrow interpretation of when the ordinary family or commercial dealing extension can apply, and by default broadening the potential scope of S100A. Given that certain practices considered legitimate in a family context are now under question, this has exposed a large number of practitioners to potential scrutiny. Our members are of the view that Parliament or the judicial system should determine what is an ordinary family or commercial dealing, rather than the ATO as administrator of our tax system.

2. Summary of the current view of this provision:

2.1 History - Original intention and broadly drafted

Section 100A ITAA 1936 was inserted on 13 March 1979 as an anti-avoidance provision to counter aggressive trust stripping arrangements and the "bottom of the harbour" schemes prevalent during this period. Having regard to the nature of those schemes, it only required a tax reduction purpose, rather than a dominant purpose of tax avoidance, as required under Part IVA. Further, unlike the amendment period restrictions that apply under Part IVA, there is no time limits under S100A. In view of the differences between, and wider scope of S100A as compared to the general tax avoidance provisions of Part IVA, it seems clear that the focus of the policy intent was to limit S100A to aggressive trust stripping arrangements where it is appropriate to limit taxpayer protections such as time limits and dominant purpose requirement.

S100A broadly has application where a beneficiary who is presently entitled to a share of trust income is not the person who actually benefits from that income under a reimbursement agreement. The term agreement is defined and specifically excludes 'entered into in the course of ordinary family or commercial dealing' which is one of a number of exclusions contained in S100A. The legislation is silent on the definition of 'ordinary family or commercial dealing' for the purposes of S100A and therefore takes its ordinary and legal meaning having regard to its statutory context (shut down aggressive trust stripping arrangements)

TR 2022/D1 has now provided transparency on what the ATO interprets this phrase to mean and based on this guidance is much narrower than what most practitioners had ever expected. Based on the statutory intention of the legislation and the specific exclusion for ordinary family or commercial dealings, the interpretation was that s100A did not apply to any familial beneficiaries but rather, introduced beneficiaries.

The ATO has simultaneously released Section 100A reimbursement agreements - ATO compliance approach (**PCG 2022/D1)** to help practitioners to assess their level of risk with respect to the updated S100A guidance. This risk framework uses coloured risk zones to achieve this outcome. Unfortunately, PCG 2022/D1 makes it clear that trust distributions to adult children are in the red zone where the effect of an arrangement is that the funds representing the trust distribution end up in the hands of the parents (who are on higher tax rate than their children). This becomes problematic for practitioners who have engaged in these types of tax planning practices in the past, firmly in the belief that such practices fell within the ordinary family dealing exception.

2.2 Case law

There have been several cases that have considered and applied s100A:

- *Re East Finchley Pty Ltd v FCT* [1989] FCA 481;
- *Prestige Motors Pty Ltd as trustee of Prestige Toyota Trust v FCT* [1997] FCA 346; and
- *Raftland Pty Ltd as trustee of the Raftland Trust v FCT* [2008] HCA 21

These cases involved blatant, egregious, and contrived arrangements and did not consider the exemption for 'ordinary family or commercial dealing'. Accordingly, the decisions did not provide precedence for common taxpayers' situations and supported disregarding the application of s100A to familial arrangements.

The issue is there has been limited judicial interpretation of the meaning of an 'ordinary family or commercial dealing' as it applies for the purposes of s100A, except in a recent decision handed down on 21 December 2021, namely *Guardian AIT Pty Ltd ATF Australian Investment Trust v FCT* [2021] FCA 1619 (Guardian). In the Federal Court Guardian decision, the judgement did provide some commentary (obiter dictum) on the meaning of an ordinary family or commercial dealing. In this case the Federal Court Judge concluded that an arrangement involving a distribution of trust income to a corporate beneficiary, which in turn distributed a dividend back to the trust, did not constitute a 'reimbursement agreement' for the purposes of s100A. Also, even if there was an agreement, the arrangement was an ordinary family and commercial dealing (which is excluded from the definition of 'agreement' in section 100A (13). While this decision provides some limited non precedential guidance on the application of s 100A, it is limited to its facts and is under appeal to the Full Federal

Court. Notwithstanding, it highlights that the 'ordinary family and commercial dealing' exclusion requires judicial clarification in the context of S100A.

