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Resolving R&D disputes

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THE TAX INSTITUTE

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Tax News – at a glance

by TaxCounsel Pty Ltd

August – what happened in tax?

The following points highlight important federal tax developments that occurred during August 2019. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 109 (at the item number indicated).

Amending legislation: tax avoidance

The Treasury Laws Amendment (2019 Tax Integrity and Other Measures No. 1) Bill 2019, which was introduced into parliament on 24 July 2019, contains measures that are aimed at stopping tax avoidance, protecting the integrity of Australia's tax and superannuation systems, and saving businesses time and money through implementing an electronic invoicing framework. **See item 1.**

Foreign vendors CGT withholding tax

On 26 July 2019, the Minister for Housing and Assistant Treasurer announced that the government's foreign resident CGT withholding laws have raised more than $1b since their introduction on 1 July 2016. **See item 2.**

Phoenixing crackdown

The Treasury Laws Amendment (Combating Illegal Phoenixing) Bill 2019, which was introduced into parliament on 4 July 2019, contains amendments aimed at curbing phoenixing activity. **See item 3.**

Other amendments

An amending Bill (the Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2019) which was introduced into parliament on 4 July 2019 contains amendments to implement several 2018-19 Budget measures. **See item 4.**

Travel and overtime meal allowances

The Commissioner has issued a determination that sets out the amounts that he considers are reasonable for the substantiation exception in Subdiv 900-B ITAA97 for the 2019-20 income year (TD 2019/11). **See item 5.**

Debt and equity rules

A final determination has been issued which is to the effect that the debt and equity rules in Div 974 ITAA97 cannot limit the operation of the transfer pricing rules in Subdiv 815-B ITAA97 (TD 2019/10). **See item 6.**

Default assessments upheld

The AAT has rejected objections by a taxpayer against default assessments issued to her for two income years based on trust distributions that were made by two New Zealand trusts (*Campbell and FCT* [2019] AATA 2043). **See item 7.**

Division 7A: when was a loan made?

The AAT has held that a loan was made by a trust to the taxpayer for the purpose of Div 7A ITAA36 in the 2010 income year and not, as contended for by the taxpayer, the 2009 income year (*Howard and FCT* [2019] AATA 1910). **See item 8.**

Tax agent registration: fit and proper person test

The AAT has upheld a decision of the Tax Practitioners Board to terminate the registration of a tax agent (on the basis that he was not a fit and proper person) and to prohibit him from reapplying for registration for a period of 12 months (*Schmuel and Tax Practitioners Board* [2019] AATA 2168). **See item 9.**

Onus not discharged

The Full Federal Court (Greenwood, Burley and Colvin JJ) has unanimously affirmed a decision of Steward J in which his Honour dismissed appeals by a taxpayer against objection decisions made by the Commissioner involving amended default assessments for eight income years which increased the taxpayer's taxable income for those income years by a total of $2.86m and imposed penalties of $2.08m (*Bosanac v FCT* [2019] FCAFC 116). **See item 10.**

Other news

Car limit: 2019-20

The 2019-20 car limit under s 40-30 ITAA97 that applies for capital allowance purposes is $57,581. There is no change from the 2018-19 limit.

CGT improvement threshold: 2019-20

The 2019-20 capital gains tax improvement threshold that applies for the purpose of determining whether an improvement to a pre-CGT asset is a separate asset is $153,093 (up from the 2018-19 threshold of $150,386).

Division 7A: benchmark interest rate

The 2019-20 income year benchmark interest rate for private companies with a regular 30 June accounting period is 5.37%.

President's Report

by Tim Neilson, CTA

The music of the spheres

President Tim Neilson reviews what goes into an Institute event.

In the classical world, people believed that the visible celestial bodies gave off a constant humming sound which was in theory audible, but which was so constant and uniform that no human being was able to notice it.

Similarly, we can observe what happens at a Tax Institute event, but it's not always obvious what goes on behind the scenes to make it all happen.

Take, as an example, one of our annual major events, such as National Convention, a state convention, or a specialised event like the member-only Noosa Tax Intensive.

The first step in planning is, of course, members' feedback. As soon as one year's event is finished, the evaluations and other feedback are collated and analysed. This provides a clear picture of what was liked and what you'd prefer changed. That's always the basis for what happens next, which is why your feedback is so important.

Then, within a couple of months, Institute staff start to set up the organising committee for the next year's event. They'll contact suitable members — usually people who have had experience on the organising committee of that event before — and one of those members will accept the role of chair of the organising committee.

Then, the organising committee is formed. The chair and Institute staff identify a list of potential committee members, having regard to getting a suitably diversified committee. The types of diversity needed depend in part on the nature of the event. For example, for National Convention, it will be important to have committee members from SME and private client backgrounds as well as from large business backgrounds, whereas for some of the specialised events that type of diversity is unnecessary and perhaps even undesirable. But tapping into all demographics of our membership base is always a good idea.

The organising committee will probably start meeting around nine or 10 months before the date of the event. (That may seem like a long time, but experience tells us that it isn't too long.) The planning process has two main strands.

There's the logistical and operational side, which is handled largely by Institute staff, usually with one of the Event and Member Services executives having primary responsibility for that event. The operational side includes the fundamental things like choosing and booking a venue that has suitable facilities and is satisfactorily located for transport purposes. If it's a national-type event, there's likely to be a social program, which again needs to be decided on and put into place.

There's also of course the technical program. The committee's first task is to select topics. That's not easy. First, the committee has to be almost clairvoyant. Topics have to be chosen and speakers confirmed before the program can be made public, and the promotion needs to start some months before the event in order to give sufficient advance notice to attendees, so the committee has to predict what's going to be important several months after the program topics are chosen. During those several months, politicians can announce new initiatives, abandon old ones, and tell Treasury to put things on the backburner in favour of other priorities. The ATO can issue new guidance or announce its own new initiatives. Court cases can sometimes surprise us. But somehow our organising committees keep getting it pretty much right.

Then the speakers are selected. Again, that's not straightforward. The committee has to coordinate to ensure that the collective group of speakers comprises a wide variety of voices so that attendees will be getting input from a broad range of viewpoints and backgrounds. Also, it's desirable to have well-known names speaking to act as drawcards for the event, but we also want to make sure that less well-known members, including of course younger or newer members, are given a chance to show their talents and to become the next generation of drawcards. All pieces of the puzzle must be carefully fitted together.

And, of course, when the time comes to approach the speakers, not all of them will be available. So, putting together the group of speakers is very much an iterative process.

But finally, it's all done. That's when Institute staff can put the brochure together and inform members of what's in store.

The speakers then get ready behind the scenes. They are, of course, chosen for their expertise in the area they're going to speak on, but it's still a considerable task to write a well thought out, cohesive paper, even on a topic that you know well. (But it is a rewarding task. I've always learned a lot when I set out to teach something.)

The speakers' draft papers are then peer reviewed by committee members or other Institute volunteer members. There may be some discussion, for example, if there's an issue that the committee member thinks that attendees would like to know more about. Eventually, the papers and other materials (such as slides) are ready for Institute staff to load up onto the system.

Finally, the big day arrives and it's showtime. Of course, we're only human and nothing ever runs perfectly. But I hope you agree that our big events are excellent productions. And when the committee chair, or the president, thanks all those involved, we mean it. It just wouldn't happen without the things that don't get noticed.

CEO's Report

by Giles Hurst

Stepping into a season of new beginnings

CEO Giles Hurst reflects on this year's achievements and what he's looking forward to.

As we step into spring, the season of new beginnings, we continue the year's transformation theme and bring you additional improvements to your member services.

So far this year, these include the introduction of the Monthly Tax Updates with CPD (for Associates, Fellows and CTAs), the digitisation of *Taxation in Australia*, and the federal Budget website, to name a few.

Before unveiling the latest improvements to member services, I want to acknowledge that we have succeeded in bringing these changes and reaching these milestones because of the unique levels of support we have received from our members.

The best and brightest in the profession volunteer their time to sit on our boards, lobby on tax policy, speak at CPD events, develop and deliver our formal learning and, more recently, contribute to the widely read *TaxVine*.

The voluntary involvement of members is increasing, and we encourage more tax professionals to participate.

I am pleased to say that the Institute's presence at this year's AOTCA conference in Busan, South Korea, is projected to grow. I fully expect, as the evident internationalisation of tax gathers pace, that our involvement in regional efforts to represent our profession will further increase.

Member portal

We are in the final throws of testing the new online member portal. Launching soon, the member portal will be the one-stop place for you to access your member services. You can also access your CPD history (and add additional CPD), download event papers, or make changes to your membership and other subscriptions. We are hoping this will help you find the information you need quicker and easier.

Tax Adviser of the Year Awards 2020

Applications for the Tax Adviser of the Year Awards are now open.

Every year, we receive applicants of the highest standard, with the finalists and winners representing the best and brightest in the profession. In 2020, the awards will again be across four categories: Emerging Tax Star of the Year; SME Tax Adviser of the Year; Corporate Tax Adviser of the Year; and Chartered Tax Adviser of the Year. I believe that the Institute plays a pivotal role in highlighting the contribution of our members and these awards play an important part in this.

I have spoken with many of you regarding this, and the passion that has been shown for these awards — and for change — is refreshing.

One thing that has been raised with me is the importance of diversity in the award winners. The representation of our winners reflects the representation in our membership base; however, we continue to keep a watchful eye to ensure that we maintain that important balance.

With the exception of the Emerging Tax Star award, these awards are only open to members. I encourage all members to call on their peers and members of their team and tell them why they should become a member. Do you know a tax professional whose career could benefit from becoming more involved in our tax community?

Women in Tax Congress

As part of our ongoing support for women in the profession, the 3rd Women in Tax National Congress will be held in Sydney in November. With emotional intelligence having been identified as a key determinant of professional success, this year's congress focuses on personal growth and performance. The event has been designed to appeal to current and aspiring leaders at all stages of their career. I hope to see you there.

Member survey

Thank you in advance to those who take part in our member survey. We are committed to making membership even better and the survey is a key way to do that. The survey will be issued on a quarterly basis to a random selection of members. Keep an eye on your inbox for when your turn comes up. As always, we welcome, and indeed positively encourage, all feedback.

Tax Counsel's Report

by Stephanie Caredes, CTA

Guidance for tax and superannuation laws

In this month's column, tax counsel Stephanie Caredes highlights ongoing issues with guidance for tax and superannuation laws.

Twelve months ago, an independent review of the Australian Public Service (APS) was undertaken by the Department of Prime Minister and Cabinet. Members will be well aware of all of the "touchpoints" that the tax profession has with public service and semi-government entities, which include the Australian Taxation Office, Federal Treasury, the Board of Taxation, the Tax Practitioners Board, the Inspector-General of Taxation, and the state and territory Revenue Offices and Departments of Treasury.

The Tax Institute made a comprehensive submission to this review which is available on our website.[1] In our submission, we considered that improvements to the policy development and consultation phases of tax and superannuation law formation would result in better law.

Our submission focused on the two key agencies involved in policy, law design and administration in the Australian tax and superannuation systems — being Treasury and the ATO.

The matters raised in our submission were directly relevant to these aspects of the APS review:

– delivering high-quality policy advice, regulatory oversight, programs and services;
– tackling complex, multi-sectoral challenges in collaboration with the community, business and citizens;
– improving citizens' experience of government and delivering fair outcomes for them; and
– acquiring and maintaining the necessary skills and expertise to fulfil its responsibilities.

For Treasury and the ATO to properly fulfil their policy and regulatory roles respectively, these agencies need sufficient resources, including both the requisite skill sets and experience, and time to properly consider issues arising on the formation and interpretation of tax and superannuation law. This also includes addressing deficiencies in the consultation process. In the absence of improving the resources of these agencies, policy advice and regulatory oversight will be of a lesser standard than what is demanded of such a complex area of law to develop and administer.

Another concern that members had at the time of the review is when the ATO changes a longstanding view on how it interprets a particular area of the law and the uncertainty, cost and inconvenience this causes for taxpayers.

We refer members to our website for the details of the submission.[1] In short, this submission identified re-emerging concerns with the tax policy development and consultation process, and growing concerns with the nature and quality of guidance emerging from Treasury and the ATO.

The first issue, the concerns with the tax policy development and consultation process, could easily be addressed by reference to the recommendations in the Board of Taxation's *Improving Australia's tax consultation system report* (February 2007) and the subsequent review by the Tax Design Panel in 2008 in *Better tax design and implementation: a report to the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs* (30 April 2008).

Subsequent to these reviews, Treasury and the ATO entered into the *Treasury and Australian Taxation Office Tax and Superannuation Protocol* in 2012. The purpose of this protocol was to provide a framework for the working arrangements between Treasury and the ATO "to enable the best possible functioning of the tax and superannuation systems that Treasury and the ATO share stewardship of". The working arrangements are to apply in designing new policies and laws for tax and superannuation and for their administration. The protocol also clearly defines Treasury's and the ATO's roles:

– Treasury: accountable for providing advice to the government on policy and law design issues; and
– the ATO: administration of the enacted laws, which includes forming views about the interpretation of those laws, and recognising that the courts are the final arbiter on matters of statutory interpretation.

Which brings us to one year later.

In May 2019, The Tax Institute banded together with the Corporate Tax Association, Chartered Accountants Australia and New Zealand, the Law Council of Australia and the Institute of Public Accountants. We wrote[2] to the newly appointed Assistant Treasurer, the Hon. Michael Sukkar, with our joint concerns about required improvements to consultation on tax and superannuation policy and administration of the system, having already escalated this issue to the ATO's National Taxation Liaison Group. The objective here is to put these issues back on the agenda.

The growing concerns with the nature and quality of guidance emerging from Treasury and the ATO remain.

The role of The Tax Institute is to bring these issues to light, which we are doing, with the 120 members involved in our National Technical Committee network providing the support needed to advance these issues.

We are in the process of preparing submissions which will put the issue of guidance squarely in the frame. Numerous recent examples illustrate these ongoing concerns. Members interested in this issue should look out for the Institute's submissions which will be available soon.

References

1 The submission is available at taxinstitute.com.au/tisubmission/independent-review-of-the-australian-public-service.

2 The submission is available at taxinstitute.com.au/tisubmission/letter-to-assistant-treasurer-re-consultation-improvements-to-consultation-on-tax-policy-and-administration-of-the-tax-system.

Tax News – the details

by TaxCounsel Pty Ltd

August – what happened in tax?

The following points highlight important federal tax developments that occurred during August 2019.

Government initiatives

1. Amending legislation: tax avoidance

The Treasury Laws Amendment (2019 Tax Integrity and Other Measures No.1) Bill 2019, which was introduced into parliament on 24 July 2019, contains measures that are aimed at stopping tax avoidance, protecting the integrity of Australia's tax and superannuation systems, and saving businesses time and money through implementing an electronic invoicing framework.

The measures in the amending Bill will:

- impose new rules (that are to apply from 8 May 2018) to improve the integrity of the tax treatment of concessional loans involving tax-exempt entities that are privatised and subsequently become taxable;
- ensure that partners in partnerships cannot inappropriately access the small business CGT concessions when they alienate future income from the partnership. Partners will only be eligible for the concessions when such rights make the assignee a partner in the partnership. This measure is to apply from 7.30 pm on 8 May 2018;
- extend to family trusts (from 1 July 2019), a specific anti-avoidance rule that applies to other closely held trusts that engage in circular trust distributions;
- strengthen (from 1 July 2019) the integrity of the tax system by denying some taxpayers a deduction for expenses associated with holding vacant land. This denial of deductions will, however, not apply to expenses associated with holding vacant land if it is used by the owner or a related entity in carrying on their business (say of primary production or property development). Nor will the amendments apply to corporate tax entities, managed investment trusts or public unit trusts; and
- provide the ATO with the discretion to disclose to credit reporting bureaus the tax debt information of particular businesses that are not effectively engaging with the ATO to manage their tax debts. This information can only be disclosed when certain conditions and safeguards are met, including that at least $100,000 of the debt is overdue for more than 90 days.

The amending Bill also introduces changes to confer on the Commissioner functions and powers to develop and/or administer a framework or system for electronic invoicing.

Lastly, the Bill contains an important measure to protect workers by closing loopholes that have been used by unscrupulous employers to short-change employees who make salary sacrificed contributions to their superannuation.

2. Foreign vendors CGT withholding tax

On 26 July 2019 the Minister for Housing and Assistant Treasurer announced that the government's foreign resident CGT withholding laws have raised more than $1b since their introduction on 1 July 2016.

The minister said that more than half a billion dollars in CGT assessments have also been captured in compliance and engagement activity by the Tax Avoidance Taskforce over the last two years. This includes $290m in cash collected as a result of the focus on property and other asset sales by multinationals and foreign residents.

The minister also said that the enhanced data analytics and technical expertise of the Tax Avoidance Taskforce, led by the ATO, ensures that sales are identified and investigated more quickly than ever. The taskforce is now intervening and engaging with non-resident vendors in real time, ensuring that where it is required, tax is collected on the spot before the sales proceeds can leave the country. In some instances, additional security has been sought over other assets to ensure that foreign resident taxpayers meet their obligations.

The taskforce's compliance activity covers both direct property sales and sales of interests in companies and trusts whose assets are primarily property. The types of property include major infrastructure assets, agricultural assets, mining tenements, hotels and office towers.

3. Phoenixing crackdown

The Treasury Laws Amendment (Combating Illegal Phoenixing) Bill 2019, which was introduced into parliament on 4 July 2019, contains amendments aimed at curbing phoenixing activity.

In brief, the amendments will:

- introduce new phoenixing offences to prohibit creditor-defeating dispositions of company property, penalise those who engage in or facilitate such dispositions, and allow liquidators and ASIC to recover such property;
- ensure that directors are held accountable for misconduct by preventing directors from improperly backdating resignations or ceasing to be a director when this would leave the company with no directors;
- allow the Commissioner to collect estimates of anticipated GST liabilities and make company directors personally liable for their company's GST liabilities in certain circumstances; and
- authorise the Commissioner to retain tax refunds where a taxpayer has failed to lodge a return or provide other information to the Commissioner that may affect the amount the Commissioner refunds.

4. Other amendments

An amending Bill (the Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2019) which was introduced into parliament on 4 July 2019 contains amendments to implement several 2018-19 Budget measures.

The measures will:

- strengthen the integrity of the thin capitalisation rules by improving the reliability of asset valuations that are used to support debt deductions. Multinationals will be required to rely on the asset values that they publish in their financial statements;
- ensure that all foreign controlled consolidated groups are recognised as inward-investing entities, even if they have foreign operations. This will confirm that these entities are not able to use thin capitalisation tests that are only appropriate for outbound investors;
- level the playing field for hotel bookings in Australia by ensuring that offshore sellers of Australian hotel accommodation calculate their GST turnover in the same way as local sellers from 1 July 2019; and
- ensure that (from 1 January 2019) luxury car tax is not payable on cars that are re-imported into Australia after being refurbished overseas. This will mean that the same tax treatment will apply to luxury cars, irrespective of where the car is refurbished.

The Commissioner's perspective

5. Travel and overtime meal allowances

The Commissioner has issued a determination that sets out the amounts that he considers are reasonable (reasonable amounts) for the substantiation exception in Subdiv 900-B of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) for the 2019-20 income year (TD 2019/11).

The determination relates to claims made by employees for:

- overtime meal expenses: for food and drink when working overtime;
- domestic travel expenses: for accommodation, food and drink, and incidentals when travelling away from home overnight for work (particular reasonable amounts are given for employee truck drivers, office holders covered by the Remuneration Tribunal and federal Members of Parliament); and
- overseas travel expenses: for food and drink, and incidentals when travelling overseas for work.

The approach outlined in the determination can only be used where the taxpayer receives an allowance to cover the particular expenses that he or she is claiming, for example, the taxpayer received an accommodation allowance and is claiming accommodation expenses.

The reasonable amounts only provide the maximum amount that can be claimed by a taxpayer without being required to substantiate the expenditure. If a taxpayer relies on the reasonable amounts and the ATO checks the taxpayer's income tax return, the taxpayer will still be required to show:

- that the taxpayer spent the money in performing his or her work duties (for example, in travelling away from home overnight on a work trip);
- how the claim was worked out (for example, a diary was kept);
- that the money was spent by the taxpayer him or herself (for example, using a credit card statement or other banking records) and was not reimbursed (for example, a letter from the employer); and
- that the allowance was correctly declared as income.

6. Debt and equity rules

A final determination has been issued which is to the effect that the debt and equity rules in Div 974 ITAA97 cannot limit the operation of the transfer pricing rules in Subdiv 815-B ITAA97 (TD 2019/10).

The determination points out that s 815-110(1) ITAA97 states expressly that nothing in the income tax assessment legislation (other than Subdiv 815-B) limits the operation of Subdiv 815-B.

Where s 815-115 ITAA97 applies in respect of conditions that operate between an entity and another entity in connection with a scheme that is a debt interest or equity interest, the "arm's length conditions" within the meaning of s 815-125 ITAA97 are taken to operate for the purposes set out in s 815-115(2) — that is, working out the amount of the entity's taxable income, taxable loss of a particular sort, tax offsets and withholding tax payable.

In such instances, Div 974 applies to classify the interest that arises under the scheme by reference to the arm's length conditions, not to the actual conditions.

Recent case decisions

7. Default assessments upheld

The Administrative Appeals Tribunal (AAT) has rejected objections by a taxpayer against default assessments issued to her for two income years based on trust distributions that were made by two New Zealand trusts (*Campbell and FCT* [1]).

Acting on information provided by AUSTRAC, the Commissioner wrote to the taxpayer on the basis that she had received distributions from the Sandra Campbell Trust for the 2013 and 2014 income years. After no reply was received, the Commissioner issued default assessments for the two income years and imposed penalties for each income year for failing to lodge a document (a return of income).

