THE JOURNAL FOR MEMBERS OF THE TAX INSTITUTE

Taxation in Australia

VOL 54(9) APR 2020

Structuring cross-border transactions: part 1

Renuka Somers and Peter Harper

The director penalty regime and its extension to GST

Tamara Cardan, ATI, and James Donoghue

Death and income tax – some discrete issues: part 2

Ian Raspin, CTA, Lyn Freshwater and Mark Morris, FTI

SMSF death benefit distributions: lessons from Marsella v Wareham

Courtney van Zyl

THE TAX INSTITUTE

2020 Tax Adviser of the Year Awards

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Peter Feros, CTA, Clayton Utz
Dr Julianne Jaques, CTA, Victorian Bar
Manuel Makas, CTA, Greenwoods & Herbert Smith Freehills

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Natalie Claughton, MC Tax Advisors
Leanne Connor, CTA, WGC Business Advisors
Karen Rooke, CTA, Australian Taxation Office
Tania Waterhouse, Waterhouse Lawyers
Chris Wookey, CTA, Chris Wookey Chartered Accountants

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Matthew Popham, CTA, Newmont Goldcorp Australia
Norah Seddon, ATI, PwC
Adrian Varrasso, ATI, MinterEllison

Emerging Tax Star
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Melissa Bader, ATI, KPMG Law
Donovan Castelyn, Curtin University and Curtin Tax Clinic
Amy Liu, CTA, Kelly+Partners Chartered Accountants
Peter Scott, FTI, Arnold Bloch Leibler
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JUDGING PANEL

Applications were assessed by an independent, expert judging panel made up of key industry figures and leading members of the profession.

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Robyn Jacobson, CTA, Tax Banter

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THE WINNERS

Chartered Tax Adviser

Dr Julianne Jaques, CTA

Victorian Bar

Julianne is a barrister with over 25 years' experience as a tax adviser. She spent five years with each of Coopers & Lybrand and Freehills before becoming senior tax adviser to the Federal Assistant Treasurer during the introduction of GST and business tax reforms.

Corporate Tax Adviser

Adrian Varrasso, ATI

MinterEllison

Adrian is the head of MinterEllison's tax practice and also leads their corporate tax offering. He is a corporate tax specialist with extensive experience in commercial transactions across a full range of sectors, and a client base that spans many international markets.

SME Tax Adviser

Leanne Connor, CTA

WGC Business

Leanne is a Director of WGC Business Advisors Pty Ltd, a chartered accountancy firm specialising in taxation and strategic advice to SMEs and high net worth individuals. Leanne has over 30 years' experience providing accounting, business advisory, strategic superannuation and taxation services.

Emerging Tax Star

Donovan Castelyn

Curtin University and Curtin Tax Clinic

Donovan is the Co-Founder and Clinic Supervisor of the Curtin Tax Clinic, Australia's first pro-bono tax clinic and the impetus for the National Tax Clinic Program. Donovan is also an Associate Lecturer at Curtin University where he teaches into the taxation major and LLB streams with a primary focus on international taxation and Australian tax jurisprudence.

Gordon Cooper Memorial Scholarship

The Tax Institute is privileged to honour Gordon Cooper's name and contribution to the profession with the Gordon Cooper Memorial Scholarship. Awarded annually to the Emerging Tax Star, the scholarship covers the cost for the Institute's Chartered Tax Adviser program.

Nominations for the 2021 Tax Adviser of the Year Awards will open in August 2020.

To register your interest, please email taxawards@taxinstitute.com.au.

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Invitation to write

We welcome original contributions that are of interest to tax professionals, lawyers, academics and students.

For details about submitting articles, please see Guidelines for Publication on our website taxinstitute.com.au, or contact publisher@taxinstitute.com.au.

Tax News – at a glance

by TaxCounsel Pty Ltd

March – what happened in tax?

The following points highlight important federal tax developments that occurred during March 2020. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 475 (at the item number indicated).

Super guarantee amnesty

The *Treasury Laws Amendment (Recovering Unpaid Superannuation) Act 2020*, which contains the amendments that provide for the one-off superannuation guarantee amnesty, is now law. **See item 1.**

Productivity Commission: remote area tax concessions and payments

On 26 February 2020, the Assistant Treasurer announced that the Productivity Commission had released its final study report on remote area tax concessions and payments. **See item 2.**

Transfer pricing: use of non-resident-owned mobile offshore drilling units

The Commissioner has issued a practical compliance guideline that sets out the ATO's compliance approach to transfer pricing issues for projects involving the use in Australian waters of non-resident-owned mobile offshore drilling units such as drill-ships, drilling rigs (including but not limited to submersibles, semi-submersibles and jack-up rigs), pipe-laying vessels and heavy-lift vessels (PCG 2020/1). **See item 3.**

Margin scheme valuations

The Commissioner has released a draft legislative instrument that specifies the requirements for making valuations for the purposes of applying the margin scheme in Div 75 of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (MSV 2020/D1). **See item 4.**

Buy-back of certain hybrid securities

The Commissioner has released a discussion paper that addresses the uncertainty and inconsistent tax treatment in relation to the redemption or buy-back of hybrid securities. **See item 5.**

Glencore case: decision impact statement

The Commissioner has released a decision impact statement in relation to the High Court's decision in the *Glencore* case (*Glencore International AG v FCT* [2019] HCA 26). **See item 6.**

CGT foreign resident withholding

The Commissioner has issued a draft variation instrument that, when operative, will vary to nil the amount that would otherwise have to be paid to the Commissioner under s 14-200 of Sch 1 to the *Taxation Administration Act 1953* (Cth) (certain acquisitions of taxable Australian property from foreign residents) in specified circumstances when land is acquired as a result of the exercise by a mortgagee of a power of sale (Variation 2020/D1). **See item 7.**

Default assessment upheld

The AAT has rejected a taxpayer's challenge to a default assessment raised by the Commissioner under s 167 of the *Income Tax Assessment Act 1936* (Cth) (*Bourne and FCT* [2020] AATA 190). **See item 8.**

Response to the coronavirus crisis

As part of its economic stimulus package announced on 12 March 2020, the government will:

- increase (from 12 March 2020) the instant asset write-off (IAWO) threshold from $30,000 to $150,000 and expand access to the threshold to include all businesses with an aggregated annual turnover of less than $500m (up from $50m). The IAWO is due to revert to $1,000 for small businesses (with a turnover of less than $10m) from 1 July 2020. This proposal applies for new or second-hand assets first used or installed ready for use in the timeframe mentioned; and
- introduce an investment incentive by accelerating depreciation deductions. Key features of this incentive include:
  - it is to apply to new depreciable assets acquired by businesses with an aggregated turnover of less than $500m;
  - the asset must be acquired after 12 March 2020 and be first used or installed by 30 June 2021; and
  - a deduction of 50% of the cost of the depreciable asset will be allowable on installation, with existing depreciation applying to the balance of the asset's cost.

President's Report

by Peter Godber, CTA

Reflections from The Tax Summit 2020

President Peter Godber on the appetite for tax reform and the value of genuine connections.

What a showcase The Tax Summit 2020 proved to be for The Tax Institute. Delegates numbering in excess of 1,400 enjoyed the uplifting surrounds of Sydney's International Convention Centre, and we were able to demonstrate the important role played by the Institute in Australia's tax community by hosting such an event.

Tax reform was a constant theme, from our Q&A panellists providing diverse views on what matters most in the current environment, to one of our energetic keynote speakers, the Hon. Peter Costello, reminding us of the challenges of actually achieving reform (such as the major change of introducing GST some 20 years ago). In another keynote address, the NSW Treasurer, the Hon. Dominic Perrottet, challenged governments to push ahead with reform.

It appears that we all want reform, but there will still be strident debate about what tax reform should look like in years to come. It seems that there is no better time than the present, and we cannot wait for bipartisan support for any measure. Let us keep the debate going.

At The Tax Summit, we also thanked the Commissioner of Taxation, Mr Chris Jordan, for his time in attendance and support for the event. In his keynote speech, he acknowledged the very important partnership that the ATO has with tax professionals. In response, we welcome the ongoing collaboration between the ATO and the tax profession, now and into the future. Tax professionals play a vital role in protecting the health of the tax and superannuation systems. It is crucial that the relationship between tax professionals and the ATO works effectively, and the Institute will continue to work on strengthening the level of mutual trust necessary to make that happen.

We will have many other reflections on The Tax Summit. What I was able to reflect on in my welcome address was how lasting my memories are of my early engagement with The Tax Institute. I can remember attending intensive learning events in the mid-1980s. I was young but, often after a day's learning, I would find myself in the company of senior professional advisers, even leading tax counsel. They took an interest in me and I was welcomed into discussions of complex issues of the day. I have been lucky to be mentored all through my career by wonderful tax professionals. But one common factor was that they have all been well connected to The Tax Institute, and the Institute has always been the recognised source of our extended knowledge and learning in tax. It continues to be so.

And this emotive connection with The Tax Institute was also evident in many of the wonderful and genuine comments made by our Tax Adviser of the Year award winners at The Tax Summit gala dinner, including expressions of gratitude for the opportunities received as a result of being involved with the Institute. It is nice to hear those comments, from young emerging tax professionals to the most experienced, right across the spectrum of professional life. Congratulations again to all of our nominees, finalists and winners in all categories at this year's Tax Adviser of the Year Awards. We all celebrate your success.