An extract from the judgement is as follows:

*Read in context, the adjective "ordinary" in "ordinary family or commercial dealing" has particular work to do. It is used in contradistinction to "extraordinary". **It refers to a dealing with contains no element of artificiality.** This is confirmed by reference to the relevant explanatory memorandum, where one finds reference to addressing the mischief of specifically introduced beneficiaries having a fiscally advantageous status. This explanatory memorandum confirms what a reading of s 100A would suggest, which is that the section is directed to addressing, according to its terms, "trust-stripping".*

Whilst the obiter dictum comments lack legal precedence, they are at odds with the view taken by the ATO (TR 2022/D1 at para 79).

*The essential feature of ordinary family or commercial dealing is that it is ordinary. …dealing is ordinary where a person can examine the acts and predicate that they can be explained by the familial and/or commercial objects they are apt to achieve without further explanation. …Dealing is not ordinary just because it is commonplace. **Similarly, dealing can fail to be ordinary dealing even where it is not artificial.***

2.3 Previous Guidance – S100A factsheet

The previous ATO web guidance on s100A was first issued in 2014. It provided limited guidance on the definition of an 'ordinary family or commercial dealing'. Again, the guidance did not assist common taxpayers' situations and further supported disregarding the application of s100A to familial arrangements. Only a small number of arrangements were included as part of this guidance which has led many to believe that S100A was something that only applied to artificial arrangements outside of the family group.

2.4 Recent trust case Law

On 6 April 2022, the High Court delivered its judgment in *Commissioner of Taxation v Carter* [2022] HCA 10. This case confirmed the impact of a beneficiary's ability to 'disclaim' a distribution from a trust. A resident beneficiary (with no legal disability) will be 'presently entitled' and taxed on the income of a trust under Division 6 ITAA 1936, where a reasonable period has not yet elapsed after the end of the income year for the beneficiary to have disclaimed that entitlement.

If S100A applies, it is our understanding that the distribution is invalid for tax purposes and the trustee is liable to pay tax on the distribution at the top marginal tax rate of 47%. In effect the beneficiary is deemed to never have been made presently entitled, allowing a trust distribution to be retrospectively invalidated for tax purposes. The beneficiary is able to

amend their tax return outside of any amendment period restriction to obtain a refund of any tax paid on the distribution (S170(10).

If this is the correct application of the law, further guidance needs to be included in this draft Ruling to clarify the impact of this decision on any application of S100A whereby a beneficiary distribution is invalidated.

Whilst S100A can invalidate a distribution for trust law purposes, the provision may not invalidate a distribution for trust law purposes which can create other legal and practical complications.

It is generally accepted that the Commissioner has an unlimited amendment period in relation to S100A. A 2008 Full Federal Court decision, *Metlife Insurance Limited v FCT* (2008) FCAFC 167 potentially impacts the Commissioners power to an unlimited period of time to assess/amend an assessment in respect of S100A.

It would be useful if the draft Ruling could clarify the Commissioners view of an unlimited amendment period for S100A amendments under S170(10) in light of the abovementioned Metlife case.

2.5 Reimbursement agreement – no relevant connection between the present entitlement and any reimbursement agreement

Where distributions that have been made on or before 30 June are retained in the trust, in the vast majority of cases the beneficiaries are aware that it is available at call with the expectation that it will be paid out or dealt with at some later point in time. The retention in the family business is almost never part of any understanding, express or implied, at the time of making the distribution. The distributions credited are made on the basis that the beneficiaries can call on it at any time. Even if annual distributions are made and retained over many years until the adult children make a call, this is not connected to, or contemplated when, making the distributions on 30 June. In these circumstances there is no relevant connection between the present entitlement of 30 June to any 'reimbursement agreement' or 'benefit to another'.

The requisite relevant connection requirement to precede the present entitlement of income required under S100A provisions requires more explanation in the context of family trusts.

3. Major concerns

We provide our concerns about two specific issues with the draft Ruling:

3.1 Ordinary Family Dealing

The substantiveness of this draft Ruling has focussed on the definition of 'ordinary family dealing' as it has previously not been defined by legislation and lacks judicial precedence. The draft Ruling has provided guidance where a familial dealing may not be excluded from s100A. This is a significant change to common practices where familial beneficiaries have been considered outside this provision. The legislative exemption has compounded the presumption that s100A does not apply to distributions to family members, but rather introduced beneficiaries for predominantly tax avoidance purposes.