The Commissioner included the amounts in the assessable income of the taxpayer on the basis that s 99B of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) (receipt of trust income not previously subject to tax) applied.

The AAT held that the taxpayer had not discharged her onus of establishing that the default assessments were excessive. Given the state of the records and the lack of corroborating, or any explanation by the taxpayer, the trustee of the trust, the lawyers or the accountants for the trust, the AAT was not satisfied that the distributions in question were corpus of the trust.

8. Division 7A: when was a loan made?

The AAT has held that a loan was made by a trust to the taxpayer for the purpose of Div 7A ITAA36 in the 2010 income year and not, as contended for by the taxpayer, the 2009 income year (*Howard and FCT*[2]).

The taxpayer was in the business of bulk cargo handling, storage and stevedoring. Bulk Cargo Services Pty Ltd (Services) and Bulk Cargo Storage Pty Ltd (Storage) were companies incorporated in Australia and were two of the taxpayer's operating entities. At all relevant times, the taxpayer was the sole ordinary shareholder and director of Services, and the sole shareholder and director of Storage.

The BJ Howard Finance Trust (the Finance Trust) was settled by deed of settlement on 25 June 2009 with BJ Howard Finance Pty Ltd ACN 137 820 127 as trustee. The Finance Trust at all relevant times held one W class share in Services.

The case before the AAT concerned a loan made between the Finance Trust, as lender, and the taxpayer as borrower, which the Commissioner contended was a deemed dividend in the 2010 income year by virtue of the Div 7A interposed entity provisions on the basis that: the private company was Services; the interposed entity was the Finance Trust; and the target entity was the taxpayer.

By an amended assessment, the Commissioner applied the interposed entity provisions to deem an amount of $3,454,290 to be an unfranked dividend under s 109D ITAA36 that was assessable to the taxpayer pursuant to s 44 ITAA36 in the 2010 income year.

There was a loan agreement between the Finance Trust (as lender) and the taxpayer (as borrower) dated 26 May 2010. Evidence was adduced on behalf of the taxpayer which sought to establish that the loan was made in the 2009 income year. However, the AAT held that, on the state of the evidence, it was not satisfied that the payment of a dividend had occurred by 30 June 2009, or even that the declaration of a dividend had occurred by that date.

The taxpayer's case was that the loan to him from the Finance Trust occurred by way of set-off, but the AAT agreed with the Commissioner's submission that the precise nature of the so-called set-off remained obscure. The AAT accepted the submission of the Commissioner that the written loan agreement recorded what had occurred by or about the date of that document and consequently after 30 June 2009.

The AAT also rejected several other arguments by the taxpayer.

9. Tax agent registration: fit and proper person test

The AAT has upheld a decision of the Tax Practitioners Board to terminate the registration of a tax agent (on the basis that he was not a fit and proper person) and to prohibit him from reapplying for registration for a period of 12 months (*Shmuel and Tax Practitioners Board*[3]).

The board contended that the applicant did not meet the fit and proper person requirement on the basis that the applicant:

– failed to comply with his taxation obligations;

– provided false and misleading statements to the board in failing to declare on his annual disclosure to the board that he had outstanding tax obligations and had been issued with a default judgment order and a bankruptcy notice;

– failed to advise the board (as required by s 30-35(1)(b) of the *Tax Agent Services Act 2009* (Cth)) that an event affecting his registration had occurred in the past five years, namely, that he became an undischarged bankrupt on 20 February 2018;

– failed to respond to the board in a timely, responsible and reasonable manner as required by the Code of Professional Conduct;

– failed to meet other statutory obligations as a bankrupt and also as a company director; and

– entered a plea of guilty to a criminal charge involving dishonesty under the Criminal Code of the Commonwealth.

After considering each issue in some detail, the AAT said that the central purpose of the *Tax Agent Services Act 2009* was the protection of the public and, with that in mind, it would be an inappropriate use of the discretion to disregard the nature and extent of the applicant's conduct in failing to meet his legal and regulatory obligations and the risk that repeated conduct of that kind may have for existing and future clients of the applicant, as well as the public at large, on the basis of uncorroborated health issues which, by the applicant's own evidence, remained ongoing. This was particularly so where, as in this case, the applicant had not demonstrated any reasonable level of acknowledgment, contrition or remorse for his conduct.

The AAT also upheld the decision of the board that the applicant be precluded from applying for re-registration for a period of 12 months.

10. Onus not discharged

The Full Federal Court (Greenwood, Burley and Colvin JJ) has unanimously affirmed a decision of Steward J in which his Honour dismissed appeals by a taxpayer against objection decisions made by the Commissioner involving amended default assessments for eight income years which increased the taxpayer's taxable income for those income years by a total of $2.86m and imposed penalties of $2.08m (*Bosanac v FCT*[4]).

Steward J held that the taxpayer had failed in relation to each income year in dispute to demonstrate that any of the amended assessments issued to him were excessive. That was because, in addition to rejecting his evidence concerning the nature of the deposits (other than in relation to a car), the taxpayer failed to positively adduce evidence as to the quantum and nature of his foreign and domestic earnings in each income year in dispute. The taxpayer needed to go further than his attack on the basis on which the Commissioner had issued the amended assessments to him, and positively prove what his taxable income was in each year. He needed to lead evidence constituting a wide survey and exact scrutiny of his business activities. This he never did.

The Full Court said that, although the nature of the task for the court on appeal against an objection decision is the same irrespective of whether an assessment is the subject of an objection issued under s 166 or 167 ITAA36, the differences between the way those assessments are made may mean that there is the possibility that the manner in which it may be demonstrated that an assessment is excessive may be different depending on the power that is exercised. In the case of a default assessment under s 167, there is a lump sum assessment of taxable income, rather than the computational process under s 166 of considering allowable deductions that may produce the taxable income.

So, for example, in the case of an assessment under s 166, it is possible for the taxpayer to accept aspects of the calculations (assuming the Commissioner does not seek to advance a different position on the appeal) and focus on whether certain deductions should have been allowed. Whereas, in the case where the assessment is made under s 167, the taxpayer will have to demonstrate by evidence both sides of the equation because the assessment involves the exercise of a power to make a lump sum assessment of the taxable income based on the information available to the Commissioner. The same will be the case when the objection decision is based on calculations or upholds an assessment on a lump sum basis. However, in either case, the burden to prove that the assessment was excessive could not be discharged without proving the taxable income of the taxpayer. It is that burden that Steward J at first instance found that the taxpayer had failed to discharge.

The Full Court also said that a concession by the Commissioner that a particular amount did not form part of the taxable income of the taxpayer in a particular year was an insufficient basis on which the court could reach a conclusion as to the actual extent of the taxpayer's income in that year. There needed to be evidence establishing the level of income after allowing for the concession.

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References

1 [2019] AATA 2043.
2 [2019] AATA 1910.
3 [2019] AATA 2168.
4 [2019] FCAFC 116.

Tax Tips

by TaxCounsel Pty Ltd

Vacant land: the deduction amendments

Amending legislation to restrict deductions being allowed in relation to "vacant land" have been introduced into parliament.

Background

It was announced in the 2018-19 Budget that, from 1 July 2019, the integrity of the tax system would be improved by denying certain deductions for expenses associated with holding vacant land.

It was officially stated that this measure is intended to address integrity concerns that deductions are being improperly claimed for holding vacant land (for example, deductions for interest expenses) where the land is not genuinely held for the purpose of earning assessable income. As the land is vacant, there is often limited evidence about the taxpayer's intent other than statements by the taxpayer. The reliance on a taxpayer's assertions about their current intention leads to compliance and administrative difficulties.

It was also stated that tax incentives would be reduced for land banking, which denies the use of land for housing or other development.

An amending Bill which contains the amendments that are to give effect to what may be called the "vacant land deduction changes" was introduced into parliament on 24 July 2019. The amending Bill is the Treasury Laws Amendment (2019 Tax Integrity and Other Measures No. 1) Bill 2019 (the amending Bill) and the proposed amendments are contained in Sch 3 of the amending Bill with the main amendment being the enactment of a new s 26-102 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).

This article briefly considers the main features of the proposed amendments.

Commencement of operation

The proposed vacant land deduction changes are to apply in relation to losses or outgoings incurred on or after 1 July 2019. It is immaterial when the land was acquired, that is, whether the land was acquired before, on or after 1 July 2019.[1]

The circumstances in which, and the time at which, a loss of outgoing is incurred would clearly be determined by reference to the principles that have been developed in relation to the word "incurred" in the general deduction provision (s 8-1 ITAA97).

Exclusion: entities that are not affected

The first point to note is that not all kinds of entity will be affected by the proposed vacant land deduction changes. The most fundamental question in a particular situation is, therefore: is the particular entity of a kind that is affected?

All entities are potentially affected unless specifically excluded. The specifically excluded entities are:

- corporate tax entities;[2]
- superannuation plans (other than self-managed superannuation funds);
- managed investment trusts;
- public unit trusts; or
- unit trusts or partnerships of which each member is an entity that falls within any of the above (proposed s 26-102(5)).

Thus, any entity that is not covered by the above items would be potentially affected by the proposed new rules. For example, a trust, even if it is a unit trust that does not fall within the last item, will be potentially affected, even if it has a corporate trustee.

Exclusion: carrying on business

There is also an exclusion from the vacant land deduction changes in respect of a loss or outgoing to the extent that the land is in use, or available for use, in carrying on a business by one or other of certain defined entities. This exclusion is commented on below under the heading "The carrying on business exclusion".

The basic rule

The basic operative provision in the proposed new deduction denying provision is s 26-102 ITAA97, which reads as follows:

> "**26–102 Expenses associated with holding vacant land**
>
> *Limit on deduction*
>
> (1) If:
>
> (a) at a particular time, you incur a loss or outgoing relating to holding land (including interest or any other ongoing costs of borrowing to acquire the land); and
>
> (b) at the earlier of the following (the ***critical time***):
>
> (i) that time;
>
> (ii) if you have ceased to hold the land—the time just before you ceased to hold the land;
>
> there is no substantial and permanent structure in use or available for use on the land having a purpose that is independent of, and not incidental to, the purpose of any other structure or proposed structure;
>
> you can only deduct under this Act the loss or outgoing to the extent that the land is in use, or available for use, in carrying on a business covered by subsection (2) at the time applying under subsection (3).
>
> Note 1: The ordinary meaning of structure includes a building and anything else built or constructed.
>
> Note 2: The land need not be all of the land under a land title."

Various aspects of this provision and the other provisions of proposed s 26-102 are discussed below.

"Vacant land"

The heading to proposed s 26-102 is "Expenses associated with holding vacant land". However, the operative provision of the proposed section does not use the expression "vacant land". Rather, the operative provision refers to there being:[3]

> "… no substantial and permanent structure in use or available for use on the land having a purpose that is independent of, and not incidental to, the purpose of any other structure or proposed structure."

"Relating to holding land"

For a loss or outgoing to potentially fall within the operation of proposed s 26-102, it must be a loss or outgoing "relating to holding land".

The proposed section gives some indication of what losses and outgoings may be covered by the words "relating to holding land" by referring, in parenthesis, to "including interest or any other ongoing costs of borrowing to acquire the land". The explanatory memorandum gives other examples of relevant holding costs as being land taxes, council rates and maintenance costs.

The meaning of the expression "relating to" was referred to by Fitzgerald JA in *Oceanic Life Ltd v Chief Commissioner of Stamp Duties (NSW).*[4] His Honour said that the width of the phrase "relating to" was undoubted and referred to the observation of Taylor J in *Tooheys Ltd v Commissioner of Stamp Duties (NSW)*[5] that "the expression 'relating to' … is … vague and indefinite" and "leaves unspecified the plane upon which the relationship is [to be] sought and identified". Overall, the position judicially adopted has been that the operation of the phrase "relating to" is determined by the statutory context and purpose.

It is suggested that the concept of "holding land" in proposed s 236-102 is conceptually wider than owning the land and could include the situation of a lessee under a lease of the land; it could be said that a lessee of land held the land in the relevant sense and the explanatory memorandum accepts that this is the case.[6] In this kind of situation, the most obvious loss or outgoing of the lessee that could be affected would be the rental payable under the lease.

This means that, in the case of a lease of land, the proposed provision would need to be applied at two levels, that is:

– in relation to the owner; and
– in relation to the lessee.

What land is relevant?

The relevant area of land is the land to which the loss or outgoing relates. For most losses and outgoings relating to holding land, this will be the land covered by a single property title as the loss or outgoing relates to that title.

For example, if an entity becomes liable to rates in respect of a property, the relevant land is the property that is the subject of the rates notice. If this land contains a substantial and permanent structure that has an independent purpose and it is not incidental to the purpose of another structure or proposed structure, the land is not vacant and the loss or outgoing may be deductible.

In other cases, a loss or outgoing may relate to only part of the land covered by a title or to land covered by multiple titles.

"Substantial and permanent"

The expression "substantial and permanent" ("no substantial and permanent structure") will potentially create difficulty. For example, the word "substantial" has been described as not only being susceptible of ambiguity, but also as a word calculated to conceal a lack of precision (*Tillmanns Butcheries Pty Ltd v Australasian Meat Industry Employees' Union*[7] per Deane J).

Substantial

The explanatory memorandum states that, to be substantial, a building or other structure needs to be significant in size, value or some other criteria of importance in the context of the relevant property. Whatever makes the structure substantial must be a feature of that particular structure — a structure is not substantial if it only has value as an adjunct to another structure. For example, a letterbox would not be substantial, and a residential garage would be unlikely to be substantial.

Permanent

The explanatory memorandum states that, to be permanent, a structure needs to be fixed and enduring. A fixed structure that is not built for a temporary purpose is a permanent structure even if it would not be expected to remain standing forever. Likewise, the fact that a structure may require some repairs either at the present time or at some future point does not affect its permanency.

Independent rather than incidental purpose

Whether a particular structure has an independent purpose that is not incidental to the purpose of another structure or proposed structure on the land is a question of fact. It needs to be considered in the context of the structure, the land on which it is located and the other structures (if any) that have been, are in the process of being or may be expected to be constructed on that land. The explanatory memorandum also makes these points:

– structures that exist to support the use or functioning of another structure, such as pipes or powerlines, will not satisfy this requirement; and
– similarly, structures that have the purpose of increasing the utility of another structure will not satisfy this requirement.

For example, structures such as a residential garage or shed are constructed for the purpose of adding utility for individuals using the residence on the land. Such structures do not have an independent purpose and are incidental to the related residential premises.

On the other hand, a commercial parking garage complex, a woolshed for shearing and baling wool, and a grain silo would all usually have an independent purpose, rather than being incidental to some other structure, as they operate separately from and independent of any other structure on the land. In general, the separate primary use of a structure to generate income will be an indication that the structure satisfies the independent purpose requirement.

Time at which land must contain a structure

For a loss or outgoing to be deductible, the relevant land must generally contain a structure at the time the loss or outgoing is incurred (proposed s 26-102(1)). However, the explanatory memorandum points out that, in some cases, a taxpayer may incur a loss or outgoing after ceasing to hold the land to which it relates (for example, they may pay interest on a loan after the land has been sold). In this case, the loss or outgoing will be deductible if the land was not vacant (in the sense explained above) immediately before the taxpayer ceased to hold an interest in the land (proposed s 26-102(1)(b)).

The carrying on business exclusion

As indicated earlier, there is an exclusion from the vacant land deduction changes in respect of a loss or outgoing to the extent that the land is in use, or available for use, in carrying on a business by one or other of certain defined entities.

The relevant entities are:

- the holder of the land (the taxpayer);
- an affiliate of the holder of the land;
- an entity of which the holder of the land is an affiliate;
- a spouse, or a child aged under 18 years of age, of the holder of the land; or
- an entity that is connected with the holder of the land (proposed s 26-102(2).

The concepts of "affiliate" and "connected with" take the meanings ascribed to them in ss 328-130 and 328-125 ITAA97 for the purposes of the definition of a "small business entity".

What constitutes the carrying on of a business will frequently raise issues, sometimes difficult issues, of fact.

The use of the expression "to the extent that" the land is in use etc requires an apportionment of the use of the land and, hence too, of a loss or outgoing by reference to the use, or availability for use, of the land in appropriate circumstances. The explanatory memorandum gives the following example.

Example

Howard owns one hectare of land in Queensland. He uses one third of the land for carrying on his firewood sales business. He stores all his firewood in the open and there are no structures on the land. Howard has set aside the remainder of the land to construct a rental property. The remaining part of the land is separately fenced off and has been subject to site work including earthworks to clear the land ready for construction.

Howard is eligible to claim losses and outgoings relating to holding the part of the land that he uses for carrying on his firewood business, to the extent that the loss or outgoing is necessarily incurred for the purpose of gaining or producing the assessable income.

The remainder of his land is not used or held available for use in carrying on his firewood business. Further, as there are no structures on Howard's land, it cannot contain a building or other structure that meets the requirements of these amendments. As a result, Howard is not entitled to claim any deductions relating to the costs of holding this part of the land even though he intended to derive income from it in the future as a rental property.

Past business use

In some cases, a taxpayer may incur holding costs relating to a time when land was previously used or made available for use in the course of carrying on a business. The effect of proposed s 26-102(3) is that these costs can be deducted based on the use of the land at that prior time as they relate to the time at which the prior business use occurred, despite being incurred after this use had ceased.

The explanatory memorandum, by way of example, gives a taxpayer who may have borrowed money to acquire land for use in carrying on a business. On ceasing to carry on that business, the taxpayer disposes of the property and repays the loan including outstanding interest. Even though this interest cost is incurred after the business ceases to be carried on, the proposed vacant land deduction changes would not prevent it from being deductible. This is because it relates to (ie is deductible because of) the prior use or availability for use of land in the period in which the land was used in carrying on the business.

Further examples

The explanatory memorandum gives the following further examples in relation to the carrying on of a business exclusion.

Example: expenditure incurred in carrying on a business deductible

Albert carries on business as a property developer and owns a significant property portfolio of vacant land in Melbourne. He incurs outgoings relating to holding the vacant land including interest payments and council rates. Some of this vacant land is currently in use. Other areas are being held available for use in future developments.

As Albert incurs the expenditure to hold the land in carrying on his business for the purpose of producing assessable income, it is deductible. It does not matter whether the land is currently being developed or if it is held for future use.

Example: expenditure incurred in carrying on a business by a related party of the holder of land

Gina owns vacant land in New South Wales which she rents to her spouse Robin for use in a farming business he carries on. Robin, as Gina's spouse, forms part of the class of related parties (spouses, children under 18 years old, affiliates and connected entities) that allow Gina to deduct her costs of holding the land. This is because Robin is carrying on a business on it to produce assessable income.

Residential premises

There is a special rule that is to apply when determining if land that contains residential premises within the meaning of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) is vacant. The land is treated as remaining vacant for the purposes of the vacant land deduction changes until the residential premises are:

- able to be lawfully occupied; and
- leased, hired or licensed, or available for lease, hire or licence (proposed s 26-102(4)).

The explanatory memorandum explains that this rule means that a taxpayer cannot deduct the costs of holding land containing residential premises until the premises can be legally rented and the taxpayer is actively seeking to derive income from the use of the property as residential premises. It ensures that, in the context of a rental property, statements about intention are not sufficient. Instead, deductions are only available for the costs of holding land containing residential premises if the premises are available for rent and are placed on the rental market.

The special rule is only relevant once an amount would otherwise be deductible. This means that:

– the land must contain a substantial and permanent building on it with an independent purpose that is not incidental to another building or structure on the land or to be built on the land; and
– the building must be in use or ready for use to generate income,

in order to satisfy both the general requirements for deductibility under this measure and the separate deductibility requirements in s 8-1 (proposed s 26-102(1) and (4)).

Example

Anna purchased a block of vacant land and built new residential premises on it. Occupancy permits are issued for the residential premises once the building is considered suitable for occupation and the building is actively made available for rent.

Anna can deduct the costs of holding this block of land to the extent that expenses are incurred once the property is legally available for occupation and is leased, hired or licensed, or otherwise available for lease, hire or licence.

Treatment of losses and outgoings that are not deductible

Losses and outgoings that are not deductible in an income year as a result of the vacant land deduction changes are not able to be deducted in later years. However, they may be included in the cost base of the asset for CGT purposes, resulting in a corresponding reduction in any capital gain when a CGT event happens if they meet the cost base criteria.

The relevant CGT event would typically be the sale of land (CGT event A1) but could include other CGT events such as granting, renewing or extending an option to purchase land (CGT event D2) or entering into a conservation covenant over land (CGT event D4).

The explanatory memorandum points out that this CGT treatment is consistent with the tax treatment that applies for holding vacant land for private use. For instance, an individual who buys land to later build a holiday home solely for private use can include expenses, such as rates and borrowing expenses, in their CGT cost base on sale if they have never been entitled to claim the expenses as deductions and they are ordinarily a cost base element.

TaxCounsel Pty Ltd

References

1 Item 4, Sch 3 to the Treasury Laws Amendment (2019 Tax Integrity and Other Measures No. 1) Bill 2019.

2 An entity will be a corporate tax entity if it is a company, a corporate limited partnership or a public trading trust (s 960-115 ITAA97). The other categories of excluded entities are also defined in the ITAA97.

3 Proposed s 26-102(1)(b).

4 [1999] NSWCA 416.

5 [1961] HCA 35.

6 Para 3.28 of the explanatory memorandum to the Treasury Laws Amendment (2019 Tax Integrity and Other Measures No. 1) Bill 2019.

7 [1979] FCA 85.