At The Tax Summit, I was also fortunate to be present at a breakfast on the first day to bestow certificates to our recent national graduates in the Graduate Diploma of Applied Tax Law. That was another great example of The Tax Institute playing a role in the professional lives of those willing to undertake extra study, and those who have hopefully developed their appetite for continued learning as professionals of the future.

We also announced the destination for The Tax Summit 2021, and the winner was … Melbourne! How terrific will that be? Very soon, we will commence planning for our second summit event, The Tax Summit 2021, and more details will be released in due course. I can only encourage all members to put this event in your diary. Hopefully, those who attended the Summit in Sydney will be inspired to be in Melbourne. And if you missed the Sydney event, you now have the opportunity to experience a Tax Summit event next year.

We can now take a breath, debrief and reflect on the experience and success of The Tax Summit 2020. We continue to learn a lot about how we can deliver services to members in today's and in future environments, and now we can turn our minds to how we build on our special engagement with members at all levels, in all demographics, across the country. Again, as I have noted before, this has become a key focus of the Institute this year.

Times are uncertain with COVID-19, and we are vigilant in making sure that we are fully compliant with all government directions and best practice in the conduct of events. I am confident that we will all get through this and continue to enjoy all that is on offer from The Tax Institute.

CEO's Report

by Giles Hurst

At the heart of a thriving tax community

CEO Giles Hurst on the Tax Adviser of the Year Awards, turbulent times ahead and succeeding as part of a professional community.

As you will have read in this month's President's Report, The Tax Summit 2020 is now behind us. But in the days since we all left the ICC, so much generosity has been extended by our members in the form of written and spoken compliments regarding what was surely one of the most comprehensive events entirely dedicated to tax ever held in Australia.

Of particular note has been the observation about the sheer breadth and depth of the content shared across all of the sessions prepared for our delegates. In addition, comments were equally generous with regard to the numerous networking opportunities that were provided and, in particular, we were praised for how we brought the tax community together for the glittering gala dinner to celebrate the Tax Adviser of the Year Awards.

Increasingly referred to as Australia's "Tax Oscars", the winners of these coveted awards attach significant personal value to being recognised by their peers for their achievements and professional dedication. Two years ago, we set ourselves a goal to significantly revitalise these awards, and I was so pleased to hear the award winners' heartfelt acknowledgment of the role that the Institute has played in their career success. That is at the heart of why The Tax Institute exists and why our Australian tax community is thriving once more.

The weeks and months ahead look to be uncertain for so many reasons and I have no doubt that the combined and layered challenges of drought, bushfires and now the spreading COVID-19 virus will severely test our economy. In turn, so too will our members and their clients be challenged.

In response, we intend to use the success of The Tax Summit 2020 to supercharge our servicing resources to arm you with what you need to navigate your way through the choppy waters ahead. Communication and early indications of impending changes to the professional services landscape will be key. So too will increased support for members who face additional challenges in delivering for their clients.

Please do not hesitate to reach out to any member of my team here at The Tax Institute if you need support or assistance in any way where you feel we might be able to provide it.

For now, we will continue to deliver our events and education programs, albeit with one eye on the need to adapt to rapidly changing circumstances and government direction. We will assess the challenges as they develop but, currently, we anticipate no major changes in how we support the tax community that we serve.

I extend my congratulations to the winners of this year's Tax Adviser of the Year Awards and urge all members to continue to demonstrate such incredible support of peers at all stages of their professional careers, because this is what makes our tax community and *this* Institute so special.

Tax Counsel's Report

by Stephanie Caredes, CTA

Is 40 the new 30?

In this month's column, tax counsel Stephanie Caredes discusses the Tax Practitioners Board's proposal to increase CPE for registered agents to 40 hours a year.

They say that 40 is the new 30, but I thought that only related to one's age. With the release of the Tax Practitioners Board (TPB) proposal to increase the required number of continuing professional education (CPE) hours from 90 hours across three years (which averages out to 30 hours a year) to 40 hours a year (notably, not 120 hours over three years), I started to wonder whether the "40 is the new 30" trend was morphing into other areas.

On 19 February 2020, the TPB released for public consultation a discussion paper containing a proposal to increase the number of required hours of CPE for all registered agents — tax and BAS agents and tax (financial) advisers. In essence, the proposal is to move away from differing requirements for tax and BAS agents and tax (financial) advisers and essentially make the number of hours required for CPE uniform.

The Financial Adviser Standards and Ethics Authority (FASEA) requires 40 hours of continuing professional development, and a number of the accounting bodies require their members to complete 120 hours of CPE over a three-year period, which averages out to 40 hours a year. With this in mind, at face value, it looks as though the TPB will be "on trend" by also increasing its required CPE to 40 hours a year. However, to make a change such as this, there should be much more reason behind the change.

Paragraph 23 of the discussion paper contains the TPB's proposal:

> "To facilitate improved guidance and professionalism, and simplify regulatory compliance, the TPB is considering an increase to the minimum number of hours required for all tax practitioners to 40 hours per year (excluding conditional agents — see below), in conjunction with a staged implementation approach."

The first question that comes up is, of course, what does "to facilitate improved guidance and professionalism" mean? The Tax Institute has been left to interpret what this expression means. It is thought that the TPB is directing its comments to improving the competence of registered practitioners, but we are not sure. From this, the logical conclusion to draw may be that the TPB is thinking, if CPE hours are increased, then the professionalism of practitioners will be increased. However, The Tax Institute does not believe that this is the logical conclusion for the following reasons.

If the TPB's intention is to improve the professionalism of registered practitioners when providing tax services to taxpayers by increasing the number of CPE hours required to be completed by registered practitioners to 40 hours a year, The Tax Institute considers that increasing the hours of CPE will not necessarily achieve this outcome. We do not consider that there is necessarily a correlation between an increase in CPE hours leading to an increase in the professionalism of registered practitioners and consequently an increase in the quality of tax services provided.

In particular:

- there is no supported evidence presented in the discussion paper that shows a positive correlation between an increase in the CPE hours required from 30 (on average) to 40 per year and an increase in "guidance and professionalism";
- there is no supported evidence presented in the discussion paper that shows that the current failings of certain registered practitioners are linked to a failure to undertake sufficient CPE and the effect of that failure on their "guidance and professionalism"; and
- even if it is accepted for the sake of argument that the proposed increase will improve such outcomes (which is not admitted), the discussion paper does not analyse whether the marginal benefit to the community of improving those outcomes justifies the marginal increase in cost to the registered practitioner community of requiring the additional CPE hours to be completed.

In the Institute's view, if the TPB has concerns with the professionalism of certain practitioners, this issue should be addressed directly. This could be done by way of random audits of the CPE undertaken by registered practitioners.

For now, the TPB has put this proposal out for consultation. There is no proposed start date. Whether the TPB goes ahead with this proposal remains to be seen. In particular, with the recommendations from the broader review of the TPB and the *Tax Agent Services Act 2009* yet to be released, any major proposals such as this one relating to CPE would inevitably be subject to the outcome of the broader review.

What does this mean for registered agents in the meantime? Keep on with the current required CPE hours according to your registration with the TPB. For tax agents, this means staying with 30 hours.

Is there a real issue with the professionalism of some registered agents? If there is, increasing CPE hours for all will not resolve it.

The Tax Institute's submission is available on our website.

Tax News – the details

by TaxCounsel Pty Ltd

March – what happened in tax?

The following points highlight important federal tax developments that occurred during March 2020.

Government initiatives

1. Super guarantee amnesty

The *Treasury Laws Amendment (Recovering Unpaid Superannuation) Act 2020*, which contains the amendments that provide for the one-off superannuation guarantee amnesty, is now law.

The amendments are intended to encourage employers to voluntarily disclose historical superannuation guarantee (SG) non-compliance and pay an employee's full entitlement, including the employee's individual shortfall, nominal interest, and any related general interest charge on unpaid amounts of SG charge.

This outcome is achieved by providing a one-off amnesty to allow employers to claim tax deductions for payments of SG charge or contributions made during the amnesty period to offset SG charge, as well as reducing penalties and fees that may otherwise apply in relation to historical SG non-compliance to nil.

In general terms, to qualify for the amnesty, an employer must disclose to the Commissioner information related to an SG shortfall for a quarter that ends at least 28 days before the start of the amnesty period.

The Commissioner may notify an employer that they have ceased to qualify for the amnesty if the employer fails to pay, or enter into and comply with arrangements to pay, any SG charge imposed on the disclosed shortfall for the quarter. This means that the employer will lose all benefits from the amnesty.

From the day after the amnesty period ends, the amendments limit the Commissioner's ability to remit Pt 7 penalties in certain circumstances. This limit ensures that the Commissioner cannot remit penalties imposed under s 59 of the *Superannuation Guarantee (Administration) Act 1992* (failure to provide statements or information) below 100% of the amount of SG charge payable by the employer for a historical quarter that was covered by the amnesty where the employer did not disclose the shortfall as part of the amnesty.