The draft Ruling states that 'a dealing is not ordinary just because it is commonplace'. This claim is unsupported, as a reasonable person may consider common, ordinary, customary, mundane, obvious, prevalent, typical, and normal acceptable synonyms. This is beyond the argument: '*was done last year*' or '*always done this way*'. Furthermore, in 2022, the definition of family is highly fluid.

The most familiar use of 'ordinary' in legislation is the definition of 'ordinary' income under s6-5 ITAA 1997, and this has a plethora of case law to support interpretation. There is no case law supporting the interpretation of 'ordinary' in the context of s100A.

Arguably the draft Ruling interpretation is not aligned with either the intention of the legislation or the previous ATO guidance. This narrow ATO view is an overreach in the absence of any case law to support the interpretation in this draft Ruling. The interpretation needs to be supported by a test case, and judicial precedent established to support the views in the draft Ruling.

3.2 Retrospective application

Importantly, s100A has no limited amendment period and accordingly, compliance action can be retrospective.

Even though subsequent ATO announcements have indicated no specific S100A compliance activities are contemplated, there is no protection afforded to taxpayers if the Commissioner decides to take retrospective action. We are concerned that when subjected to any other ATO compliance for some other aspect of tax law, s100A would be brought into the review's scope.

The narrow interpretation of ordinary family and commercial dealings in the draft Ruling once tested in the judicial system should be applied prospectively given the lack of guidance

provided in the 2014 factsheet. Whilst both the ATO and Assistant Treasurer have both made comments regarding retrospective compliance activity, in both cases the caveat attached to these statements is that this only applies where a taxpayer has relied upon the 2014 factsheet. The ATO maintain that the draft Ruling is consistent with the 2014 factsheet leaving many practitioners exposed unless Parliament decides to amend the law for unintended consequences.

3.3 Distributions to Loss entities

S100A has potential application to distributions to loss making entities particularly where the economic benefits of the trust distribution are utilised by the trustee or an entity other than the beneficiary. There are already well-established integrity measures around trusts (trust loss provisions in Schedule 2F). Some commentary around the interaction of these existing integrity measures and S100A is warranted, to understand the rationale for the concerns in the draft ruling.

3.4 Consultation process

The updated guidance material on S100A was a result of a confidential consultation process similar to 'Professional Profits allocation' ruling. We recognise that confidential consultations that involve the right participants do have a place, particularly when dealing with highly sensitive issues. A confidential consultation which continues for a protracted time with a limited ability to communicate with others outside the process has in these two instances lead to widely differing views of the ATO draft guidance as compared to what those outside the consultation would have landed on in relation to sensitive issues. Whilst differing views is not a cause for any concerns, this is so long as parties have had the opportunity to fully consider choices and understand positions taken before settled positions are communicated more broadly through the public consultation process.

3.5 Practical Compliance Guide

We will not be separately providing a submission in relation to 'ATO compliance approach (PCG 2022/D1)'. We are of the view that we need to finalise the ATO's interpretation of S100A before we can deal with the practical administration aspect of the draft Ruling. The draft Ruling may change after the submission process has ended, resulting in consequential risk rating re-assessments. If there was more certainty with respect to the ATO views contained in the draft ruling, we would have welcomed the simultaneous release of the PCG 2022/D1 as it would have provided much needed guidance on where taxpayers stood managing their tax affairs. There are a number of technical issues with the ATO's interpretation which are untested which could prove problematic in applying S100A against a taxpayer if it was litigated through the judicial system. The uncertainty particularly in light of the Guardian case decision is enough to question the legal basis upon which the draft Ruling is based.

Lastly, subsequent comments from the ATO have indicated that, “The vast majority of small businesses operating through a trust will not be affected by this public advice and guidance.” This contradicts the feedback we have received from our members.

If you would like to discuss our comments, please do not hesitate to contact me.

Yours sincerely

Tony Greco

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Institute of Public Accountants