Mid Market Focus

by Andrew Burns, CTA, HLB Mann Judd

Black economy measures increase taxpayers' compliance

While most people will agree with curbing the black economy, measures to do so often place a greater compliance burden on all taxpayers.

In recent years, there has been considerable activity to curb the black economy. This activity includes the increase in reporting requirements, as well as increased to the Australian Taxation Office (ATO), and other regulators, to increase their compliance activities to ensure that everyone meets their reporting requirements and pays their fair share.

However, as Australia's taxation system operates on a basis of self-assessment, it is not possible to specifically target measures which only affect those trying to avoid paying tax. Rather, additional reporting requirements have been placed on groups of taxpayers, increasing the amount of data available to the ATO. This increased data is then used to identify those who have either under-reported their income, or not reported their income at all.

Taxable payments annual report

Rightly or wrongly, the building and construction industry has historically been seen as one involving a number of "cash jobs" where not all income was reported for tax purposes. This was made possible by the presence of large numbers of contractors who often worked on a large number of projects during the year, each for a short period of time.

Without any tracking of the payments to these contractors, it was possible for the head contractor to pay a subcontractor for work performed, claiming a tax deduction. However, the subcontractor may not include that payment in their assessable income.

The taxable payments annual report (TPAR) was introduced from 1 July 2012 to counteract this by requiring businesses involved in the building and construction industry to report any payments that they make to contractors.

To determine whether they are subject to the TPAR requirements, businesses need to determine whether they are in the building and construction industry, whether the payments are being made to a contractor, and whether the contractor is providing building and construction services.

This reporting allows the ATO to match the details reported by a business in their TPAR to the details reported by the contractor in their income tax return, and in their business activity statements (if registered for GST).

While these reporting requirements have now existed for seven years, it still relatively easy for businesses to make an error when making one or more of the above determinations.

As the use of contractors is not confined to the building and construction industry, the TPAR system has been expanded to include cleaning services and courier services from 1 July 2018, as well as road freight services and information technology services from 1 July 2019.

While the TPAR requirements provide the ATO with additional data, reducing the ability to hide income, this system is also not foolproof. A contractor may provide services to a number of businesses and individuals during the year, but it is only those businesses which are in the building and construction industry who are required to submit a TPAR.

Taxable payment annual reports are required to be submitted to the ATO by 28 August each year. This places an additional compliance burden on businesses at a time which is already busy with compliance.

Denial of tax deduction for non-compliant payments

Another measure which is intended to reduce the ability to under-report income is to deny taxpayers a tax deduction for payments where they have not met their PAYG withholding obligations.

From 1 July 2019, payments which include a PAYG withholding obligation will only be deductible if the taxpayer withholds the appropriate amount of tax from the payment and reports it to the ATO. Payments which do not meet both of these requirements will be called non-compliant payments.

As with the TPAR, ensuring that payments are reported provides information to the ATO which can be matched against the income of the recipient of the payment to determine if they have declared all of the income that they should.

Payments which are subject to these measures include the following:

- salary, wages, commissions, bonuses or allowances to an employee;
- directors' fees;
- payments to religious practitioners;
- payments under a labour hire arrangement; and
- payments for services where the supplier has not provided their Australian business number (ABN).

While most employers are familiar with their obligations to withhold amounts from employees' salaries and wages, and report these amounts, they may not be as aware of their withholding obligations in relation to other payments. Other taxpayers who do not have employees may also be affected by these measures.

Possibly, the least understood withholding obligation is in relation to the failure to quote an ABN. This is illustrated by a recent example that the author has seen: a community organisation which regularly paid a member for cleaning the organisation's premises. As the payments exceeded $75, and the members had not quoted ABNs, the organisation should have withheld 47%. This was easily resolved by having the members sign declarations stating that they were not eligible for an ABN as they were not carrying on an enterprise in Australia.

As the organisation making the payments in this example is tax exempt, the denial of a tax deduction will not have any detrimental effect. However, other entities may not be as fortunate.

An example where this denial of a tax deduction would be of consequence is where an individual who owns a rental property pays a friend $200 for some painting at the property. Most people would not think to withhold 47% of the payment to their friend unless they either provide their ABN or a declaration advising that they do not require an ABN as they are not carrying on an enterprise in Australia.

If a taxpayer makes a genuine mistake, they will retain their tax deduction provided that they make appropriate voluntary disclosures through their activity statements prior to any ATO audit activity.

Single touch payroll

While employers with 20 or more employees have been subject to the single touch payroll (STP) reporting requirements since 1 July 2018, all other employers became subject to these rules from 1 July 2019.

Single touch payroll not only provides the ATO with more timely information on payments made to employees, but it also provides a tool to monitor whether employers are complying with their PAYG withholding requirements as well as meeting their superannuation guarantee obligations.

As the ATO will receive regular data fees from an employer's payroll system, it will require considerable collusion between the employer and employee for any salary or wages to be completely "off the books" or through an alternate payroll system.

While STP reporting is essentially a new way of providing the ATO with information which employers were already required to report, employers need to ensure that their payroll systems are STP-compatible and be able to report the details required. To this end, there has been significant numbers of employers upgrading their accounting software to STP-compatible versions, or for very small businesses, using accounting software for the first time.

Highly visible mobile strike teams

Along with the increased data collection offered by the above measures, the funding of the ATO's compliance activity has been increased over a number of federal Budgets. This increased funding allows the ATO to extend its compliance activities to detect tax avoidance and combat the black economy. One of these activities is the setting up of what the ATO describes as "highly visible mobile strike teams".

From time to time, word spreads of teams from the ATO arriving in a particular location en masse, going from business to business checking their records. Depending on what the team members find during these visits, there may be follow-up activity to determine any tax shortfalls or other breaches.

Clearly, these strike teams do uncover illicit activity, from software designed to only record a portion of the sales actually processed through the sales register to the use of multiple sets of accounts. These visits also help to identify those individuals whose lifestyles do not reflect their reported incomes.

Many business operators see compliance and record-keeping as an important, but secondary, issue in relation to their business. Their main focus is on the provision of the goods or services which they are in the business of providing. As a result, the sudden appearance of ATO staff asking about their records may be seen as an unwelcome imposition, and can be quite stressful. This is particularly the case where the business operators do not necessary understand their obligations, and outsource them to experts.

For advisers, addressing any issues identified by the ATO during these visits, or providing additional information requested as a follow-up, can be time-consuming, and is the type of work where clients do not see any clear benefit to their business.

Conclusion

Despite their best efforts to do the right thing, honest taxpayers will continue to be subject to stricter reporting requirements as the authorities attempt to identify those who are not meeting their tax obligations. As a result, taxpayers will need to regularly update their systems to keep up-to-date with these changes.

The onus also passes on to advisers to not only keep themselves up-to-date, but to also educate their clients on any changes which affect them.

Andrew Burns, CTA
Manager
HLB Mann Judd

Tax Education

by Revital Folan

The CTA Program: a good foundation for YTPs

The Tax Institute's CTA duces in study period 1, 2019 are sharing their learning experience and future plans.

ATL001 CTA1 Foundations Dux Award for study period 1, 2019

Name: Caitlin McKenna

Position: Lawyer

Company: Cooper Grace Ward Lawyers

State: Queensland

Can you tell us about your background?

I graduated with a Bachelor of Commerce/Laws from the University of Queensland in 2017 and started my career in tax as a law graduate at Cooper Grace Ward in early 2018. Since then, I have gained experience providing advice, managing disputes and applying for rulings in a broad range of areas, including income and capital gains tax, GST, duty, payroll tax, land tax and customs.

What is the most valuable aspect of ATL001 CTA1 Foundations that you have taken away?

The many practical examples and opportunities to test my understanding of the technical content in CTA1 stood me in good stead for dealing with tax issues in practice. I have found it noticeably easier to identify and find solutions to clients' complex tax issues since completing the course.

Have you gained confidence in new areas?

CTA1 broadened my knowledge of areas that I hadn't encountered much in practice, such as superannuation and FBT. It also sharpened my understanding of areas with which I was already familiar, giving me greater confidence when advising clients.

Can you tell us about the main reason for undertaking the course?

I wanted to develop a strong foundational knowledge of basic tax principles. The CTA Program was recommended to me for its focus on developing practical skills, in addition to technical knowledge.

What is your next step with education?

I hope to complete CTA2A and CTA2B this year and, ultimately, CTA3. After that, a Masters of Tax is on the cards.

ATL003 CTA2A Advanced Dux Award for study period 1, 2019

Name: Jason Hawe

Position: Associate

Company: MinterEllison

State: Queensland

Can you tell us about your background?

I studied law and commerce (majoring in accounting) at university and decided to pursue a career in law. Following a rotation through MinterEllison's tax team as part of their graduate program, I found that working as a tax lawyer provided me with the perfect opportunity to solve complex legal problems while using the skills I developed in my commerce degree at university. I now provide advice to clients on corporate and international tax issues, with my interest being business structuring, inbound investment and the taxation implications of post-deal implementation, such as consolidation and capital gains tax cost base calculations.

How many years of experience do you have?

I commenced working at MinterEllison at the beginning of 2012 while studying at university. I have since gained experience working as a lawyer in both the property and the energy and resources teams before joining the corporate tax team in 2017.

What is the most valuable aspect of ATL003 CTA2A Advanced that you have taken away?

My experience so far has been that the CTA courses provide a broad level of foundational knowledge in a very practical and useful way. I have used the skills that I learned in both CTA1 Foundations and CTA2A Advanced to solve real problems for my clients.

Have you gained confidence in new areas?

I have been able to directly apply the knowledge I gained in CTA2A Advanced on capital gains tax roll-overs to a number of large-scale commercial transactions that I have recently been involved in.

Can you tell us about the main reason for undertaking the course?

My career experience so far has shown me that you do not typically solve the same problem twice. I am keen to learn about areas of tax law that I have not yet had the opportunity to experience in everyday practice. This enables me to be better prepared to assist my clients when they present me with a new problem to solve.

What is your next step with education?

Ongoing education is fundamental to staying on top of an ever-changing profession and having a successful career. I would like to become a Chartered Tax Adviser and so

I intend to complete both CTA2B Advanced and CTA3 Advisory in the coming year.

What are some challenges of juggling study and work? Do you have any tips for managing study and work?

Be efficient and flexible with your time. For me, I know that I cannot set a specific time to study each week because my job or life commitments will invariably encroach on this time. However, I do aim to spend a few hours learning and revising course content each week. If you do have a quiet day or two at work, use this time productively to study. From my experience, putting extra effort in during the early weeks of the semester makes it a bit easier come exam time. I also find that regular exercise helps clear my head and enables me to focus on the task I'm undertaking, whether it be study or work.

What advice do you have for other tax professionals considering the ATL003 CTA2A Advanced subject?

From the perspective of someone at the beginning of their career in tax, I recommend this course for all junior tax professionals wanting to develop their career and gain a deeper understanding of taxation law in Australia.

Member Profile

This month's column features Jacquii Reeves, CTA, from EY, Brisbane.

Member since

2010

Areas of specialty

Income tax advisory for family owned business and high net wealth Individuals

Why are you a member of The Tax Institute?

I am a passionate member of The Tax Institute because it provides opportunities in professional development and education, and a sense of community. The Tax Institute and its members have been an integral part in shaping me as a tax professional.

How is your membership beneficial to your practice and clients?

Being able to attend high-quality events and join with like-minded professionals in shaping our tax community has helped me to become a better adviser. The knowledge and skills I gain through being a member of The Tax Institute means I grow and learn and, in turn, are reflected in the quality of advice I can provide to clients.

How did you end up in tax?

After finishing my accounting degree, I started in business services providing tax and accounting services to SMEs. It was there that I had the opportunity to work with a director who was passionate about tax and encouraged me to follow my passion for complex tax advisory matters. He was the one who encouraged me to join The Tax Institute and I am grateful to him for inspiring me to specialise in tax.

What are the challenges for tax practitioners this year?

Maintaining a work–life balance is one of the challenges we face as a profession. The wonderful advancements in technology means information is always at our fingertips. However, without sufficient time to "switch off", we run the risk of burnout and mental fatigue. Having a healthy work–life balance means bringing our best selves to work, so remember to take time to recharge.

Most memorable career moment to date

It is hard to define just one moment, but what gives me satisfaction each day is helping clients. Working with family owned businesses gives you a real sense of satisfaction in that the advice you have provided has helped them achieve their personal and business goals.

How do you relax?

Spending time with my boys, usually with a glass of wine in my hand.

Advice to those entering the profession

Follow your passion and be willing to dedicate time to your own professional development. Tax is an ever-changing landscape and that will continue as society, technology and the political environment change. This challenge is exciting for those of us with a thirst for knowledge and continuous improvement, but it can also be daunting for those starting out in their career. Find a mentor and an ally — they will be your biggest supporter and challenge you to achieve all you want out of your career.

Resolving R&D disputes

by Hugh Paynter, CTA, Partner, and
Brock Gunthorpe, Solicitor,
Herbert Smith Freehills

Taxpayers who claim the R&D tax incentive face a challenging regulatory environment which makes the successful resolution of R&D disputes with Innovation and Science Australia (ISA) and the Australian Taxation Office (ATO) a difficult task. This article examines the technical issues which arise in R&D disputes, including the recent Full Federal Court guidance in *Moreton Resources* and the impact of ISA and ATO subject matter guidance. It also looks at the interaction with the promoter penalties regime, with a view to assisting taxpayers and their advisers to understand the technical and practical issues presented.

Overview

Taxpayers who claim the research and development (R&D) tax incentive face a challenging regulatory environment. Innovation and Science Australia (ISA), an independent statutory board created under the *Industry Research and Development Act 1986* (Cth) (assisted by AusIndustry), as well as the Australian Taxation Office (ATO) have significantly increased their review and audit activities in recent years. It is possible to successfully resolve an R&D incentive dispute. However, many issues arise in the course of the dispute process which taxpayers need to be alive to. This article discusses some of these issues.

Current environment

The R&D incentive scheme has, until recently, seen continued growth since its introduction in 2011.[1] Integrity, compliance and review measures have grown accordingly with the scheme. Based on information released by the ATO under freedom of information (FOI), as an illustration, in 2017-18:

- the ATO paid or applied $5.4b of R&D incentive offsets to 13,156 companies;
- the ATO received 13,156 claims for the R&D incentive, representing a 0.7% increase in the number of claiming taxpayers, but an overall decrease of 13% in the quantum of the offsets claimed; and
- the ATO completed compliance activities in the order of 270 companies, raising approximately $200m in liabilities.

This recent data is part of a larger trend. In the past three years, the ATO has undertaken around 600 compliance cases, resulting in more than $700m of adjusted liabilities.

Successfully resolving R&D incentive disputes is difficult. A quantitative illustration is given by the 151 "high-risk" refund reviews undertaken in 2017-18 by the ATO, where:

- 52 refunds were paid in full to taxpayers;
- 50 refunds were partially adjusted adverse to taxpayers; and
- 49 refunds were fully disallowed.

The number of unsuccessfully resolved disputes is likely larger, given that the available statistics exclude those claims caught up in ISA's remit.

More generally, the R&D incentive scheme itself is under examination. For example:

- in some corners, calls have been made for a re-think of the scheme, owing to a perceived crackdown targeting start-ups and smaller companies;[2]
- there is an ongoing tender process by government to outsource aspects of the compliance process. However, core decision-making will remain with government, according to reports;[3] and
- the Prime Minister is reported as having said that "the R&D incentive's application to software companies is untenable, and the rug is being pulled from under promising young companies at a critical time … Minister Karen Andrews has begun to reopen the discussion about solutions to this problem".[4]

Guidance on technical issues from courts and tribunals

The increased compliance and review activities have taken place in an environment where there has been little public guidance available from decided cases in the Administrative Appeals Tribunal (AAT) and the Federal Court.

As at July 2019, there was:

- one merits decision of the AAT under the amended regime;[5]
- one merits decision, with an appeal judgment from the Full Court of the Federal Court of Australia remitting it for reconsideration according to law;[6] and
- one procedural decision of the AAT under the amended regime as to an approach for dealing with the complexity of R&D disputes.[7]

Guidance can be drawn from cases decided under the previous legislative regime, but they should be treated with caution. Guidance from the Full Court of the Federal Court of Australia in the *Moreton Resources* case was limited to one or two narrow legal questions needed to dispose of the appeal — and therefore, may not provide practical guidance for resolving R&D disputes.

The void, however, has been filled by the ATO and AusIndustry, which have:

- issued taxpayer alerts, including for specific industries;[8] and
- issued (and recently updated) guidance publications, including to clarify the eligibility of software development activities under the R&D incentive.[9]

Technical issues

Before addressing more pragmatic issues associated with R&D disputes, it is appropriate to consider the technical legislative standards that taxpayers must meet. There are three key questions for consideration.

Are claimed activities "core R&D activities"?

For the R&D incentive, a key eligibility question is whether activities meet the threshold set in s 355-25 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97):

> "(1) ***Core R&D activities*** are experimental activities:
>
> (a) whose outcome cannot be known or determined in advance on the basis of current knowledge, information or experience, but can only be determined by applying a systematic progression of work that:
>
> (i) is based on principles of established science; and
>
> (ii) proceeds from hypothesis to experiment, observation and evaluation, and leads to logical conclusions; and
>
> (b) that are conducted for the purpose of generating new knowledge (including new knowledge in the form of new or improved materials, products, devices, processes or services)."

There is a slew of specific exclusions from the definition which arise on a case-by-case basis, eg market research, research in social science, arts or humanities, and developing, modifying or customising computer software for the dominant purpose of use by entities for their internal administration.[10]

As dealt with below, the key issues which arise from the "core R&D activities" definition are:

- Are the activities "experimental activities"?
- What is the outcome of the activities? And is that outcome one which:
  - cannot be known or determined in advance on the basis of current knowledge, information or experience; but
  - can only be determined by applying a systematic progression of work?
- Was the systematic progression of work one based on established science? What is the branch of applicable science?
- What was the hypothesis for the work (this is a key factual issue)?
- Assuming there was a hypothesis, was there a systematic progression of work that recognisably progressed from "hypothesis to experiment, observation and evaluation, and leads to logical conclusions"?
- Were the activities "conducted for the purpose of generating new knowledge (including new knowledge in the form of new or improved materials, products, devices, processes or services)"?

The taxpayer must succeed on each of the criteria. The legal meaning and effect of most of those criteria are open to dispute, either legally and/or factually. Accordingly, it is fair to conclude that, in a contentious environment, meeting each of those criteria is challenging.

If there are "core R&D activities", are claimed activities "supporting R&D activities"?

Supposing a taxpayer claims for "core R&D activities", the regime permits claims for "supporting R&D activities":[11]

> "(1) ***Supporting R&D activities*** are activities directly related to core R&D activities.
>
> (2) However, if an activity:
>
> (a) is an activity referred to in subsection 355-25(2); or
>
> (b) produces goods or services; or
>
> (c) is directly related to producing goods or services;
>
> the activity is a supporting R&D activity only if it is undertaken for the dominant purpose of supporting core R&D activities."

The drafting of s 355-30 ITAA97 should be noted:

- activities will qualify if they are "directly related" to core R&D activities. The word "related" is normally of wide import but is qualified here by the word "directly". The taxpayer will usually want a wide definition of the term "directly related" in subs (1);
- however, if the activities produce goods or services or are directly related to producing goods or services, it would appear a more difficult standard applies, ie the activity is only a supporting R&D activity if it is undertaken for the dominant purpose of supporting core R&D activities.

Two aspects arise:

1. while a taxpayer prefers an expansive definition of "directly related" in subs (1), the taxpayer may want a narrow definition in subs (2)(c); and
2. plainly, the concept of related, qualified by "directly", is broader than the concept of an activity undertaken for the dominant purpose of supporting core R&D activities.

If there are core and supporting R&D activities, to what extent is expenditure incurred on R&D activities?

The two issues of whether activities are core or supporting are "ISA issues" or what can be referred to as "science issues".[12] That leaves a further issue being the "ATO issue" or what can be referred to as "the quantification issues".

Supposing a taxpayer successfully demonstrates the eligibility of their R&D activities, their entitlement to claim is limited by a "nexus" (or quantification) requirement:[13]

> "(1) An R&D entity can deduct for an income year (the ***present year***) expenditure it incurs during that year to the extent that the expenditure:
>
> (a) is incurred on one or more R&D activities:
>
> (i) for which the R&D entity is registered under section 27A of the *Industry Research and Development Act 1986* for an income year; and
>
> (ii) that are activities to which section 355-210 (conditions for R&D activities) applies; and
>
> (b) if the expenditure is incurred to the R&D entity's associate--is paid to that associate during the present year."

The linkage "to the extent that" in s 355-205(1) ITAA97 appears to permit apportionment by taxpayers of amounts of expenditure between R&D and other activities,[14] adopting a fair and reasonable[15] mechanism of apportionment.

Moreton Resources decision gives guidance on some technical issues

As alluded to earlier, the *Moreton Resources* decision is the first court decision interpreting the current R&D provisions. A background to the disputes and the Full Court's decision are set out below.

Claimed "R&D activities"

Moreton Resources undertook a pilot project to test the viability of using underground coal gasification (UCG) technology at its Kingaroy site to produce UCG syngas that would then be cleaned and stabilised for production of electricity using gas turbines. As it happened, in March 2010, the pilot project failed causing underground water contamination (and was subsequently shut by agreement with the Queensland Government). Relevantly, Moreton had registered in FY10 activities encompassing the setup of the pilot project.[16]

In August 2015, the ISA Board made findings that none of the activities registered in FY12 to FY14 were "core R&D activities" or "supporting R&D activities". Moreton contended that, during FY12 to FY14, it carried out qualifying activities in relation to the pilot project, in particular, to remediate the site following the failure of the pilot project. Many of those remediation activities occurred as requirements of environment assessments attached to the pilot project, and subsequent action by regulators. Moreton argued that these activities were either "core R&D activities" or, alternatively, "supporting R&D activities". The ISA Board decision was upheld following internal review.