The restriction of the Commissioner's general discretion to remit penalties is intended to strengthen the operation of the amnesty by providing employers with higher minimum penalties for failing to come forward during the amnesty in relation to historical SG shortfalls.

The "amnesty period" is the period that started on 24 May 2018 and ends six months after 6 March 2020 (the day that the amending Act received royal assent).

2. Productivity Commission: remote area tax concessions and payments

On 26 February 2020, the Assistant Treasurer announced that the Productivity Commission had released its final study report on remote area tax concessions and payments.

In its final study, the Productivity Commission made a number of findings and recommendations relating to the zone tax offset, fringe benefits tax remote area concessions and the remote area allowance. The findings in the final study were consistent with those in the Commission's draft report released in September 2019.

The Assistant Treasurer said that, were they to be implemented, the Productivity Commission's recommendations would result in significant disruption to existing arrangements. This was confirmed by the volume of submissions which the Productivity Commission received in response to its draft report, the overwhelming majority of which were not supportive of the proposed changes.

Given the challenges faced by regional Australia, including as a result of the impacts of the recent drought, bushfires and now coronavirus, the government will not be acting on the Productivity Commission's recommendations.

The Commissioner's perspective

3. Transfer pricing: use of non-resident-owned mobile offshore drilling units

The Commissioner has issued a practical compliance guideline that sets out the ATO's compliance approach to transfer pricing issues for projects involving the use in Australian waters of non-resident-owned mobile offshore drilling units (MODUs) such as drill-ships, drilling rigs (including but not limited to submersibles, semi-submersibles and jack-up rigs), pipe-laying vessels and heavy-lift vessels (PCG 2020/1).

While typically these assets are the subject of lease-in lease-out arrangements whereby the asset is sourced from the non-resident owner via a chain of related-party bareboat leases, the scope of the guideline may also include related-party bareboat leasing direct from the non-resident (legal or in-substance) owner. The guideline addresses transfer pricing issues related to the use of these assets in Australian waters by the operator, be it one or more of:

- an Australian tax resident; or
- a non-resident entity with a permanent establishment in Australia.

The expression "the operator" is intended to include the entity, or entities, who ensures the performance of the drilling (or similar) contract in satisfaction of the project specifications, coordinating both the MODU and highly skilled personnel (who operate the MODU). In the case of an operator performing these functions, the framework in the

guideline is intended to assist an operator in assessing its compliance risk and understanding the ATO's compliance approach for these activities.

The guideline does not apply to:

– oil and gas production platforms, which are not engaged in any drilling activities and are permanently anchored to the ocean floor;
– cable-laying vessels which lay telecommunications and electric power transmission systems, operating in a different industrial context, under quite different technical and regulatory conditions, risks and economic circumstances;
– port works, such as hard-stand construction, dredging, rock-dumping, reclamation and associated activities, which involve quite different technical and regulatory conditions, risks and economic circumstances; or
– tax risks other than tax transfer pricing risk.

Nor does the guideline apply if the substance of the arrangements differs from their legal form.

4. Margin scheme valuations

The Commissioner has released a draft legislative instrument that specifies the requirements for making valuations for the purposes of applying the margin scheme in Div 75 of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GSTA99) (MSV 2020/D1).

The requirements apply to valuations for taxable supplies of real property made on or after 1 March 2010. The draft instrument is substantially the same as the instrument that it replaces (MSV 2009/1). Therefore, if a taxpayer has a valuation that satisfied the previous instrument, it will continue to satisfy the draft instrument.

5. Buy-back of certain hybrid securities

The Commissioner has released a discussion paper that addresses the uncertainty and inconsistent tax treatment in relation to the redemption or buy-back of hybrid securities.

The discussion paper states that a common form of security in the market is a preference share or note, generically known as a "hybrid security". The terms of such hybrid securities will generally permit (but not require) the issuer of the hybrid security to "repay" investors at a particular time if certain conditions are satisfied (where the issuer does not elect to repay investors at that time, the hybrid security will usually convert into ordinary shares in the issuer, or it will continue to remain on issue until another relevant date, with the option to repay or convert).

The actual form of repayment will depend on the legal form of the hybrid security. When the hybrid security is in the form of a preference share (hybrid share), the issuer may, among other mechanisms, repay the investor through an off-market buy-back of the share or, when the hybrid security is in the form of a note (hybrid note), through redemption of the note. Where this happens, the income tax law will require the holder of the hybrid security to determine the market value of the hybrid security as a part of the process of determining their capital gain or capital loss.

The ATO has been made aware of some uncertainty and inconsistent tax treatment in relation to the redemption or buy-back of hybrid securities. In particular, there have been instances whereby taxpayers have either assumed that it is not necessary to determine the market value of the security, or the market value has been assumed to be the face value (that is, the actual proceeds received) on redemption or buy-back of the security.

The ATO also recognises the practical problems for investors in determining the market value of the securities for the purposes of calculating their capital gain or capital loss on these transactions.

The discussion paper is seeking feedback on a potential practical compliance approach for determining the market value of certain hybrid securities when they are bought back or redeemed (as relevant) from an investor holding their hybrid securities on capital account. A practical approach to determining market value may be published as a practical compliance guideline (and, depending on the feedback received from the discussion paper, it may be published as a draft or final practical compliance guideline).

6. Glencore case: decision impact statement

The Commissioner has released a decision impact statement in relation to the High Court's decision in the *Glencore* case (*Glencore International AG v FCT*[1]).

That case raised the question of whether legal professional privilege (LPP) provided the holder of privilege at common law with a positive, actionable right to recover privileged documents from another person and to restrain by injunction the use of knowledge derived from such material by that person, or whether it was, as the Commissioner argued, only an immunity.

In a unanimous decision, the High Court found that LPP is only an immunity (that is, a defence) to the exercise of a power which would otherwise compel the disclosure of privileged communications. It is not a source of positive rights.

The court also observed that where injunctions have been granted in respect of the use of confidential documents that were also privileged documents, this was because the documents were confidential, not because they were privileged.

The second issue before the High Court was an alternative argument put by the Commissioner that s 166 of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) (assessments) provided a defence against any common law action by a privilege holder to recover privileged communications. The High Court held that, given its decision in respect of the first issue, there was no need to consider this alternative ground.

The decision impact statement states that the High Court's decision reflects what the Commissioner has always understood to be the law. The decision impact statement notes that the decision of the High Court also does not affect the right of a taxpayer to refuse to furnish documents that are privileged in response to the exercise of a power of compulsory disclosure.

7. CGT foreign resident withholding

The Commissioner has issued a draft variation instrument that, when operative, will vary to nil the amount that would

otherwise have to be paid to the Commissioner under s 14-200 of Sch 1 to the *Taxation Administration Act 1953* (Cth) (TAA53) (certain acquisitions of taxable Australian property from foreign residents) in specified circumstances when land is acquired as a result of the exercise by a mortgagee of a power of sale (Variation 2020/D1).

More particularly, the variation will apply where:

- there is a transaction where a mortgagee that is an authorised deposit-taking institution (as defined) exercises a power of sale over the land;
- the mortgagee has determined that the residue from the sale proceeds will be zero or less than zero; and
- the mortgagee has provided the transferee with a written declaration stating that the amount to withhold is varied to nil under the variation instrument.

In the absence of the variation, when a person acquires land in a transaction where a mortgagee exercised a power of sale, an amount would be required to be paid to the Commissioner equal to 12.5% of the purchase price.

The purpose of the variation is to provide certainty for purchasers and mortgagees in the relevant transaction that no amount is required to be withheld where there is no residue that will be payable to the mortgagor. The instrument, when made, will ensure that there are no unintended consequences for the parties in a conveyancing process in the event that failure to obtain a variation results in a delay or failure to complete settlement.

The "residue" in this context is the amount remaining after expenses incidental to the sale, and amounts payable to registered mortgagees over the asset, are taken out of the sale proceeds. The expenses incidental to the sale include amounts that are ordinarily payable during the conveyancing process, such as adjustments for council rates, land rates, water rates, legal fees and conveyancing fees.

In the event that there is a residue payable to the mortgagor but this is insufficient to satisfy the 12.5% withholding obligation, a variation request must still be submitted to the Commissioner. A variation request must also be submitted to the Commissioner in the event that the power of sale is subject to potential challenges or disputes (such as equitable claims), or there is any other uncertainty regarding the application of the sale proceeds.

Recent case decision

8. Default assessment upheld

The AAT has rejected a taxpayer's challenge to a default assessment raised by the Commissioner under s 167 ITAA36 (*Bourne and FCT*[2]).

During the 2015 income year, the taxpayer was the sole director of Promotional Directories Group Pty Ltd (PDG). The taxpayer did not lodge an income tax return for that income year by the due date of 2 November 2015.

On or about 21 March 2016, PDG issued to the taxpayer a payment summary. The payment summary was authorised by the taxpayer and reported gross payments of $390,000 and total tax withheld of $187,638.

On 22 June 2018, the Commissioner issued a letter to the taxpayer advising him that the Commissioner was reviewing his income tax obligations for the 1 July 2012 to 30 June 2017 period. The taxpayer was advised, among other things, that:

- he was required by 25 July 2018 to lodge his overdue income tax returns for the 2015, 2016 and 2017 income years;
- if he did not lodge the overdue tax returns, the Commissioner may issue default assessments; and
- if that occurred, he may be liable for a penalty of 75% on any tax he may owe.