AAT decision

After setting out the legislative framework, and the history of activities undertaken in 2012 to 2014 by Moreton Resources, the tribunal considered whether any of the claimed core R&D activities were "experimental activities" within the meaning of s 355-25(1). In doing so, the tribunal formed the view that:

- activities conducted for the purpose of demonstrating a known fact are not "experimental activities" within the meaning of s 355-25(1); and
- the word "experimental" qualifies activities which are eligible, and activities will not be "experimental activities" if they meet the dictionary definition (a test or trial undertaken for the purpose of discovering something unknown or for testing a principle).

The AAT found that none of the FY12 to FY14 activities were core R&D activities. Subsequently, in answering whether the claimed "supporting R&D activities" qualified, the tribunal considered the "core R&D activities" definition again when determining whether the pilot project (as a whole) met the test, such that the FY12 supporting activities would qualify if directly related.

Again, the tribunal started with the meaning of "experimental activities", holding that the pilot project failed because:

- "it was not an activity that it needed to do in order to solve a problem, develop a new product or improve a process. It was testing the application of existing technology at a particular site and nothing more"; and
- "beyond that site specific knowledge that would be generated … the pilot UCG project was [not] undertaken for the purpose of generating new knowledge. It was not undertaken to develop UCG technology itself and nor was it undertaken to develop any new form of, for example, pilot plant, devices or processes".

Having formed that view, the tribunal did not proceed to consider:

- whether, in fact, the FY10 activities had been carried out by Moreton;
- whether claimed "core R&D activities" were alternatively "directly related" to registered activities for FY10; and
- whether claimed "core R&D activities" were alternatively undertaken for the "dominant purpose" of supporting registered FY10 activities.

Appeal submissions

When appealing the tribunal's decision, Moreton identified 10 grounds of appeal relating to the tribunal's construction of the "outcome of experimental activities" and a further eight grounds of appeal relating to the tribunal's factual findings as to "purpose of generating new knowledge". The parties' submissions put in issue:

1. whether the tribunal misconstrued s 355-25(1)(a) when deciding that the provision did not extend to experimental activities whose outcome, while unknown, related to the application of an existing technology to a specific site;
2. whether the tribunal misapplied s 355-25(1)(a) by mischaracterising the "outcome" of the experimental activities as being the outcome of applying an existing technology to a specific site;
3. whether the tribunal misapplied s 355-25(1)(a) by limiting its consideration to the "outcome" of particular experimental activities rather than the "outcome" of the overall experimental activities;
4. whether the tribunal misconstrued s 355-25(1)(a) when deciding that its central focus is "the experimental activities themselves … and the way they are conducted";
5. whether the tribunal otherwise erred in concluding, on the basis of facts fully found, that none of, and no part of, the activities constituting the pilot underground coal gasification project, including those registered for the years ended 30 June 2009, 30 June 2010 and 30 June 2011, answered the description in s 355-25(1)(a);
6. whether the tribunal misconstrued s 355-25(1)(b) by deciding that "new knowledge" was limited to knowledge of a certain kind, which excluded knowledge obtained with respect to the application of an existing technology to a new site;
7. whether the tribunal misapplied s 355-25(1)(b) by mischaracterising the "new knowledge" to be generated from the experimental activities as knowledge about what would be produced from the application of an existing technology to a new site;
8. whether the tribunal misapplied s 355-25(1)(b) by limiting its consideration to "new knowledge" to be generated from particular experimental activities, rather than the "new knowledge" to be generated from the overall experimental activities; and

9. whether the tribunal otherwise erred in concluding, on the basis of facts fully found, that none of, and no part of, the activities constituting the pilot UCG project, including those registered for the years ended 30 June 2009, 30 June 2010 and 30 June 2011, were "conducted for the purpose of generating new knowledge" within the meaning of s 355-25(1)(b).

Full Court reasoning

The Full Court unanimously allowed the appeal and remitted the decision to the tribunal for reconsideration according to law. In resolving the appeal, the Full Court narrowly disposed of the proceeding based on its view that the tribunal had erred in construing the expression "core R&D activities" based on its construction of the "experimental activities".

Relevantly, the Full Court provided the following practical guidance:

- the word "experimental" in the opening line of s 355-25(1) has very little work to do. Rather, the expression "experimental activities" is descriptive of activities meeting the conditions in subs (1)(a) and (b);
- the tribunal had erred in its construction of the expression "for the purpose of generating new knowledge" by allowing its view of "experimental activities" to influence the construction. There is no basis for excluding, from core R&D, activities undertaken with the purpose of generating new knowledge with respect to the application of an existing technology at a new site;
- the text in the explanatory memorandum which states that the knowledge sought by an activity "must go beyond merely implementing existing knowledge in a different context or location" are not inconsistent with activities being undertaken with the purpose of generating new knowledge with respect to the application of an existing technology at a new site;
- the tribunal's earlier interpretive finding that activities which are "a test or trial undertaken for the purpose of discovering something unknown or for testing a principle" could not be qualifying activities was wrong. The conditions in subs (1)(a) and (b) were determinative; and
- the tribunal's interpretation was not supported by the purpose of the legislation, which the Full Court of the Federal Court reiterated was to "encourage industry to conduct research and development activities that might otherwise not be conducted because of an uncertain return from the activities, in cases where the knowledge gained is likely to benefit the wider Australian economy".

Finally, the decision contains the following additional comments:

- that a purpose of the activities might include whether a process "can be operated in a safe and environmentally responsible manner". That is, subject to the statutory exclusion in s 355-25(2)(f) regarding activities associated with complying with statutory requirements, it is possible that a taxpayer's hypothesis and activities might be eligible if experimentation has occurred to determine whether it is possible to achieve an outcome with certain requirements imposed by the taxpayer and their context; and
- the characterisation of activities as "testing the application of existing technology at a particular site and nothing more" was open to question where those activities resulted in a world first (the first gas turbine making electricity from syngas from UCG) or was a pilot which occurred under close government supervision as a test of the environmental impact of a process.

The matter was remitted to the AAT. As at the time of writing, there is no evidence of a special leave application having been made to the High Court.

Managing AusIndustry reviews and findings

Joint administration

As is well known, the R&D incentive scheme is administered by both ISA and the ATO. While the governing legislation creates distinct roles for each, through their inter-agency memorandum of understanding, both have been increasing the alignment of their approaches to support integrity activities. In recent times, both AusIndustry and the ATO received additional funding from the Commonwealth to ensure the integrity of the program and deliver targeted guidance to assist taxpayers to correctly claim eligible R&D.

In early 2019, this led to the publication of new guidance, said to have been prepared in consultation with R&D consultants and the community.[17] The impact of guidance is discussed below.

From registration to findings and beyond

To understand the different points at which disputes can arise, it is worthwhile charting the many paths through an R&D incentive dispute, depending on a taxpayer's individual circumstances. The procedural course of an R&D dispute is set out in Diagram 1, while an indicative timeline for the long-running *Moreton Resources* case prior to the recent judgment is set out in Diagram 2.

At all stages during a formal "findings" review by ISA, internal review and external AAT review, the decision-makers are empowered to make findings on the "science" questions. That is, the technical questions of the eligibility of activities as core/supporting R&D activities.

If, and once, made, the findings of ISA bind the ATO, leading to expenditure and substantiation queries in respect of the findings (the "quantification" questions). As demonstrated in Diagram 1, the ATO and ISA review processes can overlap. Australian Taxation Office reviews can take place while an ISA review is underway, or the matter is before the AAT/courts.

Evidentiary requirements versus AusIndustry guidance

When proving a taxpayer's eligibility, the requirements can be considered as discrete questions. As is set out in the Appendix at the end of this article, AusIndustry's published guidance adopts much the same approach.

Registration: an initial step

If a taxpayer's R&D activities are subject to review, they may face the antecedent question (particularly with whole-of-project registrations) of whether the activities carried out are in fact within the ambit of the registration. This is

Diagram 1. Possible procedural course(s) of an R&D dispute

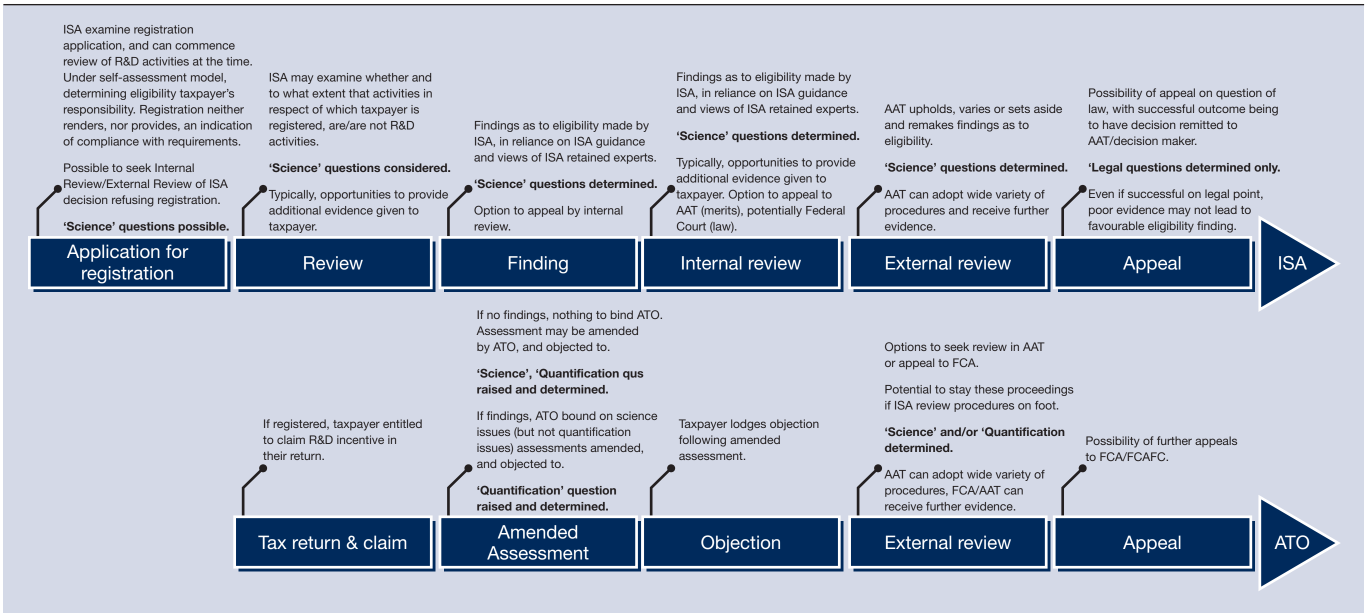
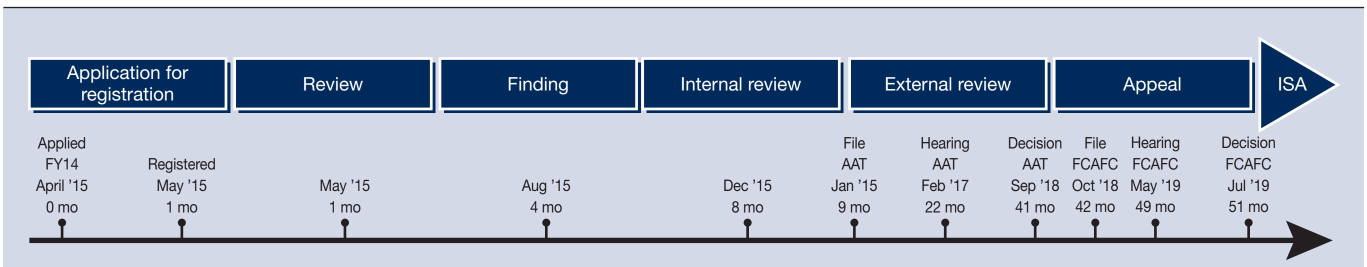


Diagram 2. Moreton Resources dispute resolution timeline



often the first hurdle to surpass in dealing with the ISA on the "science" questions.

Evidencing eligibility requirements

Taxpayers who lodge claims for the R&D incentive need to consider whether they can answer the following questions:

– Could the outcome sought by the taxpayer have been known or determined in advance on the basis of current knowledge information or experience at the relevant time?
– What hypotheses did the taxpayer have?
– What is the field of established science relevant to the activities?
– Did the taxpayer follow a systematic progression of work based on principles of the relevant established science?
– Did the taxpayer conduct the activities for the purpose of generating new knowledge, *including* in the form of new and improved processes and products?
– Alternatively, if not core R&D activities, are the activities directly related to core R&D activities?

Should such evidence not exist, consideration will need to be given to gathering additional lay/documentary evidence, and the need for the taxpayer to seek out its own appropriately qualified experts in addition to those used by ISA in its review.

The authors' view, contrary to guidance, is that these questions need not always be answered through contemporaneous documentation. Under the previous R&D laws, there were stricter requirements around documentation (including, for example, the preparation of an R&D plan). This is not a *legislative* prerequisite to claiming the R&D incentive nowadays. It is, of course, much more *forensically* challenging to successfully resolve an R&D dispute in the absence of such evidence.

It is also arguably wrong to suggest that eligible R&D activities should proceed by following a linear documented "R&D plan". Documentary records (such as emails sent at the time) can be deployed in a dispute. Further, in many scientific fields, a systematic progression of work may be adopted by following an iterative cycle which can only be developed as experimentation and observation progresses.

While the above suggests that it is not a strict requirement to have contemporaneous records, plainly, taxpayers looking to adopt what we consider best practice would have matters such as "hypotheses", "purpose" and prior "current state of knowledge" inquiries articulated and documented by technical staff involved in the R&D at the time, with the support of advisers, rather than having documentation:

– solely prepared by R&D advisers; and
– prepared at the point in time of an R&D registration or claim by advisers and/or the taxpayer.

In particular, keys to successful claims are the *hypothesis* and *could not be known or determined in advance* limbs. For the first, it is essential to be able to demonstrate with precision what the hypothesis was and, further, that it was actually held by the taxpayer. Without clear answers to these questions, ISA will likely make findings contrary to the taxpayer. On the other hand, the existence of a hypothesis will likely assist the taxpayer in meeting the other requirements of core R&D activities.

Similarly, unless the taxpayer has clear evidence to support their enquiries as to the pre-existing state of knowledge, it might be said that there is a post-hoc trend of ISA and its experts reaching conclusions that the outcomes of R&D activities were capable of being known in advance. Further, it is noted that this requirement is not satisfied by the *subjective* state of mind of the taxpayer, but potentially a global search for whether an expert in the field knew the outcome based on their current knowledge, information or experience. The taxpayer will need to rely on expert evidence in order to show that the outcome could not be known in advance on an *objective* basis.

The critical nature of evidence preparation is underscored by the recent decision in *Re Ultimate Vision Inventions Pty Ltd and Innovation and Science Australia* where an unrepresented applicant failed in its application for review because it lacked sufficient evidence, including objective, contemporaneous evidence as to the purpose of the activities.[18]

> *"Guidance is not a substitute for a proper statutory construction exercise — ISA and the ATO cannot modify the meaning of the statute."*

ISA and ATO guidance on evidencing eligibility requirements

To assist taxpayers in what is a self-assessed scheme, ISA (together with the ATO) has produced general and specific guidance. Some key guidance as regards the evidentiary questions are summarised in the Appendix below. The key points to reflect on are:

– guidance is not a substitute for a proper statutory construction exercise — ISA and the ATO cannot modify the meaning of the statute by their guidance; and
– notwithstanding the general obligations on taxpayers to keep records, there are no requirements in the regime for the kind of evidence which must be kept. That is, although guidance places a strong emphasis on documentary records, it is not fatal, and is often necessary, to rely on other evidence.

Resolving disputes with regulators

If a taxpayer finds themselves in a dispute, review or audit, the following should be considered, noting that each of ISA and the ATO have different focuses.

Resolving disputes with AusIndustry

The potential for a dispute first arises at the point of registration. A few issues arise:

– Do the activities described in the registration document fairly reflect the activities undertaken by the taxpayer, as understood by the relevant technical staff?
– Does the registration seek to pick up activities which go beyond what may be core and supporting activities — and can the taxpayer narrow a claim if required?
– Is there a file of contemporaneous files which the taxpayer can readily draw on if the matter is reviewed?

During the phases of registration, or the making of findings, there is little utility in taking up interpretive questions regarding eligibility. As alluded to earlier, in a space with little court guidance, the guidance of ISA itself is key, and taxpayers should be articulating how, in any event, they meet those thresholds. Of course, given that evidence filed during the findings process (and any review) may later be part of the record before the AAT, any lay or expert evidence prepared should also be appropriate for that forum.

Of all of the eligibility questions, practical experience suggests that demonstrating an eligible hypothesis and that the outcome of activities was unknown in advance are the most problematic area of claims at this stage. On the first, considerable scepticism has been shown towards hypotheses with commercial objectives (eg whether it is possible to provide a system which operates in real time for customers), or with some facet unique to a taxpayer (eg whether it is possible to achieve something within the taxpayer's architecture). On the second, there are evident difficulties with demonstrating, globally, that no persons could have known or determined the outcome of activities in advance.

The timing of the preparation and filing of additional evidence (if such an opportunity is provided) is another key factor to ensure that it is available to ISA and their experts in the process of making a statutory finding. Consistency and conformity with evidence described in the guidance is crucial.

There is no procedural inability for a taxpayer to reach a settlement with ISA or the ATO at any point of a review. Review proceedings occur in a no-cost jurisdiction and settlements can either be effective by discontinuance, or approved settlement and orders by the AAT. The prospects of a successful settlement turn principally on the filed evidence.

Resolving disputes with the ATO

Generally speaking, the ATO does not become involved with the scientific merits of the R&D incentive claim. Instead, the ATO considers matters such as the nexus between eligible activities and expenditure, and whether the claimed expenditure is substantiated, and, within the taxpayer's registration.

An important consideration for both taxpayers and the ATO is that the ISA finding process regarding R&D activities could well result in findings that parts of activities (rather than all, as registered) are eligible. Accordingly, consideration should be given to the adaptability of the available substantiation evidence and how apportionment is to occur in that situation.[19]

Further, it should not be assumed that eligibility will not be raised by the ATO: the ATO is only bound by ISA findings if they are made. If not made, the ATO is not bound and therefore may engage on the science issues.

There is no formal regime to prevent the ATO from resolving expenditure questions within its scope while scientific matters are being resolved with ISA. There is some sense in those questions following one another, given that a formal finding by ISA (or the AAT) would bind the Commissioner. The risk of administrative action on two fronts can make R&D incentive disputes challenging. There are some measures which can mitigate this particular risk.

It is also unclear from the guidance how a taxpayer might precisely substantiate its expenditure to the ATO's satisfaction, although timesheets appear to be the most rigorous method suggested. For example, one piece of guidance suggests that "exported content from task tracking or project management tools (demonstrating the % of time staff worked on activities)" could be relied on.[20]

Lessons learned: reflections on prior disputes

1. **The importance of taxpayers getting registration right.** Notwithstanding the legislative requirement to examine the activities engaged in, ISA treats the question of whether evidenced activities are within the ambit of the registration form as an important preliminary question in internal and external reviews. Without clearly satisfying the registration requirement, taxpayers face the risk of an allegation of retrospective reconstruction of activities, or ISA considering that it cannot make any findings in respect of activities (due to their not having been registered).

2. **Proper data collection for substantiation of expenditures.** The possibility that ISA or the ATO might not find the entirety of an activity eligible (core or supporting) means that evidence substantiating expenditure needs to be similarly flexible. Taxpayers whose internal records (eg timesheets) are sufficiently granular and connected to core/supporting R&D activities (and their constituent parts) to allow them to pivot based on the scientific findings are best placed to succeed in R&D disputes.

3. **Vastly different approaches of ISA and the ATO to settlement.** ISA tends to treat the statutory questions within its jurisdiction as binary. That is, an activity is registered, or it is not; or an activity is experimental, or not. This failure to adopt a risk-weighted approach to disputes means that a reaching a settlement on the scientific merits is difficult. The ATO, by comparison, has established measures for agreeing settlements with taxpayers, and adopts a more risk-weighted perception of disputes in their jurisdiction.

Promoter penalties

In addition to taxpayers, advisers have been coming under increased scrutiny. For example, information released in November 2018 under FOI reveals that the ATO has entered four enforceable voluntary undertakings with tax advisers regarding tax promoter penalties in relation to the R&D incentive.[21] The regime and some issues specific to the R&D incentive are set out below.

Penalty regime

The main civil penalty provision is that contained in s 290-50(1) of Sch 1 to the *Taxation Administration Act 1953* (Cth) (TAA):

> *"Promoter of tax exploitation scheme*
>
> (1) An entity must not engage in conduct that results in that or another entity being a *promoter* of a *tax exploitation scheme*."

The expression "entity" has a broad definition.[22] Each of the key terms "promoter" and "tax exploitation scheme" are defined in ss 290-60 and 290-65 TAA (which in turn incorporate further definitions):

> "(1) An entity is a promoter of a tax exploitation scheme if:
>
> (a) the entity markets the scheme or otherwise encourages the growth of the scheme or interest in it; and
>
> (b) the entity or an associate of the entity receives (directly or indirectly) consideration in respect of that marketing or encouragement; and
>
> (c) having regard to all relevant matters, it is reasonable to conclude that the entity has had a substantial role in respect of that marketing or encouragement.
>
> (2) However, an entity is not a promoter of a tax exploitation scheme merely because the entity provides advice about the scheme.
>
> (3) An employee is not to be taken to have had a substantial role in respect of that marketing or encouragement merely because the employee distributes information or material prepared by another entity.
>
> …
>
> (1) A scheme is a tax exploitation scheme if, at the time of the conduct mentioned in subsection 290-50(1):
>
> (a) one of these conditions is satisfied:
>
> (i) if the scheme has been implemented--it is reasonable to conclude that an entity that (alone or with others) entered into or carried out the scheme did so with the sole or dominant purpose of that entity or another entity getting a scheme benefit from the scheme;
>
> (ii) if the scheme has not been implemented--it is reasonable to conclude that, if an entity (alone or with others) had entered into or carried out the scheme, it would have done so with the sole or dominant purpose of that entity or another entity getting a scheme benefit from the scheme; and
>
> (b) one of these conditions is satisfied:
>
> (i) if the scheme has been implemented--it is not reasonably arguable that the scheme benefit is available at law;
>
> (ii) if the scheme has not been implemented--it is not reasonably arguable that the scheme benefit would be available at law if the scheme were implemented.

> (2) In deciding whether it is reasonably arguable that a scheme benefit would be available at law, take into account any thing that the Commissioner can do under a taxation law."

The appeal courts first considered the promoter penalty regime in *FCT v Ludekens*.[23] In *Ludekens*, the Full Court gave the following practical, interpretive guidance:

- the promotional behaviour captured by "markets the scheme or otherwise encourages the growth of" is potentially unlimited and must be assessed in the circumstances. Liability cannot be avoided by characterising the conduct of entities as "[mere] implementation" as distinct from marketing;
- when assessing whether a scheme is a tax exploitation scheme, s 290-65 requires an assessment of the purpose attending the entering into of the scheme as at the time of the promotional activity under examination. Further, no proof is required of what the position would have been apart from the scheme having been carried out;[24] and
- when considering the "sole or dominant purpose" test, it does not matter that the promoter has as its purpose the making of money (eg a fee for preparing an R&D incentive claim), but whether the dominant purpose of the entities entering the scheme was to obtain scheme benefits by way of a taxation advantage — not the general state of affairs, which can be presumed to be the making of some personal gain.

It should be noted that if a contravention is established, the Commissioner has a range of enforcement tools in addition to civil penalties, eg interim injunctions, mandatory and restraining injunctions, and enforceable voluntary undertakings.[25]

R&D incentive promoter penalties handed down

As guidance, advisers should consider the penalties imposed in *FCT v International Indigenous Football Foundation Australia Pty Ltd* (*Amede's* case).[26] In that case, Logan J imposed a civil penalty of $4.25m for 10 proven contraventions by a company which, through its director Ms Amede, was a promoter of tax exploitation schemes.[27]

The contravening conduct was:[28]

> "… the promotion of separate, bespoke schemes to a range of clients, each of which had, as its end, the tax exploitation of research and development incentives for which provision is made in Div 355 of the *Income Tax Assessment Act 1997* …"

In particular, as to the "bespoke" schemes, the services provided were:[29]

> "… to assist clients to register for a relevant income year as 'R&D entities', R&D being an obvious abbreviation for research and development, and for R&D activities, within the meaning of those terms, as found in s 4 of the *Industry Research and Development Act 1986* (Cth) (Industry Research and Development Act) and s 995-1 of the ITAA 1997, thereby to be eligible for research and development tax incentives under Div 355 of the ITAA 1997. The company also prepared research and development forms which incorporated information, amounts and calculations about research and development activities and expenses for the purpose of the clients obtaining taxation assessments and related refunds in accordance with those returns and forms."

It will come as little surprise that in each of the 10 contraventions pleaded, the respondents had overstated the properly claimable R&D expenditure, either because their clients had not conducted eligible R&D activities, or the respondents had made claims which were not available under the scheme or incapable of substantiation.

A key in this case was the court accepting that it was not reasonably arguable that the scheme benefit was available at law.

The court made firm remarks about the importance of the integrity of the R&D incentive scheme as a basis for the general deterrence conveyed by the substantial penalty:[30]

> "The Commissioner has submitted that compromise of the research and development incentive programs integrity can have large consequences for the consolidated revenue and, related to that, the ability to deploy, via expenditure from the consolidated revenue, funds to particular ends authorised by a vast range of Commonwealth enactments. A particular consideration in relation to the research and development program, so it is put, is that it is 'uncapped'. By that, the Commissioner has submitted, and, as a matter of law, the case is, there is no fixed budget and, thus, no expenditure cap in relation to the program.
>
> All of this may be accepted. There is a very real and corresponding need to send a loud and clear message of general deterrence by the imposition of penalty in relation to those who would seek, by conduct which contravenes the promoter penalty provisions, that such promotional activities are not acceptable and foolhardy in which to engage."

It is likely that subsequent enforcement actions would be similarly strong in their treatment of promoters, given the accepted policy considerations.

Issues in respect of R&D incentive

The R&D incentive raises interesting questions in the context of the promoter penalties regime. This stems from the often-underappreciated distinction between *dominant* and *causative* purposes.

For example, the availability of the R&D incentive is intended to have taxpayers engage in activities (R&D) which would not have otherwise occurred, but for the incentive.[31] In this way, the R&D incentive benefit operates as *a cause* of the conduct, but the taxpayer still holds the purpose of generating new knowledge (including in the form of new or improved materials, products, devices, processes or services). Such conduct would not fall foul of the promoter regime.

The difference between such a causative but not dominant purpose should be compared with the result in *Amede's* case.

It follows from the general principles of the promoter regime, and the guidance in *Amede's* case, that advisers need to be alert to:

- **understanding the precise conduct involved and its motives:** what is the precise conduct making up a course of conduct? When does that conduct occur and for what purpose? Proving that the purpose of the R&D activities was the creation of new knowledge is an important part of eligibility and avoiding the risk of a promoter penalty;

- **ensuring that they and their clients are taking "reasonably arguable" positions:** many advisory services could satisfy the "marketing" conduct threshold found in *Amede's* case. However, the absence of a reasonably arguable position that the taxpayer was entitled to the R&D incentive was the key determinant in finding that Amede had breached the promoter penalty regime;
- **the harsh deterrence for promoters in respect of the R&D incentive:** if contraventions are established, there are substantial factors in favour of high penalties at sentencing. This can be reinforced by the large benefits derived by advisers in the R&D space;
- **the availability of criminal sanctions:** liability for promotional conduct which contravenes the taxation laws is not limited to civil penalties and other remedies. While civil penalties lie towards the upper end of the spectrum of sanctions, successful prosecutions have been brought using the general criminal laws (eg a charge of defrauding the Commonwealth) applying to such conduct; and
- **an emphasis on software development:** approximately one-third of the entities registered for the R&D incentive are undertaking software development. Information released under FOI from the ATO specifies that software development activities are those being seen to involve scheme promotion and fraudulent claims.

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An earlier version of this article was presented at The Tax Institute's NSW Tax Disputes Conference held in Sydney on 31 July 2019.

Appendix. Commentary on guidance

Evidentiary question	General guidance[32]	Software guidance[33]	Comment
Evidence generally[34]	Record-keeping is an essential part of managing your R&D tax claims. Keep records which show the specific ways in which your R&D activities were carried out.	You should have detailed documentation, recording what you did and the process of each activity as it develops to: – substantiate that the activity took place; and – establish that the activity meets the legislative eligibility requirements of the R&D tax incentive program.	It is not entirely correct to suggest that "detailed documentation" is legally necessary. Evidence of key participants in R&D activities at the time is permissible. However, plainly, a taxpayer is best served by contemporaneous records.
Outcome known or determined in advance	You should document and keep records of: – what enquiries you decided to make [as to existing technologies, processes or methods]; – the results of those enquiries; and – what your technical challenges were and why they couldn't be resolved without undertaking a systematic progression of work.	– Records of literature reviews. – Email exchanges with industry experts. – Screenshots of questions posted on tech blogs. – Details of failed attempts to use existing technology.	This evidence can be obtained after the R&D activities themselves from a suitably qualified person; pre-R&D inquiries are not necessary to demonstrate an outcome could not have been in advance by a taxpayer. The authors' experience is that expert evidence is key if the matter becomes contentious.
Systematic progression of work that proceeds from hypothesis to experiment, observation and evaluation, and leads to logical conclusions	You should document and keep: – the design of your experiment including your hypothesis; – the results of your experiment; – your evaluation of the results; and – your conclusions about whether the results proved your hypothesis and what this means for your project. It must be clear from your documentation that the four parts operate together as a systematic progression of work to generate, or to try to generate, the new knowledge that you need.	Records of each step of your experimental activity, eg what the hypothesis was, how you tested it, the data from your experiment, how it was analysed, whether the hypothesis was proven true or false, and how these results were used to create any new hypotheses. – Code repositories or software versions with comments including weaknesses that were identified and rectified in successive versions. – Testing strategy and approach. – Project management documentation such as GANTT charts.	The guidance, while helpful, emphasises a potentially narrower rigid progression of work (eg classical scientific method) rather than other methods in other established fields. If relying on project management software, ensure that records are producible at all stages in a project's life (eg not just the as-final versions of key documents).

Evidentiary question	General guidance[32]	Software guidance[33]	Comment
"Purpose of generating new knowledge"	– Keep records of activity descriptions that include details of how your activities are seeking to answer questions through an experimental process. – Keep records of planning, designing and conducting the experiment, including observations and the evaluation of the results of the experiment. These records are likely to be the most useful for providing evidence of your purpose. – Other project documentation which may be useful includes board or management meeting minutes and internal notes and memos. – Good evidence of purpose is likely to be recorded before or around the time you conducted the activities.	– Minutes of board, project or team meetings where the need to conduct experiments was discussed.	There is no limitation on obtaining evidence of purpose after the work is completed, but there are foreseeable difficulties in using such evidence during a dispute. Practical experience suggests that the board and management may often be too removed from key staff for their records to be truly helpful in resolving R&D disputes. This can be particularly true in whole-of-project circumstances.
"Supporting" R&D activities	– Record and keep descriptions of your supporting R&D activities, including any relevant details to show how it meets the above requirements. – Record why the activities were undertaken and how they support the core R&D activities. This will assist in showing that excluded activities and production activities had the required purpose. – Keep plans and reports which show why and how the supporting R&D activities were undertaken. This may assist in showing that you had the required purpose when undertaking excluded or production activities.	– Technical records showing how and why the supporting R&D activity is directly related to one or more core R&D activities. For example, why a graphical user interface that is being claimed was necessary to conduct the experiments in a core R&D activity. – Production run sheets and quality control sheets that identify which units were used for experiments and which were to be sold. – Where saleable goods are produced in an activity, your records need to show that you only produced sufficient numbers for the experiments and not for any commercial activity.	For supporting activities, the required analysis is not just why and how activities support, but consideration of the "closeness" of the supporting activity to eligible core R&D activities. An activity that does not closely support eligible R&D may fail to meet the required standards. Documentary records (such as plans and reports) often disclose multiple purposes for activities (especially production ones). Competing purposes are permissible but demonstrating dominant purpose may require additional oral evidence.

References

1 In 2017-18, there was an increase in the number of claimants. However, the quantum of their claims decreased year-on-year from earlier periods.

2 D Sadler, "R&D tax audits are killing startups", *InnovationAus.com*, online, 29 May 2019. Available at www.innovationaus.com/2019/05/RD-tax-audits-are-killing-startups?.

3 D Sadler, "Govt commits to RDTI outsourcing", *InnovationAus.com*, online, 11 June 2019. Available at www.innovationaus.com/2019/06/Govt-commits-to-RDTI-outsourcing.

4 M Bailey and P Smith, "Fix R&D, visas if you want to help tech, PM told", *Australian Financial Review*, online, 25 June 2019. Available at www.afr.com/news/economy/fix-r-and-d-visas-if-you-want-to-help-tech-pm-told-20190625-p5211w.

5 *Ultimate Vision Inventions Pty Ltd and Innovation and Science Australia* [2019] AATA 1633.

6 *Re Moreton Resources Ltd and Innovation and Science Australia* [2018] AATA 3378. On 25 July 2019, judgment was delivered in *Moreton Resources Ltd v Innovation and Science Australia* (VID1291/2018).

7 *RBPK and Innovation and Science Australia* [2018] AATA 1404.

8 TA 2015/3, TA 2017/4, TA 2017/2, TA 2017/5 and TA 2017/3.

9 Some of which are discussed later and include *Software activities and the R&D incentive*, *Guide to common errors*, *Compliance readiness: the importance of record keeping*, and *R&D tax incentive: guide to interpretation*.

10 S 355-25(2) ITAA97.

11 S 355-30 ITAA97.

12 There is a technical issue which can make these science issues also issues for the ATO to consider, if ISA does not make a finding that the activities are core or supporting R&D activities.

13 S 355-205(1) ITAA97.

14 Para 3.76 of the explanatory memorandum to the Tax Laws Amendment (Research and Development) Bill 2010. The example given by parliament is apportionment of salary and superannuation contributions for employees not solely engaged in R&D activities.

15 *Ronpibon Tin NL and Tongkah Compound NL v FCT* [1949] HCA 15.

16 A minor issue in the FCAFC appeal was whether Moreton had withdrawn its FY10 registration of the pilot project activities, based on a comment in the AAT decision to that effect. It was accepted that there was no effective withdrawal of the registration — merely a notice of Moreton's intention not to claim the R&D incentive after its activities were registered.

17 Note also the historical taxpayer alerts: TA 2015/3, TA 2017/4, TA 2017/2, TA 2017/5 and TA 2017/3.

18 [2019] AATA 1633 at [82], [87]-[88] and [94]-[97].

19 Though most taxpayers will be familiar with apportionment principles from decisions such as *Ronpibon Tin NL*.

20 AusIndustry, *Software activities and the R&D tax incentive*, February 2019, p 8.

21 The undertakings relate to conduct, such as: "R&D arrangement and promoted to aim in obtaining tax advantage by claiming R&D tax offset for R&D expenditure purportedly incurred Special purpose vehicle" [sic]; "this voluntary undertaking relates to R&D claims"; "Promotion of tax avoidance/evasion schemes in assisting clients [sic] to obtain R&D tax offsets"; "R&D building & construction expenditure claims".

22 S 960-100 ITAA97.

23 [2013] FCAFC 100.

24 Ibid at [236]-[237].

25 Subdivs 290-C and 290-D, Sch 1 TAA.

26 [2018] FCA 528 (*Amede's* case).

27 *Amede's* case at [71]-[73]. The maximum possible penalty was $42.5m, each contravention being liable to a maximum civil penalty of $4.25m: *Amede's* case at [65].

28 *Amede's* case at [2].

29 *Amede's* case at [28].

30 *Amede's* case at [55]-[56].

31 Para 1.10 of the explanatory memorandum to the Tax Laws Amendment (Research and Development) Bill 2010: "To this end, the new R&D tax incentive focuses assistance on activities that are likely to deliver economy-wide benefits that would not be enjoyed in the absence of public support. It also significantly improves the incentive for smaller firms to undertake R&D".

32 AusIndustry, *The R&D tax incentive: a guide to interpretation,* guidance, February 2019. Available at www.business.gov.au/-/media/Business/RDTI/Research-and-development-tax-incentive-guide-to-interpretation-PDF.pdf.

33 AusIndustry, *Software activities and the R&D tax incentive,* guidance, February 2019. Available at www.business.gov.au/-/media/Business/RDTI/Research-and-development-tax-incentive-guidance-software-activities-and-the-rd-tax-incentive-PDF.pdf.

34 Further guidance exists in the form of: *Guide to common errors,* February 2019; and *The R&D tax incentive: compliance readiness,* November 2014.

In-house facilitation, test cases and the AAT Small Business Division

by Karen Bell, Test Case Litigation Program Secretariat, and Ram Pandey, Principal Lawyer, ATO

The ATO has a range of intervention strategies that assist access to justice and the resolution of disputes. The ATO's in-house facilitation offers a flexible and rapid approach towards the resolution of disputes that is available at any stage of a dispute and not limited to any category of dispute. The test case litigation program provides financial assistance to taxpayers to meet some or all of their reasonable litigation costs that are associated with clarifying tax, superannuation and, in some instances, debt-related issues. The Small Business Taxation Division of the Administrative Appeals Tribunal was created as part of broader government policy to assist small businesses appealing the outcome of a dispute with the ATO. Self-represented small businesses in dispute with the ATO also benefit from additional support from the Small Business Concierge Service, and where the ATO engages an external legal provider, the ATO will fund reasonable costs for equivalent legal representation.

The ATO context

The Australian Taxation Office aims to contribute to the economic and social wellbeing of Australians by fostering willing participation in the tax and superannuation systems. In 2017-18, the ATO supported essential government services by collecting net revenue of $396.6b. This is largely a cooperative process involving engagement with over 11.5 million individuals (not in business), 3.8 million small businesses and 617,000 superannuation funds (see Diagram 1).

The ATO recognises that its actions and decisions can have a significant impact on the livelihoods and personal wellbeing of taxpayers. It is not enough for the ATO to "make the right decision"; the ATO must also be seen to be "making decisions in the right way". Whenever a taxpayer deals with the ATO, it is a priority that they feel they have been heard and have been dealt with fairly. This philosophy is embodied in the ATO's four guiding principles. The ATO should be:

1. making it easier for people to participate;
2. providing contemporary and tailored services;
3. maintaining purposeful and respectful relationships; and
4. being a professional and productive organisation.

An important aspect of this approach is how the ATO and taxpayers interact when there is a dispute. While this process is relatively rare, the emotional and financial burden can be significant for the taxpayer involved.

This article provides a high-level overview of three distinct programs which seek to alleviate some of this burden and guide taxpayers through the objection process. These are:

1. in-house facilitation;
2. test case litigation; and
3. the new Small Business Taxation Division in the Administrative Appeals Tribunal (AAT).

In-house facilitation

In-house facilitation (IHF) is a free mediation process geared towards less complex disputes with individuals and small businesses. It is available at any stage from an audit up to and including litigation. The service may be requested by the

Diagram 1. ATO activities

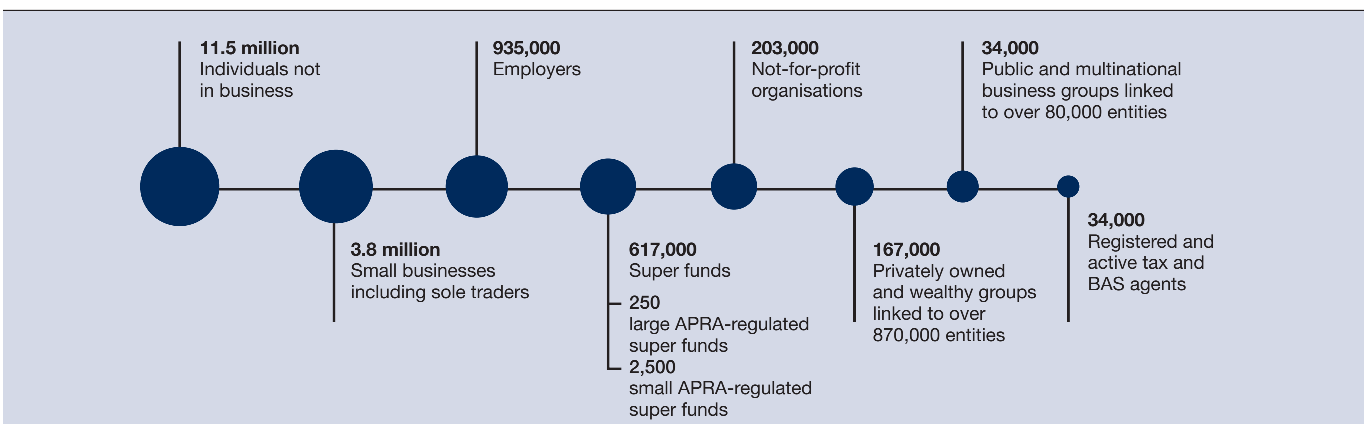
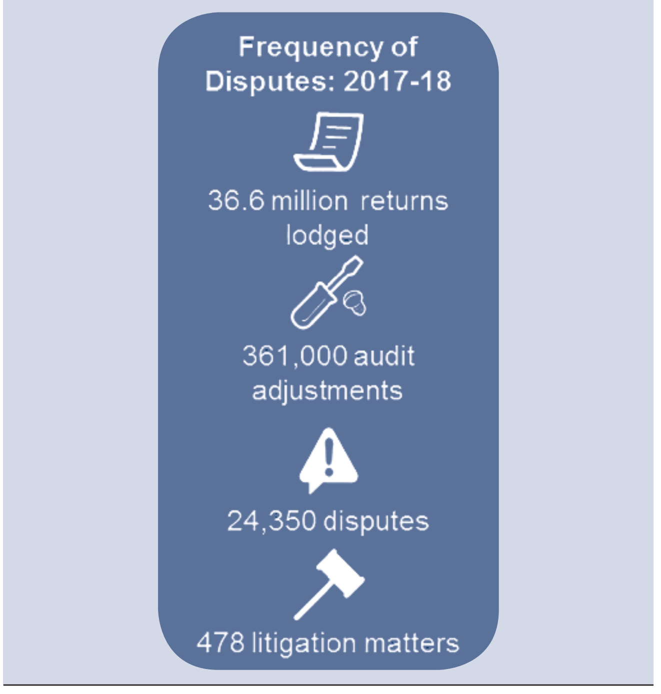


Diagram 2. Frequency of disputes: 2017-18



taxpayer, or may be offered by the ATO. Its take-up is entirely voluntary, and does not affect other rights of review.

In-house facilitation was introduced in April 2014 and involves independent ATO facilitators working with both sides of the dispute to arrive at a mutually agreeable outcome. This involves:

- identifying the issues in dispute;
- developing options;
- considering alternatives; and
- attempting to reach a resolution.