On 22 October 2018, the Commissioner issued the taxpayer with a default assessment of income tax for the 2015 income year under the ITAA36 and the *Income Tax Assessment Act 1997* (Cth), and an assessment of administrative penalty imposed for failure to provide a document under s 284-75(3), Sch 1 TAA53. As a result, the taxpayer incurred $165,590.60 tax payable together with a $120,785.00 administrative penalty for the 2015 income year. The default assessment of income tax was based on the contents of the payment summary issued by PDG, other than the tax withheld which was not paid by PDG and for which the taxpayer was not afforded a PAYG credit. The taxpayer objected against the default assessment.

The AAT pointed out that, in relation to default assessments, case law authority had established that it is not sufficient for a taxpayer to point to an error in the methodology applied by the Commissioner when making the assessment; rather, the taxpayer must demonstrate what the actual amount should be.

It was not in contention that the taxpayer caused PDG to issue him with the payment summary for the 2015 income year. Rather, the taxpayer contended that the payment summary was issued incorrectly as he had had subsequent advice that he should seek to treat the money received from PDG in the 2015 income year as the repayment of a loan.

The AAT said that the problem with the taxpayer's evidence was that he was unable to satisfactorily explain or provide supporting evidence that the amounts of money he received from PDG during the 2015 income year, which were reflected on the payment summary, were not in fact payments relating to salary and wages at the time.

In part, the taxpayer had provided evidence that would show that the assessment was incorrect. However, where default assessments are made by the Commissioner, there is no onus on the Commissioner to prove that the assessment was fully correct. The Commissioner had not had the benefit of being provided with all relevant information regarding the taxpayer's income and expenses at the time of making the default assessment. The onus was on the taxpayer to establish the amount on which his income tax ought to be levied.

Based on the evidence before it, the AAT was not satisfied that the taxpayer had discharged his onus to prove that the assessment was excessive or otherwise incorrect as he had not established what the correct amount of his taxable income actually was for the 2015 income year.

The administrative penalty (imposed pursuant to ss 284-75(3) and 284-90, Sch 1 TAA53) was correctly imposed. The taxpayer had not persuaded the AAT that the discretion (in s 298-20, Sch 1 TAA53) in relation to the remission of the administrative penalty should be exercised.

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References

1 [2019] HCA 26.

2 [2020] AATA 190.

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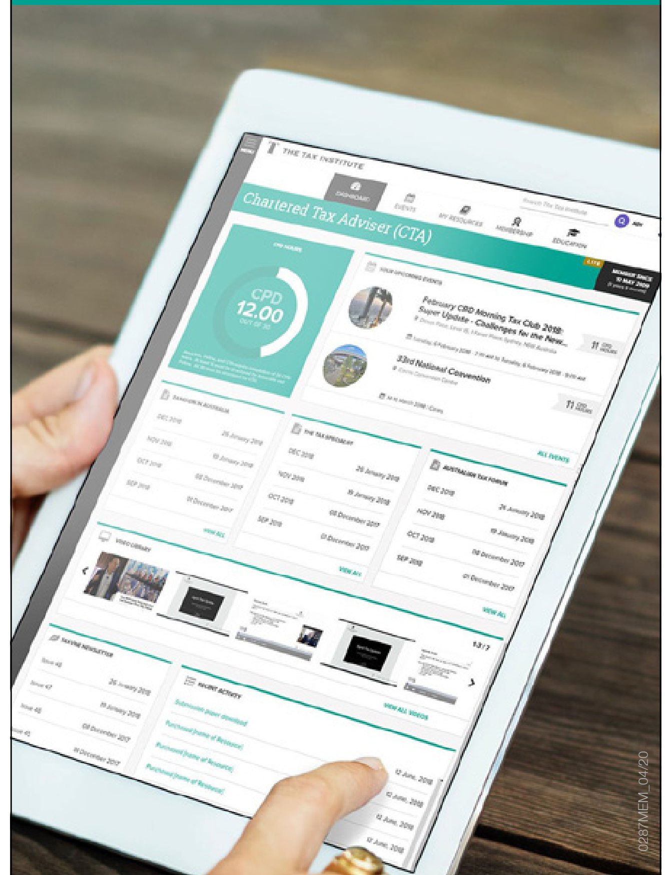

Tax Tips

by TaxCounsel Pty Ltd

A transfer of goodwill?

A recent NSW Supreme Court decision considered issues relating to the concepts of "transfer" and "goodwill" for the purposes of the *Duties Act 1997* (NSW) as previously enacted.

Background

The NSW Supreme Court decision (Ward CJ in Eq) *Favotto Family Restaurants Pty Ltd v Chief Commissioner of State Revenue*[1] was handed down on 26 February 2020. The issue to be decided was whether transactions by which the plaintiff obtained the right to operate two McDonald's restaurants (one at Menai in 2012 and the other at Lakemba in 2015) were (as contended for by the Chief Commissioner) dutiable transactions for the purposes of the *Duties Act 1997* (NSW) (as enacted at the relevant times) on the basis that they each effected a transfer of goodwill.

For the purposes of keeping the discussion straightforward, the facts relating to the Menai restaurant transaction are considered.

Menai restaurant transaction

During the period from 2008 until the relevant transaction in 2012, McDonald's Australia Ltd (McDonald's Australia), a wholly owned subsidiary of McDonald's Corporation (a Delaware corporation), had operated the Menai restaurant. McDonald's Australia had purchased the Menai restaurant in 2008 (for $2,550,000).

Sale of business agreement

Pursuant to a sale of business agreement dated 6 November 2012 (the Menai agreement), McDonald's Australia agreed to sell, and the plaintiff (the taxpayer, Favotto) agreed to buy, the "business" (that term being defined to mean "the McDonald's Restaurant carried on by [McDonald's Australia] at the Premises") and "the assets" (which term was defined to mean specified assets used in the business other than the "excluded assets" — see below) for the "purchase price" of $3,120,000 (inclusive of $477,884 for "the written down value of Plant and Equipment") plus the "stock value".

The terminology used in the Menai agreement was that of a "sale" and "purchase" (of the business and the assets): recital B recorded that the "Vendor desires to sell to the Purchaser, and the Purchaser desires to purchase from the Vendor, the Business and the Assets"; and recital C stated that the "Vendor has, at the request of the Guarantor, agreed to sell to the Purchaser and the Purchaser has agreed to Purchase from the Vendor, the Assets and Business on the terms and conditions of this Agreement".

Clause 3.1 of the sale of business agreement provided that:

> "Subject to Completion and on terms set out in this Agreement, the Vendor sells to the Purchaser and the Purchaser purchases from the Vendor, the Business and the Assets free from Encumbrances, for the Purchase Price."

The term "business" was defined to mean "McDonald's Restaurant carried on by the Vendor at the Premises". The term "McDonald's Restaurant" was, in turn, defined as "a quick service restaurant offering a range of uniform and quality food and beverage products, operated using the McDonald's Intellectual Property". The expression "McDonald's Intellectual Property" was defined as all trademarks, copyright, patent and design rights and other intellectual property rights owned or controlled under licence by the McDonald's Group, including all such rights subsisting in, or created during the development of (inter alia): the McDonald's system; the trademarks (as defined); and the corporate image and trade dress of a McDonald's restaurant, including the get-up, lay-out and specifications of premises, goods, labels and packaging.

The term "McDonald's system" was defined as "the distinctive business system developed by the McDonald's Group for operating a McDonald's Restaurant". The term "assets" was defined as "the property of the Vendor (other than the Excluded Assets) used in the Business at the opening of business on the Completion Date, comprising (inter alia) the "franchise rights intangible", which was undefined.

"Excluded assets" was defined as including "McDonald's Intellectual Property, the McDonald's Confidential Information and the McDonald's Goodwill" which was defined to mean "the goodwill attaching to the McDonald's Intellectual Property".

Ward CJ in Eq said that it was clear from the definitions that the "business" (as also was the case with the "assets") the subject of the Menai agreement related, relevantly, to the plant and equipment which was used for the McDonald's restaurant and the "franchise rights intangible".

Licence agreement

The second of the relevant transaction documents in relation to the Menai restaurant was the Menai licence agreement, by which McDonald's Australia granted to the purchaser a licence to adopt and use the McDonald's system in the Menai restaurant in consideration for: an upfront "licence fee" of $60,000; an ongoing "service fee" of 5% of the purchaser's gross sales; and an advertising contribution of not less than 4% of the purchaser's gross sales.

Recital A of the Menai licence agreement provided that: McDonald's Corporation "has developed and operates a restaurant system" (the McDonald's system); the McDonald's system includes proprietary rights and certain valuable trademarks, service marks and trade names, including the trade names "McDonald's" and "McDonald's Hamburgers", designs and colour schemes for restaurant buildings, signs, equipment layouts, formulae and specifications for certain

food products, methods of inventory and operation control, book-keeping and accounting, and manuals covering business practices and policies; and the McDonald's system is operated and is advertised widely within Australia and in other countries.

Recital B of the Menai licence agreement provided that:

> "The foundation and essence of the McDonald's System is the adherence by licensees to standards and the policies of McDonald's and its related corporations providing for the uniform operation of all McDonald's restaurants within the McDonald's System including, but not limited to, serving designated food and beverage products; the use of only prescribed equipment and building layout and designs; and strict adherence to designated food and beverage specifications and to prescribed standards of quality, service and cleanliness in restaurant operation. Compliance by licensees with the foregoing standards and policies in conjunction with McDonald's trademarks, service marks and trade names provides the basis for the valuable goodwill and wide acceptance of the McDonald's System. Moreover the establishment and maintenance of a close personal working relationship with Licensee in the conduct of his McDonald's restaurant business, his accountability for performance of the obligations contained in this agreement and adherence to the tenets of the McDonald's System constitute the essence of the licence provided for herein."

Clause 2.01 of the Menai licence agreement provided that:

> "In consideration of the payment by a Licensee to Licensor of the licence fee referred to in clause 3.01 hereof and the performance and observance by a Licensee of the obligations referred to in clause 6 hereof, Licensor hereby grants to Licensee the right, licence and privilege to adopt and use the McDonald's System in the Restaurant subject to the terms [sic] covenants and conditions contained herein."

Clause 6 of the Menai licence agreement set out the franchisee's undertakings. Relevantly, cl 6 provided that the licensee undertook to comply with the whole of the McDonald's system and to adopt and use every such component of the McDonald's system in the Menai restaurant.

The Menai licence agreement also provided that:

- the franchisee could not assign its interest in the Menai licence agreement without prior written consent; and
- the franchisee was not an agent of McDonald's Australia, and was an independent contractor.

Clause 15 of the Menai licence agreement dealt with the effect of termination of the agreement. Relevantly, cl 15(a) provided that, on any material breach of the agreement, the licensor had an immediate right to enter on and take possession of the restaurant, and cl 15(b) provided that, on the termination of the Menai licence agreement, all rights conferred on the licensee ceased forthwith, including the right to use the McDonald's system.

Lease

A further transaction document that was entered into was the Menai lease agreement by which McDonald's Australia granted to the taxpayer a lease of the premises at which the Menai restaurant was located for a term of 20 years at a monthly rent comprising a base rent of $10,000 and a percentage rent of 12.75% of the taxpayer's gross sales (less the base rent).

In McDonald's Australia's general ledger, a decrease in McDonald's Australia's goodwill was recorded in respect of the sale of the Menai restaurant business to Favotto.

The legislation

At the time of each of the transactions, s 8 of the *Duties Act 1997* (which provides for the imposition of duty on certain transactions which relate to dutiable property) relevantly provided as follows:

> "**8. Imposition of duty on certain transactions concerning dutiable property**
>
> (1) This Chapter charges duty on:
>
> (a) a transfer of dutiable property, and
>
> (b) the following transactions:
>
> (i) an agreement for the sale or transfer of dutiable property …"

"Dutiable property" was defined at that time in s 11, relevantly, as follows:

> "**11. What is 'dutiable property'?**
>
> (1) 'Dutiable property' is any of the following:
>
> (a) land in New South Wales,
>
> …
>
> (g) a 'business asset' being, at any relevant time:
>
> (i) the goodwill of a business, if the business has supplied goods in New South Wales, or provided services in New South Wales, to a customer of the business during the previous 12 months …
>
> (h a statutory licence or permission under a New South Wales law,
>
> …
>
> (j) goods in New South Wales, if the subject of an arrangement that includes a dutiable transaction over any dutiable property (other than intellectual property) elsewhere referred to in this section, not including the following:
>
> (i) goods that are stock-in-trade,
>
> …
>
> (l) an interest in any dutiable property referred to in the preceding paragraphs of this section …"

In the Dictionary to the Duties Act, "interest" was defined to include "an estate or proprietary right, and "transfer" was defined to include "an assignment and an exchange".

"Transfer"

On the issue of the concept of "transfer", the decision of the Victorian Court of Appeal in *Coles Myer Ltd v Commissioner of State Revenue (Vic)*[2] (*Coles Myer*) was applied by Ward CJ in Eq.

In that decision, consideration was given as to whether a transfer from a shareholder to a company as a result of a share buy-back transaction was a "transfer of shares" for the purposes of the revenue legislation being considered. The majority (Winneke P and Ormiston JA, Phillips JA dissenting) held that there was no "transfer". Ward CJ in Eq referred to several passages from the judgment of Ormiston JA in that

decision, including the following (emphasis added by her Honour):

> "There are two parties to every transfer, the transferor who disposes of all rights in the transferred property and the transferee who receives or acquires them so as thereafter to have the power to exercise effectively the same rights in the future. *For an instrument properly to be characterised as a 'transfer' one must be able to find that the property has passed from the transferor to transferee so that the property is vested in a transferee who for all practical purposes is then capable of exercising the same rights as were capable of being exercised by the transferor before the transfer was executed*."
>
> "*Thus, however broadly the word 'transfer' be defined, it requires at least that the transferee should, at the end of the transaction, have substantially the same right or interest in the subject matter as did the transferor before the transfer took place …*"

Goodwill

Ward CJ in Eq referred to several decisions relating to the legal concept of goodwill, including *FCT v Murry*,[3] *Commissioner of State Revenue v Placer Dome Inc*,[4] and *Sturt Football Club Inc v Commissioner of State Taxation*.[5]

Her Honour said that, as Favotto submitted, what was revealed on a consideration of the respective transaction documents when read as a whole was that the purchaser acquired a limited licence to use the respective premises and the McDonald's system for the purposes of running a McDonald's restaurant (for a limited time and on strict conditions) at each of the premises.

It was, in her Honour's opinion, significant that, on the termination of the licence arrangement, there was no goodwill that enured to the benefit of Favotto and, thus, Favotto had the temporary enjoyment of the goodwill of the relevant businesses (whether that be separate goodwill by reference to each business or an overall goodwill relating to the use of the McDonald's system as a whole), but there was no transfer as such to Favotto of the goodwill in the sense that it would be free to deal with or dispose of this at the end of the licence arrangements. Relevantly, there was no provision in the agreements that contemplated that Favotto was required to transfer back to McDonald's Australia anything that represented goodwill in respect of the business. Rather, in effect, Favotto's right to make use of that goodwill simply came to an end.

In that regard, her Honour said:

> "I do not accept that the requirements for a transfer (in the sense explained in *Coles Myer*) are here satisfied. I am persuaded by the submissions for Favotto that, here, there is the creation of new contractual rights (in the sense discussed in *Sun World International* and in *AFA*). That is to say, the transactions the subject of this proceeding, properly understood, generated new contractual rights in the forms of limited licences in the sense which I have just described. The transactions do not (whether in terms or in their effect), convey any pre-existing proprietary rights.
>
> How McDonald's Australia treats the transaction in its books (here, as a matter of fact, the recording of a decrease in goodwill on its general ledger after the sale) is not an admission against Favotto; nor do I think that there is any significance to be attributed to the accounting treatment of the payments in question. Similarly, the label given by the parties to the respective agreements (in particular to the first being a 'Sale of Business Agreement' and the second a 'Sale of Assets Agreement') is not determinative. The parties cannot, by adoption of a particular label, re-characterise the transaction in question. The 'sale' of business is somewhat of a misnomer in my opinion, in the sense that the purchaser does not acquire some kind of indefeasible title to, or ownership of, the said business — rather, it is merely given the right to conduct the business under the terms of each of the licence agreements at the premises the subject of each of the respective leases."

Certainly, those licences would carry with each the enjoyment of whatever goodwill had been engendered in relation to the relevant business up to the time of the licence (and, obviously enough, the licence holder would enjoy the benefit of whatever goodwill was generated thereafter by use of the McDonald's system during the term of the licence arrangements). However, the taxpayer had not in any sense become, through any transfer, the "owner" of that goodwill.

Ward CJ in Eq accepted that it was not clear on the face of the documents what was comprised by the term "franchise rights intangible". However, she was not persuaded that, simply because there was a separate payment by way of licence fees and the like under each of the licence agreements, it should be inferred that the purchase price payable under each of the "sale" agreements was a payment for goodwill.

Her Honour said:

> "There is to my mind an incongruity between the payment under the sale agreements of a very large sum of money to acquire a business and/or business assets and the purchaser only being able to use those assets and enjoy the benefits of the business during the term of the licence (and lease); since thereafter the terms of the assignment or sale agreements do not entitle the purchaser to any rights in relation to the business or the goodwill of the business of which it has had the benefit during the term of the licence (and any additional goodwill which it may have built up during the term of the licence). However, I accept that this does not necessarily assist in determining what was 'transferred', if anything, under the sale agreements. Similarly, any such perceived incongruity is explicable to the anticipated profits to be derived from the use of the McDonald's System, and the running of the businesses, over the relevant period. It is also important, on this particular point, to have in mind that the relevant transaction documents are to be construed as part of a single transaction in the case of each of the two restaurants. As I have already adverted to, this approach was common ground between the parties."