Australian Taxation Office facilitators are trained mediators who have no prior knowledge or involvement in the case. Importantly, their role is not to establish facts or take sides. Rather, their priority is to guide constructive conversation and keep communications open.

One of the ambitions of IHF is that, even if an agreement cannot be reached, the facilitation will provide both parties with a better understanding of each other's positions. For this reason:

- IHF is often held at a location convenient or comfortable to the taxpayer, for example, in their business premises or adviser's office;
- any information shared during the facilitation process is only to be used for this process unless the disclosing party consents.[1] For example, any new evidence disclosed by the taxpayer cannot be used as a basis to undertake further compliance action; and
- feedback is sought at the end of each facilitation process. This allows for continuous improvement and refinement of the process.

As community uptake of the IHF service has grown, the ATO has received strong positive feedback. For each successful facilitation, the ATO estimates that taxpayers save at least $50,000 which would otherwise be spent on litigation. In 2017-18, the IHF program had almost 250 referrals, of which 99% resulted in resolution or partial resolution of the dispute.

Test case litigation program

Established in 1996, the test case litigation program (TCLP) aims to promote clarity in taxation and superannuation laws, while respecting the financial imbalance which often exists between the ATO and individual taxpayers. Through the TCLP, the ATO funds the reasonable legal costs of a taxpayer who is involved in litigation that is in the public interest to litigate and achieves a precedential decision that clarifies taxation and superannuation laws.

Applications for test case funding are made through the TCLP using an application form available on the ATO's website. In some cases, the ATO may also proactively identify cases to be considered for funding. All applications are considered by the test case litigation panel, which is comprised of senior ATO officers and external members of the legal and accounting professions.[2] When deciding whether or not to grant funding, panel members consider:

- the level of ambiguity or uncertainty in the law;
- whether or not the case outcome would have a significant impact on a substantial section of the public, or would have significant commercial implications for an industry;
- whether or not it is in the public interest to litigate the matter. The ATO generally will not fund cases involving tax avoidance schemes or situations where there is an attempt to gain an outcome contrary to the intent of the legislation and public policy;
- the capability of the case to provide legal precedent capable of being used to decide other cases with similar facts; and
- the taxpayer's demonstrated willingness to progress the dispute in a timely manner.

A successful application will ordinarily cover reasonable legal costs, including legal fees, disbursements, and, in some cases, pre-litigation costs. The funding will only extend to the specified issues and proceedings. Unsuccessful applicants can ask for a review of the decision.

In 2018-19, 32 matters were considered for funding. There are currently 11 matters being funded by the program across a range of venues:

- three matters are before the AAT;
- two matters are before the Federal Court of Australia;
- two matters are before the Full Federal Court of Australia; and
- four matters are before the High Court of Australia.

Approved and declined matters are published on the Test Case Litigation Register on the ATO's website.

New Small Business Taxation Division

Announced by the Hon. Stuart Robert, then Assistant Treasurer, in November 2018, the new Small Business Taxation Division of the AAT aims to make it easier, cheaper and quicker for small businesses to resolve their tax disputes. This is in recognition of the time, cost and emotional pressures often faced by small businesses.

The key features of the measure include:

- a Small Business Concierge Service within the Australian Small Business and Family Enterprise Ombudsman (ASBFEO). This service provides:
  - information on AAT procedures;
  - access to legal advice before and after an application is lodged with the AAT;[3] and
  - ongoing support and assistance, which is not tax or legal advice, until a decision is reached;
- a Small Business Taxation Division of the AAT,[4] including:
  - a standard application fee of $500;
  - case manager support throughout the entire process;
  - a preliminary information form which is completed by the Commissioner;
  - an early case assessment process; and
  - fast-tracked decisions to be made within 28 days of a hearing; and
- ATO commitment to:
  - a fair, quick, economic and cooperative resolution;
  - creating a level playing field; and
  - an equivalent funding for legal representation where applicable.

In most cases, the ATO will not be represented by external legal counsel in the new division, but will be represented by junior dispute resolution officers.

For cases where there is significant technical or factual complexity, sensitive issues, issues of significance, or an ATO precedential view is challenged, the ATO *may* engage external legal services. Where this occurs, and the small business taxpayer is self-represented in the AAT, the ATO will fund equivalent reasonable costs for legal representation.

The Small Business Taxation Division is open to entities carrying on a business in the current financial year with an aggregated turnover of less than $10m. As at July 2019, there were 30 matters before the new division.

Summary

Since 2015-16, all taxpayer disputes are managed and resolved by officers who are independent from the original decision-making area and who report to a separate Second Commissioner. The ATO strives for fair, speedy and efficient resolution of all issues. Approximately two-thirds of objections are resolved within three weeks of being raised.

The three programs outlined in this article are specifically tailored to managing client and community expectations, and making it easier to deal with us.

In-house facilitation drives a cooperative approach between the ATO and taxpayers, allowing resolution of issues without the need to litigate.

Sometimes the issues faced by a taxpayer are issues faced by a large section of the community due to ambiguity in the law. Where this occurs, the test case litigation program allows the ATO to strategically litigate in order to clarify the law while also supporting the taxpayer financially.

The ATO also recognises that small business issues need to be resolved quickly and efficiently, and supports the establishment of the Small Business Taxation Division of the AAT. By not engaging external legal providers except where necessary, and by funding legal representation where this occurs, the ATO is working to ensure that dispute resolution is on a more even playing field.

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An earlier version of this article was presented at The Tax Institute's NSW Tax Disputes Conference held in Sydney on 31 July 2019.

References

1 There are some targeted exceptions to this approach. For example, information may be disclosed if it represents an actual or potential threat to human life or safety.

2 Current members of the panel are: Jeremy Geale, Deputy Commissioner (Chair); Grahame Tanna, Assistant Commissioner (Deputy Chair); the Hon. Kevin Lindgren, QC, former judge of the Federal Court of Australia; Peter Poulos, Partner, Minter Ellison; and Graeme Wade, Consultant, Hamilton Morello Accountants.

3 This is consists of: one hour of legal consultation with an experienced small business tax lawyer to review the facts and provide advice on the viability of the appeal requiring a co-payment of $100 from the small business taxpayer at the time of the consultation and the balance of the cost will be paid by the ASBFEO; and after lodging an application for review with the AAT, the small business taxpayer may benefit from a second complementary hour of advice from an experienced small business tax lawyer.

4 The Small Business Taxation Division commenced on 1 March 2019. The division has been established to provide a cost-effective review process that is accessible to small businesses and tailored to achieve resolution at the earliest opportunity.

Applying Subdiv 207-B and Div 6 to franked distributions

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This article considers the application of Div 6 of the *Income Tax Assessment Act 1936* (Cth) (ITAA36), Div 6E ITAA36 and Subdiv 207-B of the Income Tax Assessment Act 1997 (Cth) in circumstances where a trust receives a franked distribution that is completely extinguished by directly relevant expenses. This article illustrates the level of detailed analysis that must be undertaken when working through these rules, even in simple factual scenarios. The overall result is straightforward in that the beneficiary includes the franking credit gross up in assessable income and is entitled to a franking credit tax offset for the same amount. However, the actual process involved in reaching this conclusion involves reconstructing the trust law, taxable income and present entitlement position under Div 6E, as well as for the adjusted Division 6 percentage. Undertaking a methodical approach may assist practitioners when dealing with these rules in similar factual scenarios.

Introduction

This purpose of this article is to highlight the importance of the relationship between Div 6 of the *Income Tax Assessment Act 1936* (Cth) (ITAA36), Div 6E ITAA36 and Subdiv 207-B of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).[1] This article considers the application of these rules by working through a detailed example where a trust that is in a positive income position receives a franked distribution[2] that is completely extinguished by directly relevant expenses.

Division 207 ITAA97 deals with the effect of receiving franked distributions. Where a franked distribution is made to a member that is a trustee of a trust, an amount equal to the franking credit[3] on the distribution is also included in the member's assessable income.[4] Further, the rules ensure that a tax offset in relation to that distribution is only available to an entity (either the beneficiary or trustee) if the distribution flows indirectly to it and does not flow indirectly through it to another entity.[5] The tax offset is equal to its share of the franking credit on the distribution.

Division 6E then modifies the operation of Div 6 for the purpose of excluding amounts relevant to franked distributions and franking credits from the calculations of assessable amounts to the beneficiary or trustee.[6] In this article, the income and expenses of the trust estate for the income year are as set out in Table 1.

This article is structured by first considering the application of Subdiv 207-B and then working through Div 6 and Div 6E, respectively. The overall result is straightforward in that the beneficiary includes the franking credit gross up in assessable income and is entitled to a franking credit tax offset for the same amount. The actual process involved in reaching this conclusion involves reconstructing the trust law, taxable income and present entitlement position under Div 6E as well as for the adjusted Division 6 percentage. For completeness, this article also briefly touches on the concept of streaming.

Step 1. Calculate gross up for trust and beneficiary

First, if a franked distribution is made in an income year to a trustee of a trust, an amount is included in the assessable income of the trust equal to the amount of the franking credit.[7] The note under s 207-35(2) ITAA97 provides that the amount will affect the income tax liability of the beneficiary or the trustee of the trust[8] under Div 6. In this example, the fully franked dividend received by the trustee of the trust means that a $30 franking credit will be included in the assessable income of the trust.

Section 207-35(3) provides that s 207-35(4) applies (which allocates the gross up to the beneficiary) where a franked distribution is made to the trustee of a trust in an income year and the assessable income of the trust includes an amount referred to as the "franking credit amount" and the distribution flows indirectly to the beneficiary. The final requirement in s 207-35(3)(d) is that the entity has an amount of assessable income for that year that is "attributable to all or a part of the distribution".[9]

The "entity" referred to in this example is the beneficiary and the amount of assessable income attributed refers to the amount of net income of the trust that the beneficiary is presently entitled to.[10] An amount of assessable income

Table 1. Trust income versus net income

Item	Income of the trust estate	Net income s 95 ITAA36
Fully franked dividend	70	70
Franking credit	–	30
Rental income	90	90
Interest expense	(80)	(80)
Rental expenses	(20)	(20)
Net position	60	90

for the relevant income year is attributable where it "plays some part in" the distribution either in whole or in part.[11] Clearly, in this example, the franked distribution played some part in the assessable income inclusion of the beneficiary, notwithstanding that the interest of $80 extinguished the dividend receipt of $70. On the basis that the requirements of s 207-35(3) have been satisfied, the assessable income of the beneficiary for that income year also includes so much of the franking credit amount as is equal to its share of the franking credit on the distribution ($30) and the amount mentioned in s 207-37 ITAA97.[12] The beneficiary's share of the franking credit is its proportionate share of the franked distribution, which in this example is $30.[13]

In this example, s 207-35(5) and (6) do not apply on the basis that the trustee is not liable to be assessed and pay tax in respect of an assessable amount of the trust.[14]

Step 2. Calculate attributable amount of franked distribution

Second, it is necessary to calculate the beneficiary's share of the franked distribution under s 207-37, which is itself a three-step process. Here, the amount of the franked distribution is nil on the basis that the "directly relevant"[15] deductions, in the form of interest expense, completely extinguish the amount of the distribution. The operation of s 207-37(3) is not enlivened (which has the effect of reducing the amount of the franked distribution attributed to the dividend) on the basis that the net income of the trust ($90) does not fall short of the franked distribution (after applying directly relevant deductions).[16] In this example, the amount mentioned in s 207-37 calculated for the purposes of s 207-35(4)(b)(ii) is nil.

Step 3. Allocate franking credit tax offset

An individual beneficiary (ie the ultimate recipient of the distribution) to whom a "franked distribution flows indirectly" is entitled to a tax offset that is equal to its share of the franking credit on the distribution.[17]

Section 207-50(3)(a) ITAA97 provides that a franked distribution flows indirectly to a beneficiary of a trust only if, during the income year, the distribution is made to the trustee of a trust. This element is clearly satisfied in this example. Under s 207-50(3)(b), the beneficiary has a "share amount" equal to the share of the trust's net income for that year under s 97(1)(a) ITAA36. Here, the beneficiary is presently entitled to 100% of the trust income of $60, which means the share of the net income is $90. Finally, the beneficiary's share of the distribution under s 207-55 ITAA97 must be a positive amount (whether or not the beneficiary actually receives any of that share). This "share" of the distribution calculated under step 4 below is 100%.

Step 4. Share of franked distribution

The beneficiary's share of the franked distribution is an amount notionally allocated to the entity as its share of the distribution, whether or not the entity actually receives any of that distribution.[18] This section incorporates the concept of a "focal entity" which, although it is an undefined term, is the entity that ultimately is allocated the franking credit and, depending on the circumstances, can either be the trustee or the beneficiary. Another concept is that of an "intermediate entity", which is also an undefined term but takes its ordinary meaning and, depending on the circumstances, may be another interposed trust(s).

The share of a franked distribution where the trustee of the trust is the intermediate entity and the beneficiary is the focal entity is calculated under item 3 of the table in s 207-55(3). Here, column 1 is satisfied as the franked distribution is made to the trustee[19] and the beneficiary has, in respect of the trust, a share amount mentioned in s 207-50(3).[20] It has already been established under step 4 that the share amount is $90.

Under column 2, the intermediary entity's share of the franked distribution is, if the trust has a positive amount of net income for that year, the amount of the franked distribution, otherwise the amount is nil.[21] In this example, the trust has a positive amount of net income for the year, so the amount of the franked distribution is $70.

The beneficiary's (focal entity's) share of the franked distribution is calculated under s 207-55(4).[22] Here, the beneficiary is not specifically entitled to a share of the franked distribution and therefore no amount is calculated under s 207-55(4)(a). If there is an amount of the franked distribution to which no beneficiary is specifically entitled, the amount is calculated by reference to the beneficiary's "adjusted Division 6 percentage" of the income of the trust for the relevant income year.[23]

> *"The beneficiary's share of the franked distribution is an amount notionally allocated to the entity as its share of the distribution."*

The adjusted Division 6 percentage of an entity that is a beneficiary or trustee of a trust estate means the entity's Division 6 percentage of the income of the trust estate calculated on the assumption that the amount of a capital gain or franked distribution to which any beneficiary or the trustee of the trust estate is specifically entitled was disregarded in working out the income of the trust estate.[24] In this example, no beneficiary is specifically entitled to the dividend and so no amount is disregarded.

The Division 6 percentage for a beneficiary of a trust estate is equal to the share (expressed as a percentage) of the income of the trust estate to which the beneficiary is presently entitled.[24] In this example, the Division 6 percentage for the sole beneficiary is 100% (ie the beneficiary is presently entitled to the income of the trust estate of $60). Here, due to the operation of item 3 of column 2 in the table in s 207-55(3), there is a positive amount of franked distribution[25] and as such, the beneficiary's share of the franked distribution is 100%.

At this point, it is important to bear in mind that the beneficiary will not actually receive this share of the franked distribution as it has been extinguished by expenses, but should still be entitled to franking credit tax offset as all the elements in s 207-45 ITAA97 have been satisfied.

Step 5. Application of Div 6E

This next step requires consideration of Div 6, Div 6E and Subdiv 207-B.[26] Division 6E modifies the operation of Div 6 for the purpose of excluding amounts relevant to franked distributions and franking credits from the calculations of assessable amounts to the beneficiary or trustee.[27] Division 6E does not modify the operation of Div 6 for any other purpose.

In this example, the "income of the trust estate" for trust law purposes is $60. The net income of the trust is $90.[28] The sole beneficiary is presently entitled to all of the income of the trust estate. However, as the trust has received a franked distribution and is in a positive net income position, it is necessary to make certain adjustments in accordance with Div 6E.[29]

Division 6E income

The first assumption is that the income of the trust estate was equal to the Div 6E income of the trust estate.[30] The Div 6E income of the trust estate is worked out on the assumption that amounts attributable to the things mentioned in s 102UW(b) ITAA36 were disregarded.[31] In this example, the "things" are the franking credits on the basis that they are taken into account in working out the net income of the trust estate.[32] It may seem odd at first glance that the franked distribution is not considered to have been taken into account in working out the net income of the trust estate (this is because the franked distribution has been completely extinguished by the deductions directly relevant to it).[33] However, if this were not the case, an anomaly would arise in that Div 6E net income would be $70 ($90 less $20) which results in $10 ($70 less $60) being assessed to the trustee under s 99A ITAA36 on the basis that no beneficiary is presently entitled to that amount. Therefore, only an adjustment is made for the franking credits and not the franked distribution.

The Div 6E income is calculated as follows:

Item	Division 6E income
Fully franked dividend	70
Franking credit	–
Rental income	90
Interest expense	(80)
Rental expenses	(20)
Net position	60

Division 6E net income

The second assumption is that the net income of the trust estate was equal to the Div 6E income of the trust estate.[34] The Div 6E net income of the trust estate is worked out on the assumption that amounts attributable to the things mentioned in s 102UW(b) were disregarded.[35] In this example, the franking credits are excluded from the calculation of Div 6E net income.[36]

The Div 6E net income is calculated as follows:

Item	Division 6E income
Fully franked dividend	70
Franking credit	–
Rental income	90
Interest expense	(80)
Rental expenses	(20)
Net position	60

Division 6E present entitlement

The third assumption is that the amount of a present entitlement of a beneficiary of the trust estate to the income of the trust estate was equal to the amount of the beneficiary's Div 6E present entitlement to the income of the trust estate.[37] The beneficiary's assessable amount under s 97 ITAA36 is adjusted by the operation of Div 6E, based on the amount calculated under s 102UY(4) ITAA36, which states that:

> "A beneficiary of the trust estate has an amount of a Division 6E present entitlement to the income of the trust estate that is equal to the amount of the beneficiary's present entitlement to the income of the trust estate, decreased by:
>
> (a) …
>
> (b) for each franked distribution taken into account as mentioned in paragraph 102UW(b)--so much of the beneficiary's share of the franked distribution as was included in the income of the trust estate."

In this example, the Div 6E present entitlement is simply $60 as no adjustment is required under s 102UY(4)(b).

Streaming

Streaming of a franked distribution is possible under s 207-58(1) ITAA97 where a beneficiary of a trust estate is specifically entitled to an amount of a franked distribution made to the trust estate in an income year. The amount is calculated by reference to the following formula:

Franked distribution x Share of net financial benefit/net financial benefit

In this example, the franked distribution is $70. The concept of "net financial benefit" means an amount equal to the financial benefit[38] that is referable to the franked distribution. Importantly, this is after application by the trustee of expenses that are directly relevant to the franked distribution.[39] Here, the financial benefit of $70 is reduced to nil by the interest expense that is "directly relevant" to it. It follows then that, as the denominator in this formula is nil, streaming of the franked distribution is not possible to a particular beneficiary.

Conclusion

This article deals with a simple fact pattern that highlights the relationship and reconstruction process associated with the application of Subdiv 207-B, Div 6 and Div 6E. Ultimately, the focus is on fixing the tax position of the beneficiary with respect to the franked distribution and associated franking credits. The overall result is that the beneficiary includes $60 in their assessable income.[40] The beneficiary is required to include a gross up of $30.[41] The beneficiary is not required to include any amount related to the franked distribution in assessable income because the directly relevant deductions, in the form of interest expense, completely extinguish the amount to nil.[42] The individual beneficiary is entitled to a tax offset of $30 that is equal to its share of the franking credit on the distribution.[43] In this example, the trustee is not liable for tax on the income that forms part of the trust estate for the income year.

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References

1 Refer to s 95AAA ITAA36 which sets out a simplified outline of the relationship between the rules.

2 A franked distribution is defined in s 995-1 ITAA97 to mean a distribution that is franked by an entity in accordance with s 202-5 ITAA97.

3 It was held in *FCT v Thomas* [2018] HCA 31 at [97] that franking credits exist neither in nature nor under the general law. Franking credits have no existence other than through the operation of a taxing statute, specifically Div 207 ITAA97.

4 S 207-5(3) ITAA97.

5 S 207-5(4) ITAA97.

6 Under s 97, 98, 99, 99A or 100 ITAA36.

7 S 207-35(1) ITAA97.

8 Herein, this article only considers the situation where the beneficiary receives the benefit of the franking credit and not the trustee of the trust.

9 On the assumption that Div 6E ITAA36 is disregarded.

10 S 97 ITAA36.

11 *Thomas v FCT* [2015] FCA 968 at [124].

12 Div 6E ITAA36 must be disregarding by virtue of s 207-35(3)(d) ITAA97.

13 Worked out in accordance with the formula in s 207-57(2) ITAA97.

14 Under s 98, 99 or 99A ITAA36.

15 Para 2.53 of the explanatory memorandum to the Tax Laws Amendment (2011 Measures No. 5) Bill 2011 states that: “Directly relevant expenses could include any annual borrowing expenses (such as interest) incurred in respect of the underlying shares (allocated rateably against any franked and unfranked dividends from those shares) or management fees incurred in respect of managing an investment portfolio of shares for the purpose of deriving dividend income (allocated against dividend income as relevant)”.