Ultimately, her Honour said that the high point for the Chief Commissioner was the fact that the "sale" agreements were drafted as agreements for the sale of a business (in the case of Menai) or business assets (in the case of Lakemba), with which business any goodwill attached thereto would be inseverable, and that the agreements themselves referred to the item "franchise rights intangible". However, at least in the Lakemba agreement, it was clear that the parties did not understand or intend the agreement to be transferring "goodwill" since they included a statement "[f]or the avoidance of doubt" in the definition of "business" to make clear that any goodwill referable to the restaurant was not being sold. Therefore, and while again accepting that the labels used by the parties are not ipso facto determinative, the reference to "franchise rights intangible" in the Lakemba

agreement at least must have been understood by the parties to be something other than the goodwill.

Her Honour went on:

> "I note the Chief Commissioner's argument that, by transferring the business, this carried with it necessarily the goodwill of that business and therefore it is not to the point that the agreement contains a statement to the effect that goodwill is not being sold (since it is inseverable from the business). However, as I see it, nothing has been 'transferred' in the relevant sense; rather, what has been done is the creation of a contractual right or conferring of authority to operate the business and use of the McDonald's System (with the benefit of the goodwill attached thereto). That this is the case makes sense when one considers, as I have already pointed out, that there is no obligation, on cessation or termination of the licence arrangements, for there to be any re-transfer to McDonald's Australia of the 'business' nor of any goodwill attached to the business at that time.
>
> Contrary to the Chief Commissioner's submission that, in the absence of any adequate explanation as to that to which the so-called 'Franchise Rights Intangible' relates, this term should be treated as a surrogate for the goodwill of the business, I have concluded that Favotto has adequately explained, having regard to all of the above, what has in substance occurred through the transactions."

Comment

The decision in the *Favotto* case is of interest on both points considered, that is, the concept of transfer and the concept of goodwill.

In relation to the word "transfer", the context of the Duties Act was the identification of transactions in respect of which ad valorem duty would be payable, and the view of Ward CJ in Eq is, it is suggested, correct. The concept of transfer has its counterpart, in the context of CGT, in the concept of a change of ownership which will activate the happening of CGT event A1 (s 104-10(2) of the *Income Tax Assessment Act 1997* (Cth) (ITAA97)). In *Ellison v Sandini Pty Ltd*,[6] Jagot J (Siopis J agreeing) said:

> "As the Commissioner submitted, proprietary rights may be created or transferred which do not amount to a 'change of ownership' within the meaning of s 104-10(2) of the ITAA 1997. 'Ownership', as the Commissioner submitted, involves full, absolute rights of possession and control over the subject-matter of the rights. If such rights are not created or transferred by the orders, it cannot be said that there has been a 'change of ownership'. Moreover, such rights cannot be created or transferred if the transferor retains equivalent or similar rights."

A CGT asset is defined (in s 108-5(1) ITAA97) as any kind of property, or a legal or equitable right that is not property. It is then provided (in s 108-5(2) ITAA97), "to avoid doubt", that certain items are CGT assets, including "goodwill or an interest in it". For a ruling by the Commissioner on CGT aspects of goodwill, see TR 1999/16.

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References

1 [2020] NSWSC 120.
2 [1998] VSC 288.
3 [1998] HCA 42.
4 [2018] HCA 59.
5 [2010] SASC 279.
6 [2018] FCAFC 44.

Mid Market Focus

by Jordan Phung, HLB Mann Judd

The application of GST to sales of real property

A reminder on the importance of correctly characterising the nature of a property when considering the GST implications of a property sale.

An important consideration when purchasing or selling real property is whether GST will be applicable on the disposal of the property. Determining this is not always straightforward and, if not considered carefully, can be a costly mistake to make.

A common source of ambiguity with property disposals is how they should be characterised in the context of GSTR 2012/5, GSTR 2012/6 and GSTR 2012/7. The ATO's guidance highlights several indicators that will affect the characterisation of a property. However, similar to the residency rules, an objective evaluation of all of the facts is required and there is rarely one determinative factor that can be relied on.

In practice, a good place to start is with understanding the parties involved in the transaction and, in particular, their GST registrations (or the requirement to be registered).

Are the parties registered for GST and is the sale a "taxable supply"?

The provision of a good or service will be considered a "taxable supply" for GST purposes if the following requirements are met:[1]

- a supply is made;
- the supply is made for a consideration;
- the supply is made in the course or furtherance of an enterprise that the supplier carries on;
- the supply is connected with Australia;
- the supplier is registered or required to be registered; and
- the supply is not GST-free or input-taxed.

Given the above, the GST implications of a property disposal will be heavily influenced by whether the parties involved in the transaction are "carrying on an enterprise" and whether the property is disposed of in the course of the vendor's enterprise.

Assuming that all parties involved are registered for GST and carrying on an enterprise, the next step would be establishing whether the property is "residential premises".

Is the property "residential premises"?

The definition of "residential premises" in s 195-1 GSTA refers to land or a building occupied or intended to be occupied as a residence, and also extends to floating homes.

Generally, the sale of residential premises (such as houses and units) by entities registered for GST is input-taxed,[2] meaning that there is no GST payable in respect of the sale. However, the supply of residential premises is only input-taxed to the extent that the premises are premises used predominantly for residential accommodation.[3]

When assessing whether premises are used predominantly for residential accommodation, the ATO will first and foremost consider the physical attributes of the property. In practice, the past usage of a building and the intention of the purchaser are rarely, if ever, determining factors in this assessment.

Premises that display suitability and capability to provide residential accommodation are residential premises, even if they are used for a purpose other than to provide residential accommodation (for example, where the premises are used as a business office).[4]

On the other hand, premises that are not fit for human habitation, even if currently occupied for residential accommodation, will not be residential premises for GST purposes.[5] This would include properties that are in a dilapidated condition[6] and require significant repairs, as well as properties that do not have the required amenities to support residential living.

Once it is established that a property is "residential premises", there is a further consideration of whether the sale of the residential premises is input-taxed. Section 40-65(2) states that a sale of residential premises is *not* input -taxed to the extent that they are:

- commercial residential premises; or
- new residential premises other than those used for residential accommodation before 2 December 1998.

Is the property "commercial residential premises"?

The definition of "commercial residential premises" in s 195-1 includes the following:

1. a hotel, motel, inn, hostel or boarding house;
2. premises used to provide accommodation in connection with a school;
3. a ship that is mainly let out on hire in the ordinary course of a business of letting ships out on hire;
4. a ship that is mainly used for entertainment or transport in the ordinary course of a business of providing ships for entertainment or transport;
5. a marina at which one or more of the berths are occupied, or are to be occupied, by ships used as residences;
6. a caravan park or a camping ground; or

7. anything similar to residential premises described in points 1 to 6 above.

It is worth noting that premises may be characterised as commercial residential premises even when they are not operating. Where premises have been newly constructed and not yet operating, reference should be made to the following[7] indicators:

- the premises' physical characteristics;
- architectural plans and drawings;
- contractual documentation that provides evidence of how the premises will be used in the future; or
- council or other government planning and zoning restrictions and approvals and permissions.

For premises that are operating, the ATO will typically assess the features of the premises against common characteristics of operating hotels, motels, inns, hostels and boarding houses that are relevant to characterising premises as "commercial residential premises", such as whether:[8]

- the premises are operated on a commercial basis or in a business-like manner even if they are operated by a non-profit body;
- the premises have the capacity to provide accommodation to multiple, unrelated guests or residents at once in separate rooms, or in a dormitory;
- the premises offer accommodation to the public or a segment of the public;
- providing accommodation is the main purpose of the premises;
- the premises have central management to accept reservations, allocate rooms, receive payments and perform or arrange services. This can be provided through facilities on-site or off-site;
- the entity operating the premises supplies accommodation in its own right rather than as an agent; and
- predominantly, the occupants are travellers who have their principal place of residence elsewhere. The occupants do not usually enjoy an exclusive right to occupy any particular part of the premises in the same way as a tenant.

Where the physical characteristics of a property indicate that it is residential premises, but also suitable for multiple occupancies, for example, a dormitory adjoining a mansion, it is arguable that there is a commercial component to the sale of the property. If so, the sale of the mansion and adjoining dormitory would constitute a "mixed supply" and an appropriate apportionment method would need to be applied to distinguish between the taxable and non-taxable GST components of the sale.

Is the property "new residential premises"?

Section 40-75(1) GSTA provides that residential premises are "new residential premises" if they:

- have not previously been sold as residential premises (other than commercial premises) and have not previously been the subject of a long-term lease;
- have been created through substantial renovations of a building; or
- have been built, or contain a building that has been built, to replace demolished premises on the same land.

Accordingly, it is always prudent to consider the history of the relevant property when assessing whether it is new residential premises for GST purposes. For example, the characterisation of the property disposal when the current vendor first acquired the property would often be an important consideration.

Conclusion

While it has been some time since the ATO's guidance in GSTR 2012/5, GSTR 2012/6 and GSTR 2012/7 was written, the plethora of private rulings on this issue is a solemn reminder of the complexity surrounding GST and sales of real property in Australia.

Given the costs of getting it wrong, advisers are encouraged to err on the side of caution when advising clients on this issue. Moreover, it may be worth consulting with indirect tax experts and potentially applying for a complex issue resolution or a private binding ruling in unique cases where it is difficult to characterise the property under the relevant provisions and ATO rulings.

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References

1 S 9-5 of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GSTA).

2 Para 9 of GSTR 2003/3.

3 S 40-65(1) GSTA.

4 Para 10 of GSTR 2012/5.

5 Para 11 of GSTR 2012/5.

6 Para 20 of GSTR 2012/5.

7 Paras 86-87 of GSTR 2012/6.

8 Para 12 of GSTR 2012/6; para 12.12 of the revised explanatory memorandum to the Tax Laws Amendment (2006 Measures No. 3) Bill 2006.

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Structuring cross-border transactions: part 1

by Renuka Somers, Senior Tax Advisor, US–Australia Tax Desk, and Peter Harper, CEO and Managing Director, Asena Advisors, LLC

TD 2019/D6 and TD 2019/D7 raise important considerations in international tax planning and the structuring of Australian investments, as all capital gains (whether foreign-sourced or not) that are attributed to a foreign resident beneficiary of an Australian resident trust are now assessable to that beneficiary, unless the trust is a fixed trust. The draft determinations are contentious due to a disconnect between the relevant legislative provisions and the ATO's interpretation of them, and as they do not address Australia's double tax agreements. Further, they lead to differing tax outcomes for foreign residents assessed on capital gains from the disposal of non-taxable Australian property, depending on the structure through which they derive that gain. Consequently, foreign resident taxpayers require more clarity on this aspect of Australian tax law.

Introduction

The Australian Taxation Office's release of draft taxation determinations TD 2019/D6 and TD 2019/D7 (collectively, the DTDs) in September 2019 has generated much controversy. The DTDs have been widely criticised by tax practitioners for being inconsistent with the policy intent of, and imposing an incorrect interpretation of, the legislative context for the assessment of foreign resident beneficiaries (FRBs) of Australian resident trusts.[1]

The combined effect of the DTDs is that capital gains (regardless of source) attributed to an FRB of an Australian resident trust are assessable to that FRB, unless the trust is a fixed trust. The DTDs therefore raise important considerations for international tax planning, illustrating how the ownership structure of investments can significantly impact the tax outcomes for FRBs if held directly or through a fixed trust, instead of being held through discretionary trusts.

In this article, we consider the proposed changes with each taxation determination in the context of relevant provisions of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) and the *Income Tax Assessment Act 1997* (Cth) (ITAA97), and in part 2, we consider the potential impact of the changes on international tax planning.

The taxation of capital gains for foreign residents

The following key concepts and provisions of the ITAA36 and the ITAA97 are relevant, and provide context, for the discussion below.

The assessable income of a foreign resident includes ordinary and statutory income derived, directly or indirectly, from Australian sources, and statutory income which the ITAA36 and the ITAA97 includes based on other than an Australian source.[2] In contrast, the assessable income of an Australian resident includes ordinary and statutory income from *all* sources.[3]

The assessable income of a beneficiary of a trust who is not under any legal disability, and who is presently entitled to a share of the income of the trust, includes their share of the net income of the trust attributable to a period when the beneficiary was a resident, and their share of the net income of the trust attributable to a period when the beneficiary was not a resident and which is also attributable to sources in Australia.[4] For an FRB, a trustee is liable to be assessed and pay tax on the net income of the trust attributable to that FRB at the applicable tax rate.[5]

Assessable income includes net capital gains, and the ITAA97 provides a method statement for the purposes of calculating those gains.[6] When applying this method statement to calculate the net capital gains of a trust, Subdiv 115-C ITAA97 treats a beneficiary (resident or FRB) as having an "extra" capital gain (even though no CGT event has happened directly to the beneficiary) calculated by reference to s 115-215, so that the beneficiary can apply capital losses and the appropriate discount percentage (if any) to those gains.[7] For an FRB, the trustee must "gross up" the FRB's attributable capital gains for any discount capital gains and franking credits.[8]

A foreign resident who directly holds non-taxable Australian property (TAP) and the trustee of a foreign trust holding non-TAP can both disregard a capital gain or a capital loss from a CGT event in relation to the non-TAP.[9]

Similarly, a capital gain that an FRB of an Australian resident trust makes is disregarded where the trust is a "fixed" trust.[10] A trust is a fixed trust if beneficiaries have fixed entitlements to all of the income and capital of the trust.[11] A fixed entitlement is determined by reference to a vested and indefeasible interest in a share of the income or capital of a trust pursuant to the terms of its trust deed.[12] The Commissioner has the discretion to treat an interest as a fixed entitlement in certain circumstances; however, this discretion cannot be exercised in relation to default beneficiaries and mere objects of discretionary trusts.[13]

The DTDs

TD 2019/D6

In TD 2019/D6, the ATO states that Subdiv 855-A ITAA97 does not disregard a capital gain that an FRB (or a temporary resident beneficiary) of a resident non-fixed trust makes

because of s 115-215(3) ITAA97. Once finalised, the taxation determination is to operate retrospectively.

The ATO distinguishes between fixed trusts and non-fixed trusts, stating that a capital gain attributed to an FRB under s 115-215(3) is disregarded only if the trust is an Australian resident *fixed* trust — the consequence of which is that an FRB is assessable on capital gains on non-TAP that is distributed by an Australian-resident non-fixed trust.

The ATO explains its reasoning and the interaction of the relevant legislative provisions on the basis that favourable taxation treatment is warranted as:[14]

- a foreign resident is "investing" and bringing funds into Australia (whether directly or through a fixed trust), which does not occur with the object of a non-fixed or discretionary trust;
- the specific exemption in s 855-40 ITAA97 for fixed trusts is a strong indicator that beneficiaries of non-fixed trusts are not included in the application of the "general" exemption in s 855-10 ITAA97 which allows a capital gain to be disregarded if the taxpayer is a foreign resident (or the trustee of a foreign trust) and the CGT asset is not TAP; and
- a capital gain that an FRB makes because of s 115-215(3) is not a capital gain from a CGT event that happens to the beneficiary, but rather an event that happens to the trustee — if s 855-10(1) could disregard trust capital gains attributed to FRBs generally, it would do so without regard to whether the trust is fixed or not, thereby making s 855-40 redundant.

TD 2019/D7

In TD 2019/D7, the ATO states that the concept of "source" is not relevant:

- to determining whether an amount of a trust's capital gain is assessable to the FRB or trustee; and
- in relation to an FRB's share of TAP gains of a non-resident trust and a trustee's share of a capital gain to which s 115-222 ITAA97 applies.

TD 2019/D7 is intended to apply to capital gains included in the net income of a trust estate for Australian tax years ending 30 June 2020 and onwards.

The ATO explains its disregard of the source concept in TD 2019/D7 as follows:[15]

- the phrase "source concept'" refers to the limitation in Div 6 ITAA36 on the assessment of non-residents (or trustees) to amounts "attributable to sources in Australia" and cites ss 98A(1)(b) and 98(2)(e) ITAA36;[16]
- the capital gains and losses of a resident trust are determined without regard to whether they arise from TAP, or whether the trust has non-resident beneficiaries;
- s 115-220 ITAA97 increases the amount assessable to the trustee under s 98 without regard to whether the beneficiary's attributable gain satisfies the conditions in s 98 ITAA36 — the effect of which is to make the amount drawn from Subdiv 115-C ITAA97, without regard to source, assessable and taxable to the trustee under s 98;
- while s 6-10(5)(a) ITAA97 requires non-residents to include only Australian-sourced statutory income in their assessable income, s 6-10(5)(b) also includes other statutory income where a provision assesses it on some basis other than it having an Australian source; and
- s 99D ITAA36 (which can provide an FRB with a refund of tax paid by the trustee under s 99A ITAA36 on income from non-Australian sources) is subject to the discretion of the Commissioner in s 99D(2) to refuse a refund where there was a purpose of enabling the beneficiary to obtain the refund.

What does this mean?

As a consequence of the DTDs, capital gains (regardless of source) attributed to an FRB of an Australian resident trust would be assessable to that FRB, unless the trust is a fixed trust for s 855-40 ITAA97 purposes. Generally, s 855-40 provides a CGT exemption to an FRB for a capital gain or loss on an interest in a fixed trust that is not TAP.

The DTDs have been widely criticised by tax practitioners for misinterpreting the application of, and policy intent behind, Div 855 and Subdiv 115-C ITAA97 and Div 6 and Div 6E ITAA36. These criticisms have been widely reported and appear in a number of technical submissions made by professional services firms to the ATO since the release of the DTDs, and it is unnecessary to restate them here.

In the authors' opinion, there are two key repercussions of the DTDs:

- it is difficult to reconcile the relevant legislative provisions with the interpretation extended to them by the ATO in its discussion of the intended operation of the DTDs. If the DTDs are finalised in their present form, legislative changes are required to address this disconnect; and
- the DTDs also create concerns from an international tax planning perspective, as:
  - the DTDs both specifically state that they do not deal with the application of Australia's double tax agreements (DTAs). This creates considerable uncertainty as to how the ATO's interpretation of the relevant provisions would affect, and be affected by, Australia's obligations under the DTAs; and
  - the tax treatment of gains derived from the disposal of non-TAP assets will vary for a foreign resident, depending on whether the gain is attributable to the foreign resident:
    - through direct ownership;
    - as an FRB of a fixed Australian resident trust;
    - as an FRB of a non-fixed Australian resident trust; or
    - as a trustee of a foreign trust.