16 That is, s 207-37(2) ITAA97 is not satisfied, which means that s 207-37(3) does not apply.

17 S 207-45(a) ITAA97.

18 S 207-55(2) ITAA97.

19 Item 3(a), column 1, s 207-55(3) ITAA97.

20 Item 3(b), column 1, s 207-55(3) ITAA97.

21 Item 3(a) and (b), column 2, s 207-55(3) ITAA97.

22 For the purposes of item 3, column 3, s 207-55(3) ITAA97.

23 S 207-55(4)(b)(i) ITAA97.

24 S 95 ITAA36.

25 This is so notwithstanding the fact that the franked distribution has been extinguished by the interest expense.

26 S 95AAA ITAA36.

27 Under s 97, 98, 99, 99A or 100 ITAA36.

28 This is the position calculated under s 95 ITAA36 before the application of Div 6E ITAA36.

29 S 102UX(2) ITAA36.

30 S 102UY(2) ITAA36.

31 Also note that the Div 6E income of the trust estate cannot be less than nil.

32 S 102UW(2)(iii) ITAA36.

33 S 102UW(2)(ii) ITAA36.

34 S 102UX(3) ITAA36.

35 The Div 6E net income of the trust estate cannot be less than nil.

36 S 102UW(2)(iii) ITAA36.

37 S 102UX(4) ITAA36.

38 A financial benefit is defined under s 974-160(1) ITAA97 to include anything of economic value. Section 974-160(2) provides that, when applying s 974-160(1), benefits and obligations are to be looked at separately and not set off against each other.

39 S 207-58(1) ITAA97.

40 S 97 ITAA36.

41 Ss 207-35 and 207-55 ITAA97.

42 S 207-37(1) ITAA97.

43 S 207-45(a) ITAA97.

Superannuation

by Daniel Butler, CTA, DBA Lawyers

SMSFs investing via unit trusts

A unit trust is a popular structure to hold property and other investments. This article examines numerous methods of how an SMSF may invest in a unit trust.

Multiple unitholders

Many publicly offered managed investment funds are structured as a unit trust to allow multiple investors to invest in a diversified investment portfolio. Typically, the units in the trust reflect each investor's proportionate equity or interest in the trust. The concept of owning a unit in a unit trust is a similar but different concept to owning a share in a company.

While a self-managed superannuation fund (SMSF) investing in a larger unit trust may not have any influence on the trustee or have much opportunity to have any change to the unit trust documents, the author's firm has acted for numerous SMSFs over the years where changes have been negotiated to reduce regulatory or legal risk.

Closely held unit trusts

On a smaller scale, unit trusts are also popular for SMSFs to invest in, especially to acquire real estate. One or more SMSFs and/or other investors can combine their finances to acquire an investment property via a unit trust structure. In some cases, this may allow each investor access to a better property with considerably more upside potential compared to investing alone.

In particular, an SMSF may only want to hold a proportionate interest in a unit trust to minimise risk. There may be one or more related or other investors that also participate in the same unit trust. Each investor invests in units which, in turn, is used to finance the unit trust's acquisition of property.

However, an SMSF has to be very careful to ensure that it complies with the raft of superannuation rules before investing in a unit trust. Moreover, the quality of the unit trust deed and constitution of the corporate trustee are important to an SMSF's complying status.

Related unit trusts

An SMSF is restricted to investing no more than 5% of the market value of the SMSF's assets in "in-house assets" (IHAs). The *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA) specifies that IHAs includes an investment in a related trust of the SMSF.

A "related party" is broadly defined and includes an SMSF member, a standard employer-sponsor of the SMSF, the member's relatives, a partner in a partnership, and a company or trust that is controlled or significantly influenced by an SMSF member and his or her associates.

A related trust includes a unit trust where an SMSF member, a standard employer-sponsor or his or her associates hold more than 50% equity in the unit trust, exercise significant influence in relation to the trust, or can remove or appoint the trustee.

Therefore, an SMSF with $1,000,000 of assets could not, subject to s 66 SISA, invest more than $50,000 (ie 5%) in IHAs (including any related trust). Such a unit trust could invest in a real estate property where the remaining units were held by others, including related parties such as family members, relatives or a related family discretionary trust.

This may not be attractive to an SMSF where it's likely the 5% limit will be exceeded. For instance, if an SMSF invested more than 5%, this would contravene the SISA and significant penalties could be imposed on an SMSF by the ATO.

Accordingly, to ensure that this test is met, it is necessary to identify which assets are considered to be IHAs and then determine the market value of all assets to ensure the 5% limit is not exceeded. The acquisition of a new IHA where the fund is already at the 5% limit is an immediate contravention. Additionally, where the fund is not over the 5% limit, the acquisition of an IHA that would itself cause the fund to exceed the 5% limit is also an immediate contravention.

There is, however, a possible exception (discussed below) involving non-geared unit trusts (NGUTs) that allows an SMSF to invest in a related unit trust.

Non-geared unit trust

A related unit trust (often referred to as an NGUT) allows for one or more related investors to come together to invest in property. An NGUT allows an SMSF to hold up to 100% of the units issued in that "related" unit trust. This is permitted provided the unit trust complies with the strict criteria in the *Superannuation Industry (Supervision) Regulations 1994* (Cth) (SISR) and continues to comply with that strict criteria on an ongoing basis. Failure to comply can result in the units becoming IHAs.

As discussed above, an SMSF cannot hold IHAs that exceed more than 5% of the value of the fund's assets and may therefore need to dispose of the asset causing the SMSF to exceed this limit. Such a disposal could give rise to substantial transaction costs.

Broadly, an NGUT may be a suitable structure for holding real estate with no borrowings secured on the title to that property and to overcome the IHA prohibition. This is because the strict criteria in the SISR requires that the trust must, among other things, not:

– have any borrowings or charges (eg a mortgage) on the trust's assets;
– lease any property to a related party apart from business real property;

– invest in any other entity (eg the trust must not own shares in a company); or
– conduct a business such as property development.

An SMSF may also be permitted to acquire further units in an NGUT from a related party without infringing s 66 provided certain criteria is satisfied.

There may also be stamp duty savings on the transfer of units if the value of the property owned by the unit trust falls below the landholder threshold of the relevant state or territory (eg $2m in NSW and $1m in Victoria). However, care needs to be taken to ensure that the unit trust continuously complies with the SISR. Units in an NGUT can readily become an IHA if the strict SISR criteria is not complied with.

Unrelated unit trust

If an SMSF invests in a unit trust that is not a related trust, the SMSF is not limited in how much of the fund's assets could be invested in such a trust.

For example, an SMSF with $1,000,000 of assets could acquire a 35% unitholding in an unrelated trust; investing the entire $1,000,000 in that unit trust as the trust is not a related party. (The SMSF's investment strategy must still allow for cash flow and liquidity and may therefore hold some of its assets in cash or deposits to pay for ongoing costs of pension payments etc.) Under this scenario, the SMSF would not have control nor significant influence in respect of the unit trust and therefore the 5% IHA limit should not apply.

It may also be possible to structure an investment in property that involves two unrelated SMSFs (where each family is not related nor in a close business relationship such as a partnership etc) so that each SMSF holds exactly 50% of the units. The ATO has confirmed that a 50%/50% unitholding arrangement would not, by itself, give rise to a related trust relationship.

It should be noted, however, that the ATO has broad powers and, unless this type of 50%/50% arrangement is carefully implemented and documented, it could result in a contravention of the SISA, with significant penalties. The constitution of the corporate trustee may, for example, provide a casting vote to a chairperson that can give rise to a related trust relationship. For this reason, it is generally much safer to have, for example, three unrelated SMSFs undertaking such an investment with, say, 33.3% of units each.

Thus, where, say, two or more unrelated investors wish to combine their investments in a common structure such as a unit trust, this could provide a suitable structure for aggregating such investments between two or more SMSFs that are not "grouped" together under the IHA rules.

One example may be three SMSFs with $333,334, each combining together to invest in a unit trust to acquire a $1,000,000 investment property.

Tax treatment

Unit trusts are generally not subject to tax provided the trustee of the relevant unit trust distributes all its net income (including any net capital gain) prior to 30 June each financial year. Trusts, therefore, are often referred to as flow through structures.

To the extent that a trustee of a unit trust fails to distribute its net income prior to the end of a financial year, the trustee of the unit trust will generally be taxed at the top personal marginal tax rate (currently, in FY2020, 45% plus applicable levies).

When setting up a unit trust that SMSFs propose to invest in, it is important to select a unit trust that will qualify as a "fixed trust". Broadly, a fixed unit trust has less compliance issues compared to a non-fixed unit trust which may be required to consider, among other things, a family trust election or interposed entity election.

The unit trust deed should also cover a range of other matters that regulate what happens on the admission or departure of a unitholder and how disputes are to be resolved between the parties. A very important point to note here is that unitholders can be exposed and liable for the liabilities of the unit trust, including any damages or losses incurred by the trustee. Carefully drafted limitation of liability provisions are required to ensure that unitholders, including any SMSFs, are not placed at risk from obtaining inferior documents. It is also recommended that a suitable buy-sell agreement should be considered where there is more than one unitholder, even if that unitholder is a related party, to ensure that the parties are dealing at arm's length.

The stamp duty implications of transferring, issuing and redeeming units in each relevant state or territory also need to be carefully managed. The author is also aware of numerous unit trusts that have been set up that have incurred considerable extra stamp duty on the acquisition of property as the unit trusts had not been set up before the purchase or a change in unitholders occurred after the purchase contract had been executed.

Conclusion

Unit trusts are a popular structure for SMSFs to invest in. It is important that the various rules are clearly understood to ensure that each investment by an SMSF in a unit trust is compliant and effective. Moreover, there are considerable legal and related risks, including the tax effectiveness of the trust and stamp duty costs, that need to be carefully managed.

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Tax Cases

by Michael Norbury, CTA, Norbury Lawyers

Subjective intention and land tax

In a case involving Victorian land, was the subjective intention of the share farmer and the owner of the land to be considered?

CDPV Pty Ltd v Commissioner of State Revenue[1] considered the application of the Victorian primary production exemption to land located in the outskirts of Melbourne. In *CDPV*, the evidence of the taxpayer was equivocal, and the decision is an example of the court assessing less than ideal evidence. More importantly, *CDPV* is an example of the court using subjective evidence of the parties' intention, rather than limiting itself to objective evidence.

Facts

The taxpayer and related persons purchased approximately 167 acres of land at Plumpton, Victoria, in 1995. The land was covered with rocks. The taxpayer engaged a contractor to clear some of the rocks. In 1997, a dam was built but it did not fill owing to a drought.

In 2004, there was a change in the ownership of the land, but the taxpayer remained one of the proprietors. At that time, the land was still covered in rocks and it was infested with weeds.[2]

By 2009, the value of the land had risen substantially (it being on the outskirts of suburban Melbourne).

An exemption from paying land tax was sought on the basis that the land had always been used for primary production purposes, including growing wheat and lettuce and grazing cattle.

For the years 2009 to 2012, the Commissioner exempted the land from land tax on the basis that it was used primarily for primary production.[3] Subsequently, in late November 2013 as a result of an investigation, the Commissioner issued reassessments in respect of the land for the years 2009 to 2012, denying the availability of the primary production exemption. The taxpayer objected on the basis that the land was used for primary production.[4]

The Commissioner disallowed the objections. The taxpayer then requested that his objection be treated as an appeal to the Supreme Court.[5] Subsequently, the matter was considered by the Victorian Court of Appeal.

The law

Section 66 of the *Land Tax Act 2005* (Vic) (LTA) provides:

> "**Exemption of primary production land in greater Melbourne but not in an urban zone**
>
> Land is exempt land if the Commissioner determines that the land comprises one parcel —
>
> (a) that is wholly or partly in greater Melbourne; and
>
> (b) none of which is within an urban zone; and
>
> (c) that is used primarily for primary production."

The land was in greater Melbourne, but not in an urban zone. The appeal considered s 66(c) LTA.

The expression "primary production" was defined in s 64(1) LTA to mean:

> "(a) cultivation for the purpose of selling the produce of cultivation (whether in a natural, processed or converted state);"

Section 68 LTA provided:

> "**Exemption of land being prepared for use for primary production**
>
> (1) Land is exempt land for a land tax year if the Commissioner is satisfied that—
>
> (a) the land is being prepared for use primarily for primary production; and
>
> (b) the land will become exempt land under section 65, 66 or 67 within 12 months after the day on which the preparation referred to in paragraph (a) commenced.
>
> (2) The Commissioner may extend the period referred to in subsection (1)(b) by a further period of 12 months."

Findings of the trial judge as to use of land

The trial judge found the evidence of the taxpayer as to the use of the land inconsistent.

There was evidence of a share-farming agreement, but the documents as provided did not evidence "in any unequivocal way" the alleged oral crop share-farming agreement. They were said to evidence that wheat (and only wheat) was grown on the land, but that was contrary to the evidence of the share farmer. He gave evidence that barley was also grown. Invoices for fertiliser and weed control did not support the taxpayer's case, given that the share farmer gave evidence that he bore the costs of those expenses.

The trial judge held that the documentary evidence must have related to land other than the subject land, and that the evidence thus put before the Commissioner was "entirely misleading". The taxpayer had also misled the Commissioner as to whether primary production was taking place on the land in earlier years. The trial judge concluded that the evidence adduced by the taxpayer had to be viewed with "great caution".[6]

The trial judge observed that the evidence of a director of the taxpayer did not support his affidavit, which indicated that little weight ought to be placed on that affidavit. The evidence showed that "[the director] had little, if any, interest in what the share farmer was doing on the land". His evidence in cross-examination did not provide any basis on which it could be concluded that the terms of the purported oral crop share-farming agreement were settled between the parties. His evidence as to what happened to the arrangement when a contractor later became involved in weed management on the land was contradicted by the share farmer's evidence.[7]

The share farmer's evidence was also found to be unsatisfactory. It was not consistent with that of the director in relation to the alleged crop share-farming agreement. The judge held:[8]

> "… the proper conclusion is, in my view, that [the director] did not have any real idea what [the share farmer] was doing on the land and that there was nothing in the nature of concluded terms in any share farming agreement — if indeed any agreement of this nature was actually contemplated by the alleged parties at any relevant time."

The judge noted that the share farmer had said in cross-examination that keeping the land clear of weeds assisted him as the land would not adversely affect other nearby land that he farmed. This showed that his purpose in cultivating the land was to avoid the weeds affecting nearby land, with a possible "side benefit" of selling seed or using it for re-sowing on the land or other land that he farmed.[9]

The judge also noted the evidence of a council officer to the effect that cultivation of land is an accepted means of weed control.[10]

Ultimately, the trial judge concluded that the taxpayer had not discharged its burden of proving that s 66 applied so as to exempt the land from liability to land tax. The trial judge found that the evidence was unsatisfactory and had to be approached "with a high degree of caution". He held that the inability of the taxpayer's witnesses to give evidence as to the critical terms of the share-farming agreement meant that the assertion of that arrangement had to be rejected. The evidence was vague, self-serving and inconsistent. It showed that, at best, the cultivation of the land for the purpose of selling the produce of cultivation was a "side benefit" rather than the primary purpose. The judge concluded:[11]

> "Viewing all this evidence together, I am of the view that it cannot be said that the Land was used primarily for cultivation for the purpose of selling the produce of cultivation. At best, that was something in the nature of a side benefit. Rather, it was most advantageous for the [taxpayer] to allow [the share farmer] to use the Land for whatever cultivation purpose he chose, as long as the effect was to control weeds and otherwise generally maintain the Land. The share farmer's purpose, insofar as it might be relevant to the operation of these provisions of the Act, was also primarily to control weeds and to avoid the 'bad neighbour' problem, and if, as a side benefit, he obtained some seed for re-sowing on the Land or for sowing on other properties he was farming or made some money from the sale of seed from time to time, then he was content. The share farmer's purpose was not to use the Land primarily for cultivation for the purpose of selling the produce of cultivation."

The judge also concluded that the taxpayer "[was] seeking to do the minimum thought necessary on the Land to maintain an exemption from land tax pending its development".[12]

The primary judge found that the s 68 claim failed, as the evidence did not support there having been any relevant preparatory work. The taxpayer pointed to the construction of the dam, but that had occurred many years earlier and could not properly be regarded as preparatory work.[13]

Proposed grounds of appeal

The taxpayer had two grounds of appeal:

1. the judge erred in looking to the subjective intentions of the director (and therefore the taxpayer) and the share farmer, rather than identifying the purpose of the use of the land on an objective basis. Properly applied, the statutory test was satisfied on all of the evidence; or
2. it would suffice if it could be shown that the land had been ventured in a broader commercial farming operation for the purpose of the sale of the produce of cultivation as part of that operation.[14]

The taxpayer contended that the purpose to which reference is made in the definition of "primary production" was the purpose of the use in question, namely, the cultivation of the land. That, it was submitted, was an objective purpose which was to be determined by reference to what was actually done on the land, rather than according to the subjective intentions or motivations of those responsible. The judge had therefore erred in taking account of the subjective intentions of the director and the share farmer. The objective evidence demonstrated that the purpose of cultivation of the land was not to control weeds, but to grow a crop for sale. The fact that there had been no such sale was not decisive, as the evidence showed that environmental factors had conspired to make the crops unsuccessful. Nor did it matter that the details of the profit-sharing arrangement had not been worked out in detail in advance. The arrangement was an informal one between farmers who trusted each other to do the right thing when the time came to account for and divide the proceeds of sale.[15]

Analysis

The Court of Appeal held that the issue for decision by the trial judge was whether, in each of the years in question, the land was used primarily for cultivation for the purpose of selling the produce of cultivation. The onus was on the taxpayer to establish that fact. The relevant time for asking the question was at midnight on 31 December 2008, 2009, 2010 and 2011, taking account of events and circumstances "during a period not overlong and not over short" either side of that point in time.[16]

Following analysis of *Chief Commissioner of State Revenue (NSW) v Metricon Qld Pty Ltd*,[17] the Commissioner submitted that it was the use to which the share farmer put the land that was decisive. Although no lease was suggested, at the minimum, there must have been a licence permitting him to cultivate the land. It was not necessary to consider any different use to which the taxpayer put the land. However, that did not render the purpose of the taxpayer irrelevant. The objection that had been made alleged a share-farming enterprise and the purposes of both parties to the alleged arrangement were relevant to determining whether it existed and what its terms were.[18]

The Court of Appeal found no foundation in the text of the statute or the authorities for the taxpayer's contention that "purpose" was to be determined without reference to the subjective intentions of the person whose use of the land was in issue. The taxpayer contended that, once there is objective evidence that land was cultivated, that fact was sufficient objectively to establish the requisite purpose.

The Court of Appeal found that that submission entirely overlooked the specific statutory requirement of purpose. Cultivation may be undertaken for different purposes, including to grow crops for sale, to grow crops in order to obtain seed for re-sowing, to produce other agricultural inputs such as feed for animals, or to prevent weeds from growing. The legislation provided for an exemption only where the purpose of the cultivation was "selling the produce of cultivation". There was therefore a distinct inquiry to be made as to the purpose of the cultivation. The taxpayer's submission reduced the requirements into a single question, namely, whether cultivation took place.[19]

The Court of Appeal noted that this case was unusual in that the purpose of cultivation was not as self-evident as might normally be the case. However, the authorities made it clear that the question of whether land is "used" primarily for primary production was to be determined by "looking at all the activities together with the surrounding circumstances of [the taxpayer's] evident purpose in carrying out those activities".[20] By parity of reasoning with cases concerned with the carrying on of a business, the test was "subjective and objective: it is made by regarding the nature and extent of the activities under review, as well as the purpose of the individual engaging in them".

Similarly, the question of "purpose" in para (a) of the definition of "primary production", which looked to the purpose of the use itself, directed attention both to the activities constituting the use and to the purpose of the person or persons engaging in that use. The two inquiries were therefore closely related. Each remained objective in the sense that all surrounding circumstances must be taken into account. But, contrary to the taxpayer's submission, those circumstances may include the subjective intention of the person or persons engaging in the use of the land.[21]

Proof of the required purpose depended on the facts in any given case. The inquiry was about the purpose of the use of the land (here, its cultivation). The activities constituting the use will be critical to the task of identifying that purpose because inferences may be drawn from those activities as to the purpose for which they were undertaken. Other actions of those who engage in those activities will also be important, including, for example, what they ultimately do with the produce of cultivation.

Evidence of arrangements and transactions relevant to the use of the land may also bear on the purpose of that use. There was no reason, consistently with the approach identified in *Metricon*, why evidence of the subjective intentions of the person or persons engaging in the use of the land should not also be taken into account. Without of course being determinative, such persons are after all well placed to explain the purpose for which the land was used (or, relevantly, cultivated). Such evidence was not determinative because it must be evaluated along with the other evidence as part of the objective evaluation of the purpose of the use to which the land was put.[22]

In this case, the judge was not satisfied that the taxpayer had established the requisite purpose. The inherent likelihood that a person who grows a crop will sell it if possible did not necessarily establish that the primary use of the land was growing a crop for that purpose. The prospect of sale may be merely incidental to a different purpose, so that the land was properly characterised as being used primarily for cultivation for that other purpose. Here, the taxpayer sought to establish that sale was the purpose of the cultivation by relying on a share-farming agreement. The judge was entitled not to accept the evidence regarding the alleged share-farming arrangement, given the inability to explain the basis on which the profits would be determined. He was also entitled to treat the taxpayer's claims with caution as a result of the inconsistencies in the evidence and the false claims that had been made in pursuit of the exemption in previous years.

The Court of Appeal found that it was open to the judge to find that the share farmer's purpose in cultivating the land was to ensure that weeds from the land did not invade the neighbouring land that he was farming, and that, if he derived any crops, or seed, from his efforts, that would be a side benefit. The share farmer himself described his motivation in terms consistent with those findings. Acceptance of that evidence, together with rejection of the evidence as to the share-farming arrangement, sufficed to conclude that the taxpayer had not established that the purpose of the cultivation was to sell the produce.[23]

Moreover, the remainder of the evidence suggested that the control of weeds was the share farmer's position at all relevant times; he saw his function as "land management". The court found the evidence that the share farmer and the director seriously contemplated that there would be profits arising from selling produce grown on the land sparse and unconvincing. The evidence revealed so little attention to the prospect of deriving any profit that the judge was right to conclude that it had not been shown that the purpose of cultivating the land was to sell the produce. It was also significant that the share farmer in his statutory declaration made no reference to a profit-sharing arrangement at all but stated that he and the director discussed the share farmer alone retaining the benefit of the harvested crops.

Further, the evidence strongly suggested that the director's purpose in permitting the share farmer to farm the land was to manage the land so as to control the weeds. In practice, the crops that were grown during the years of assessment were not sold but were used by the share farmer, without payment to the taxpayer, as agricultural inputs on other farms. The overall impression left was that the prospect of sale of the crops was, for both men, at best one possible outcome of the cultivation, rather than its purpose. As such, the primary use of the land was not cultivation for the requisite purpose.[24]

The appeal was dismissed.[25]

Comment

The Victorian Court of Appeal approved of the trial judge's use of subjective intention as part of the process of determining the purpose of the cultivation which was said to constitute primary production. It may be that there would have been a different result if only objective evidence of purpose had been considered.

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Alternative Assets Insights

by Stuart Landsberg, FTI, PwC

ATO views on cross-border debt issues

The ATO has released final guidance on aspects of cross-border financing. The results may be surprising for taxpayers and their advisers.

The Australian Taxation Office continues to finalise its guidance on aspects of cross-border financing. However, for many taxpayers, this latest guidance may raise more questions than it answers.

The ATO has recently released the following tax determinations that deal with aspects of cross-border financing:

- TD 2019/10: Income tax: can the debt and equity rules in Division 974 of the *Income Tax Assessment Act 1997* limit the operation of the transfer pricing rules in Subdivision 815-B of the *Income Tax Assessment Act 1997*?; and
- TD 2019/12: Income tax: what type of costs are debt deductions within scope of subparagraph 820-40(1)(a)(iii) of the *Income Tax Assessment Act 1997*?

The cumulative effect of the two determinations is that taxpayers with cross-border related-party financing should carefully consider their thin capitalisation position and the debt equity treatment of their capital structure.

Interaction of debt equity rules and transfer pricing rules

The finalised TD 2019/10 (incorporating both an erratum and an addendum) is broadly unchanged from the draft determination, with the explanation for the lack of changes set out in a compendium that is available on the ATO's website.

The compendium itself is a useful reference guide for taxpayers and advisers to better understand the technical thinking underpinning the technical outcomes contained in the final determination.

The lack of changes from the draft determination mean that many of the issues previously raised by taxpayers continue to be relevant, including an arguable lack of clarity as to:

- how to identify the "arm's length conditions" for the purposes of Subdiv 815-B of the *Income Tax Assessment Act 1997* (Cth) (ITAA97), particularly as they relate to the debt-equity rules;
- when transfer pricing adjustments which alter the debt-equity classification of an instrument can occur under s 815-115 ITAA97 versus where those adjustments amount to a reconstruction under s 815-130 ITAA97; and
- other interactions arising from the transfer pricing provisions altering the debt-equity classification of instruments which continue to be areas of uncertainty for taxpayers and advisers.

These uncertainties result from the necessarily narrow scope of a tax determination. One hopes that these uncertainties can be resolved by further, more complete, guidance from the ATO — potentially in the form of a tax ruling. However, the ATO's "advice under development" webpage does not currently indicate that such advice is forthcoming.

An interesting change from the draft determination to the final determination relates to a change that was made to example 2 of the determination. This change was also the subject of the addendum (issued on 24 July 2019).

Essentially, example 2 related to an inbound discretionary interest loan. The draft determination stated that "on its terms" the loan "would satisfy the equity test" and "[a]ny interest paid … would constitute a non-share dividend and may be subject to dividend withholding tax".

The draft determination considered that the arm's length conditions would result in an interest-bearing loan that would be a debt interest for tax purposes and therefore that:

> "Australian Company therefore gets a transfer pricing benefit equal to the full amount of the interest withholding tax that would be payable had the arm's length conditions operated."

Finally, the draft determination commented that:

> "To the extent Australian Company would have received an allowable deduction for interest it is taken to have paid under arm's length conditions, the Commissioner may make a determination to adjust Australian Company's taxable income or loss, provided the relevant conditions are satisfied."

Essentially, the draft determination made three propositions in respect of this example:

1. that dividend withholding tax may have applied based on the actual conditions (ie dividend withholding tax may have been paid);
2. that s 815-115 would operate so that there is a transfer pricing benefit equal to the amount of interest withholding tax that would have been payable under the purported arm's length conditions; and
3. that the Commissioner may make a consequential adjustment under s 815-145 to allow for an interest deduction that would be available based on the purported arm's length conditions.

If the determination's conclusion that the substitution of actual arm's length conditions should result in the reclassification of the instrument is correct, the second and third propositions are seemingly uncontroversial.

However, this does represent a change in approach for the ATO, as earlier guidance in TR 2007/1 (albeit dealing with the former transfer pricing provisions in Div 13 of Pt III of the *Income Tax Assessment Act 1936* (Cth) rather than Subdiv 815-B ITAA97) suggested that it would not ordinarily be appropriate to make a transfer pricing adjustment for interest-free loans to resident entities (perhaps the existence of discretionary interest under the actual terms of the instrument are the justification to depart from this guidance, or perhaps the change in approach is simply justified by the change in applicable legislation).

The first proposition could be of some concern for taxpayers, as the operation of s 815-145 does not appear to extend to provide for a consequential adjustment where dividend withholding tax had erroneously been paid (this is confirmed in item 12 of the ATO's compendium). That is, in these circumstances, the dividend withholding tax that has been remitted and paid would not potentially be repaid.

The compendium does note that "the Commissioner will consider if the dividend withholding tax can be refunded in these circumstances", and it is possible, if the lender was resident in a treaty jurisdiction, that the double tax agreement may offer some relief in these circumstances. However, the initial (ie the pre-addendum) final determination significantly changed example 2 by the addition of an extra sentence:

> "Australian Company uses the funds in its offshore permanent establishment which returns income that is non-assessable, non-exempt income in accordance with section 23AH of the ITAA 1936."

The rest of the example continued generally unchanged except the following paragraph was deleted:

> "To the extent Australian Company would have received an allowable deduction for interest it is taken to have paid under arm's length conditions, the Commissioner may make a determination to adjust Australian Company's taxable income or loss, provided the relevant conditions are satisfied."

That is, the final determination does not consider the potential application of the consequential adjustment provisions at all. The compendium to the determination suggests that this was a deliberate decision, with item 11 stating that:

> "Whether the payer is entitled to a consequential adjustment to its taxable income or tax loss of a particular sort is subject to the operation of section 815-145, which is beyond the scope of the Determination."

One can assume that the change of facts (ie the suggestion that the funds were used in an offshore permanent establishment) from draft determination to final determination was designed to give another reason for there being no consequential adjustment. That is, if the funds were used in an offshore permanent establishment, interest paid would likely not be able to be claimed as a deduction because of its nexus with the production of non-assessable non-exempt income.

However, another consequence of the funds being used in an offshore permanent establishment is that any interest paid should not be subject to interest withholding tax — and therefore Subdiv 815-B should not be able to impute interest on the loan as there would not, prima facie, be any transfer pricing benefit.

The change in facts did not just mean that the example was less useful to the taxpaying community (on the assumption that the population of taxpayers who have borrowed to fund an offshore permanent establishment is smaller than the population who have borrowed to use the funds in their Australian business), but the change in facts also arguably meant that the determination was technically incorrect.

Fortunately, the ATO quickly realised this consequence and amended the determination to remove the offending paragraph suggesting that the funds were used in a permanent establishment. This was a commendably quick response to feedback to improve the quality of technical guidance.

Unfortunately, the addendum did not reinstate the paragraph, suggesting that a consequential adjustment would likely be available. This means that the Commissioner now provides no guidance at all on consequential adjustments in the final determination. Given that, as set out in the compendium, this appears to have been a deliberate narrowing of the scope of the guidance from draft to final, one hopes that it is because further guidance on the application of the consequential adjustment provisions within Div 815 is forthcoming.

The final determination makes it clear that the ATO will seek to apply the transfer pricing provisions to adjust the conditions of financing arrangements, and that these adjustments can result in a change in debt-equity classifications. This is an area of considerable uncertainty for taxpayers and the impact of tax on their Australian businesses. The result of this ATO focus is that taxpayers and advisers will need to ensure that their transfer pricing analysis supports the arm's length nature of all material conditions of cross-border related-party financing, and not just consider the price of the relevant instrument.

Meaning of debt deduction for thin capitalisation purposes

Final tax determination TD 2019/12 intends to define the meaning of debt deduction for thin capitalisation purposes.

The classification of a cost as a debt deduction is important for at least two key reasons:

1. amounts which are debt deductions may be denied a deduction where an entity breaches thin capitalisation limits; and
2. an entity must include in its adjusted average debt (an integer in the thin capitalisation calculations) all of its debt capital that gives rise to debt deductions.

Based on its first paragraph, TD 2019/12 seems to be principally concerned with the second outcome set out above. That is, the ATO appears to be focused on ensuring that debt capital is included in an entity's adjusted average debt in circumstances where it might not otherwise have been (for example, because no dividends have yet been paid on mandatorily redeemable preference shares as per the example in the determination).

The key information contained in the draft determination (beyond what is available either in the legislation or the explanatory memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001) was the ATO's view that "tax advisory costs incurred in relation to the debt capital, which relate to activities including, but not limited to, agreement drafting and valuation of the debt capital" could be debt deductions for thin capitalisation purposes. All of the other specific items mentioned in the draft determination are covered by extrinsic materials.

There are four major changes from the draft determination to the final TD 2019/12:

1. the explicit inclusion of "any costs considered to be borrowing expenses under section 25-25 of the ITAA 1997 or former section 67 of the Income Tax Assessment Act 1936 (ITAA 1936)" in the list of items which are debt deductions in para 3 of the final determination;
2. the inclusion of a footnote (likely in response to submissions) clarifying the Commissioner's view that tax advice does not include "costs of accounting for the debt capital on an ongoing basis, tax return preparation costs, and other post implementation business costs that do not directly relate to the maintenance of the finance" and hence are not considered to be debt deductions;
3. the deletion of "[s]ection 25-25 borrowing expenses are not costs of the type described in subparagraphs 820-40(1)(a)(i) and (ii)" from the final determination; and
4. the inclusion of a concluding paragraph which states that "the Commissioner considers that the underlying principle is a factual enquiry into whether the cost or costs, relevantly apportioned, has a close and direct connection with the objects of the expenditure — which can be either obtaining or maintaining the financial benefits received, or to be received. Accordingly, the same type of cost might be said to be debt deductions for one entity under the subparagraph, but not for another entity. This is so because the relevant factual enquiry is based on the entity's specific facts and circumstances".

Based on TD 2019/12, determining the extent of debt interests that should be included in the adjusted average debt balance of taxpayers is clearly a priority for the Commissioner. Moreover, the changes from the draft determination to the final determination suggest a potential evolution of the Commissioner's views with respect to borrowing costs.

Taxpayers with inbound interest-free debt instruments, where those loans are not currently included in their adjusted average debt for thin capitalisation purposes, should carefully consider their position as TD 2019/12 would appear to suggest that this will be an area of close scrutiny by the Commissioner.

The takeaway

TD 2019/10 and TD 2019/12 represent a continuation of the ATO's focus on cross-border financing.

Because of the views in TD 2019/10, taxpayers will need to carefully consider the arm's length nature of all conditions of their cross-border related-party financing (and not just pricing conditions), particularly for any arrangements that have less common features.

The conclusions reached in TD 2019/12 mean that any taxpayers who have any amounts which are classified as debt for tax purposes, but which are not included in their adjusted average debt for thin capitalisation purposes on the basis that it is not debt capital which gives rise to debt deductions, should carefully consider what, if any, deductible costs may relate to, or have related to, those instruments. This may require careful examination of the circumstances leading to the initial entry into the relevant arrangements.

Ultimately, both determinations emphasise the need for careful consideration of the tax consequences of all cross-border related-party financing.

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Successful Succession

by Khai Rocher and Katerina Peiros, ATI,
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Main residence and pre-CGT dwellings exemptions

PCG 2019/5 clarifies when the ATO will automatically extend the two-year disposal period that exempts a deceased's main residence or a pre-CGT asset from CGT.

Section 118-195 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) is the most effective tool in minimising the capital gains tax (CGT) on deceased estates and beneficiaries in relation to the disposal of an interest in the main residence or pre-CGT real estate of a deceased.

It provides that a legal personal representative (LPR) of a deceased estate or an individual beneficiary who inherits a dwelling, or an ownership interest in a dwelling, may claim the CGT exemption on disposal of that property if certain conditions are satisfied:

- the deceased acquired the property:
  - after 19 September 1985 and it was their main residence immediately before death and not income producing; or
  - before 20 September 1985; and
- the property:
  - is disposed of within two years of death;
  - is the main residence of the deceased's spouse from the date of death until disposal;
  - is subject to a right to occupy created under the will and the holder of that right occupies it from the date of death to the date of disposal; or
  - becomes the main residence of the beneficiary who inherited it.

Section 118-195 applies to any residential building, caravan, houseboat, mobile home etc and surrounding land used for private or domestic purposes not exceeding two hectares.[1] It also covers any interests in a dwelling which are less than absolute, such as a right to reside or life interest, an equitable interest, a licence etc.

This exemption targets disposals to third parties, the transfers from the deceased's name to the LPR, or from the LPR to beneficiaries being eligible for a CGT roll-over under s 128-10 ITAA97 if the transfer is pursuant to a will or on intestacy and under s 128-20(1) ITAA97 if the transfer is under a deed of family arrangement or court order. The roll-over relief is not available if the beneficiary is a tax-exempt entity, a complying superannuation fund or a non-resident taxpayer, but this is outside the scope of this column.

Most estates are entirely wound up in a period much less than two years from the date of death, the two-year time frame not being of concern to a majority of LPRs and beneficiaries.

Some less fortunate (but few in number) estates and beneficiaries have needed to request the Commissioner to exercise his discretion to extend the two-year time frame[2] in order to access the CGT exemption.[3] These applications were time-consuming, costly and delayed certainty as the extensions were granted on a case-by-case basis.[4]

The new practical compliance guideline

The new PCG 2019/5 (the guideline) is a welcome response to the uncertainty surrounding the particulars of this extension. The guideline not only provides a detailed framework of the issues that the Commissioner will consider when exercising his discretion, but also provides clear conditions for a safe harbour period whereby parties can manage the tax affairs of an estate as if an extension to the CGT-free period had already been granted.[5] This is valuable in that it gives parties greater certainty in the tax implications of managing a deceased estate where delays in the disposal of an asset are encountered. In many cases, it also eliminates the need and the costs of having to formally apply for a private ruling or extension. The guideline is retroactive so will apply to cases where delay has already occurred but a private ruling has not been applied for as yet.[6]

Scope of the safe harbour

The scope of the safe harbour protection is deliberately limited, and the ability to seek the discretion of the Commissioner to wider or more complex circumstances remains available through private rulings.[7]

Practical compliance

PCG 2019/5 allows for taxpayers to automatically take advantage of the extension of the two-year CGT-free period under s 118-195, so long as five safe harbour conditions are satisfied. The aim is to provide certainty to uncomplicated circumstances that fall within predefined categories.[8]

In verifying compliance, the ATO will not seek to determine whether or not they would have exercised the discretion, rather whether the safe harbour conditions were met, and that sufficient records were kept to support a claim to this effect. So, the extension of the CGT-free period provided by PCG 2019/5 is certain, provided that it is adhered to strictly and not jeopardised by retrospective auditing.

Safe harbour conditions

To qualify for the safe harbour, *all* of the following conditions must be satisfied:[9]

1. during the first two years after the deceased's death, more than 12 months was spent addressing one or more of the following:[8]
   a. a challenge to the ownership of the property, or the will;

  b. a life or other equitable interest given in the will delays the disposal of the property;
  c. the complexity of the deceased estate delays the completion of administration of the estate;[10] or
  d. settlement of the contract of sale of the property is delayed or falls through for reasons outside of the party's control;
2. the property was listed for sale as soon as practically possible after those circumstances were resolved (and the sale was actively managed to completion);
3. the sale was completed (settled) within 12 months of the property being listed for sale;
4. if any of the circumstances described below were applicable, they were immaterial to the delay in disposing of the interest:[11]
  a. waiting for the property market to pick up before selling the property;
  b. delay due to refurbishment of the property to improve the sale price;
  c. inconvenience on the part of the LPR or beneficiary to organise the sale of the property; or
  d. unexplained periods of inactivity by the LPR in attending to the administration of the estate; and
5. the longer period otherwise needed for the discretion to be exercised is no more than 18 months.

Extending the two-year period – exercising the Commissioner's discretion

If any of the conditions are not met or a time frame of longer than 18 months is required, the taxpayer still has the option to apply for a private ruling seeking the exercise of the Commissioner's discretion (which remains broader than the safe harbour protection). Effectively, there is a blanket automatic extension for all simple cases that fall within the criteria, but the Commissioner will still consider the more complex ones.

When considering whether to exercise the discretion, the Commissioner will take into account the sensitivity of circumstances, the degree of difficulty in locating beneficiaries or proving the will, the period of income production of the asset, and the duration of ownership. The burden of the tax on the parties is not a valid consideration.

Importantly, the circumstances preventing the disposal within the two-year period must persist for more than 12 months, and must fall within the two years beginning at the date of death.[9] That is, the circumstance prohibiting disposal of the residence not only has to persist for more than 12 months, but also this period must fall entirely "during the first two years".[9] Practically, this means that ownership, will and estate challenges, and settlement issues commenced or first experienced 12 months or later after the date of death are excluded from safe harbour protection. This is because either the necessary longer than 12-month delay will extend disposal beyond the two-year period or settlement will occur on time within the standard two years. In cases where the time frame is unclear, the Commissioner's discretion should be sought.

PCG 2019/5 considers a number of common scenarios and discusses the outcome, it is a beneficial read for advisers.

What does this mean for practitioners?

Circumstances that are safely within the conditions enjoy the automatic extension of the time frame on a self-reporting basis.

As always, the self-reporting obligations require accurate and verifiable record-keeping to substantiate the assertions and claims.

For the sake of clarity, it is the settlement of the sale that must take place within the 42 months[12] from the date of death, not merely the signing of the contract.[13] This quirk should be kept in mind to avoid tripping up.

For the risk averse practitioners, circumstances that are borderline or if it is arguable whether a condition is met, the private ruling route should still be followed. For example, consider the broadness of item 1(c) above about complex estate management. The guideline details scenarios that include intestacy, unauthorised occupation of the premises, deliberate obstruction of the sale of the property, protracted title issues and eviction. These are non-exhaustive examples, and in unusual circumstances, confirmation of safe harbour by private ruling would offer irrevocable protection for the taxpayer.

It remains best practice to encourage LPRs and beneficiaries to comply with the two-year period set out in s 118-195 and to treat the guideline as a remedy, rather than a strategy.

The guideline urges reasonable and prompt action by parties — once the circumstances prohibiting the sale of the property are resolved, the property needs to be listed for sale "as soon as practically possible".[9] Advisers should remind their clients of this rule.

Advisers and willmakers should proceed as if only the two years is available in any estate planning, for example, exercise of options relating to the willmaker's home or pre-CGT property should be exercised and given effect to within two years from the date of death. Old-world directions that the estate be preserved and not distributed for five years may have disastrous tax consequences if the estate is lucky enough to have appreciating property.

Advisers and litigants should feel the pressure to resolve any litigation within the two-year time frame, and not assume that the extra period will be available if the litigation proceeds at a slow rate or if parties divert from the model litigant guidelines.

In cases where CGT will be payable and the cost base relevant, the cost base of the LPR or the beneficiary is the market value of the asset at the date of death.

Rights to occupy and life interests that are agreed to by a deed of family arrangement, rather than set out in the will, should be referred to the Commissioner for a private ruling for confirmation that the CGT exemption is available.[14]

Finally, state-based land tax considerations persist and should be top of mind for advisers and taxpayers.

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5 Paras 8 to 10 of PCG 2019/5.

6 Para 7 of PCG 2019/5.

7 Para 53 of PCG 2019/5.

8 Para 12 of PCG 2019/5.

9 Para 11 of PCG 2019/5.

10 Paras 48 to 52 of PCG 2019/5.

11 Para 13 of PCG 2019/5.

12 Issue 7 of PCG 2019/5EC.

13 Issue 5 of PCG 2019/5EC; para 11 of PCG 2019/5.

14 Issue 12 of PCG 2019/5EC.

Events Calendar

September 2019

STATE / EVENT	DATE	CPD
National		
National GST Intensive	12/9/19	11.25
Monthly Tax Update	25/9/19	1
New South Wales		
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Morning Tax Club – Parramatta	5/9/19	1.5
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Tax Discussion Group	16/9/19	1.5
International Masterclass 2019	18/9/19	7
Queensland		
Young Tax Professionals	4/9/19	1.5
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Young Tax Professionals	18/9/19	1.5
South Australia		
SA Essential Tax Session	4/9/19	1.5
2019 SA Property Day	6/9/19	6
SA Tax Briefing Session	24/9/19	1.5
Victoria		
Victorian Property Day	5/9/19	6
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Breakfast Club – Geelong	20/9/19	1.5
Western Australia		
WA International Tax Day	4/9/19	5.75
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For information on upcoming events, visit **taxinstitute.com.au/cpd**.

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Giving back to the profession

The Tax Institute would like to thank the following presenters from our August CPD sessions. All of our presenters are volunteers, and we recognise the time that they have taken to prepare for the paper and/or presentation, and greatly appreciate their contribution to educating tax professionals around Australia.

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