The international tax aspects of the DTDs are discussed in part 2 of this article.

Disconnect between the DTDS and the ITAA36 and the ITAA97

How do we reconcile the DTDs with s 98A and Div 6E ITAA36?

Section 98A(1)(b) ITAA36 states:

> "98A(1) *Where the trustee of a trust estate is assessed and is liable to pay tax* in respect of the whole or a part of a share of the net

income of a trust estate of a year of income in pursuance of subsection 98(3), *the assessable income of the beneficiary who is presently entitled to that share of the income of the trust estate shall include*:

(a) so much of the individual interest of the beneficiary in the net income of the trust estate as is attributable to a period when the beneficiary was a resident; and

(b) *so much of the individual interest of the beneficiary in the net income of the trust estate as is attributable to a period when the beneficiary was not a resident and is also attributable to sources in Australia*." (emphasis added)

This would clearly seem to indicate that an FRB's share of the net income of a trust should only include that which is referable to *Australian sources*.

The explanatory memorandum to the Income Tax Assessment Amendment Bill 1983 (EM), which inserted s 98A into the ITAA36,[17] states:

"Clause 18: Liability of Trustee

This clause proposes the amendment of section 98 of the Principal Act to include two new sub-sections …The new sub-sections of section 98 will provide, broadly, that the trustee of a trust estate is to be assessed and liable to pay tax in respect of the relevant share of the trust income to which a beneficiary who is a non-resident at the end of the year of income is presently entitled …

Subject to the tests provided, proposed new sub-section 98(4) will apply where the beneficiary is an individual …

If all of the above tests are satisfied, *the trustee will be taxed on behalf of the beneficiary* in respect of the trust income from any source that is attributable to a period when the beneficiary was a resident (paragraph 98(4) (c)) *and in respect of the trust income from Australian sources that is attributable to a period when the beneficiary was a non–resident* (paragraph 98(4) (d)). The trustee will be so taxed at the rates of tax applicable to individuals …

Clause 19: Non-resident beneficiaries assessable in respect of certain income

By this clause, it is proposed to insert a new section 98A in the Principal Act to provide for a non-resident beneficiary, on whose behalf a trustee has been taxed under new sub-section 98(3) or (4), to be also taxed on the particular trust income — with an appropriate credit being allowed for the tax paid by the trustee. The proposed new section will also provide for a refund of any excess of the tax paid by the trustee over that assessed to the beneficiary …

The new sub-section will also apply where the trustee is taxed under new sub-section 98(4) on behalf of an individual beneficiary. Apart from providing a means of second recourse in respect of the tax involved, this will ensure, on one hand, that an individual beneficiary's total income is brought to account and the tax calculated accordingly and, on the other hand, that the beneficiary is not disadvantaged in relation to any deduction and/or rebate from which he or she would have benefited if he or she continued to be taxed directly under section 97, and which will not be allowable in the assessment on the trustee under sub-section 98(4) …

Where the proposed new sub-section applies, *the beneficiary will be taxed on the trust income* from any source that is attributable to any period when the beneficiary was a resident (paragraph (a)) and on that income *from Australian sources that is attributable to a period when he or she was a non–resident* (paragraph (b)).

Proposed new sub-section 98A(2) will provide that where sub-section 98A(l) applies — that is, where a trustee is taxed under sub-section 98(3) or (4) and the beneficiary also is taxed under sub-section 98A(l) — the tax paid by the trustee is to be offset against that assessed to the beneficiary." (emphasis added)

The ATO seems to dismiss this point in TD 2019/D7, stating:

"15. In other words, *the effect of section 115–220 is merely to make the amount drawn from Subdivision 115–C, without regard to source, both assessable and taxable to the trustee under section 98 of the ITAA 1936*. This applies even if there is no other amount (based on the Division 6E net income) assessable to the trustee …

16. *Similarly, the conditions in subsection 98A(1) of the ITAA 1936 have no application to determine the beneficiary's capital gains, as this is done by section 115–215 and other provisions within Subdivision 115–C.*

17. Division 6E of Part III of the ITAA 1936 (Div 6E) … prevents double taxation by ensuring capital gain amounts are disregarded in determining the trust income and net income that may be assessed through the ordinary operation of Division 6 of the ITAA 1936." (emphasis added)

However, the relevant provisions of Div 6E state:

"Section 102UX

(1) Make the assumptions in the following subsections for the purposes of working out in accordance with Division 6 an amount:

  (a) *included in the assessable income of a beneficiary of a trust estate under section 97, 98A* or 100; or

  (b) *in respect of which a trustee of a trust estate is liable to pay tax under section 98*, in relation to a beneficiary of the trust estate; or

  (c) in respect of which a trustee of a trust estate is liable to pay tax under section 99 or 99A.

…

(2) Assume that the income of the trust estate were equal to the Division 6E income of the trust estate.

(3) Assume that the net income of the trust estate were equal to the Division 6E net income of the trust estate.

(4) Assume that the amount of a present entitlement of a beneficiary of the trust estate to the income of the trust estate were equal to the amount of the beneficiary's Division 6E present entitlement to the income of the trust estate.

Section 102UY

…

(2) The ***Division 6E income***, of the trust estate, is the income of the trust estate worked out on the assumption that *amounts attributable to the things mentioned in paragraph 102UW(b) were disregarded*. The Division 6E income of the trust estate cannot be less than nil.

(3) The ***Division 6E net income***, of the trust estate, is the net income of the trust estate worked out on the *assumption that the things mentioned in paragraph 102UW(b) were disregarded*. The Division 6E net income of the trust estate cannot be less than nil.

(4) 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) for each capital gain taken into account as mentioned in paragraph 102UW(b) — so much of the beneficiary's share of the capital gain as was included in the income of the trust estate; and
>
> (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 …" (emphasis added)

Section 102UW(b) ITAA36 mentions the following, which is to be disregarded for s 102UY ITAA36 purposes:

> "This Division applies if:
>
> (a) the net income of a trust estate exceeds nil; and
>
> (b) any of the following things are taken into account in working out the net income of the trust estate:
>
> (i) a *capital gain* (to the extent that an amount of the capital gain remained after applying steps 1 to 4 of the method statement in subsection 102-5(1) of the Income Tax Assessment Act 1997);
>
> (ii) a *franked distribution* (to the extent that an amount of the franked distribution remained after reducing it by deductions that were directly relevant to it);
>
> (iii) a *franking credit*." (emphasis added)

It would seem that Div 6E would only operate to disregard a capital gain *already included* in the net income of the trust estate and to which (for example) a beneficiary was assessable under s 98A and the trustee was liable to pay tax for under s 98 — and which, at the threshold level, would *exclude*, in the case of an FRB, capital gains attributable to CGT assets which do not have an Australian source.

> *"… the ownership structure of investments can significantly impact the tax outcomes for FRBs."*

Residency and source: common law, the ITAA36 and the ITAA97, and ATO interpretation

Common law

The concept of "source" has its origin in common law and can vary depending on the type of income that is subject to assessment, with the focus being on the origin of the income. For example, in *Nathan v FCT*,[18] the High Court stated that the source of dividends was to be determined by the "real source of production of the dividend" which the court attributed to the company's operations which generated the profits for the payment of the dividends. This concept was reiterated by the Full High Court in *Esquire Nominees Ltd v FCT*:[19]

> "… the place where the distributed profits were made is the geographical source of the fund out of which the dividend itself is declared: therefore it may be said that that place is the geographical source of the dividend."

Similarly, the place where the intellectual property from which the right to receive royalties arose was held to be the source of the royalties in decisions such as *FCT v United Aircraft Corporation*.[20] With interest, in *FCT v Spotless Services Ltd*,[21] the Full Federal Court upheld Lockhart J's conclusion in the Federal Court that the loan contract which bound the parties was concluded with the delivery of the check in the Cook Islands, such that the interest income was sourced there.

The ITAA36, the ITAA97 and the DTAs

What the legislative provisions discussed above illustrate is that, when determining liability to taxation, the considerations applicable to a taxpayer are, first, their *residency* and, then, the *source* of that income.

The residency–source dichotomy has been incorporated in the Australia–United States income and capital tax treaty (treaty),[22] with the taxing rights being primarily attributed based on the residency of the taxpayer and with (secondary) withholding tax rights being allocated to the country of source.[23]

For example, the treaty states:

> "Article 10 Dividends
>
> (1) Dividends paid by a company which is a resident of one of the Contracting States for the purposes of its tax, being dividends to which a resident of the other Contracting State is beneficially entitled, may be taxed in that other State.
>
> (2) However, those dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident for the purposes of its tax, and according to the law of that State, but: …
>
> Article 11 Interest
>
> (1) Interest arising in one of the Contracting States, being interest to which a resident of the other Contracting State is beneficially entitled, may be taxed in that other State.
>
> (2) However, that interest may also be taxed in the Contracting State in which it arises, and according to the law of that State, but the tax so charged shall not exceed 10 percent of the gross amount of the interest …
>
> Article 12 Royalties
>
> (1) Royalties from sources in one of the Contracting States, being royalties to which a resident of the other Contracting State is beneficially entitled, may be taxed in that other State.
>
> (2) Such royalties may be taxed in the Contracting State in which they have their source, and according to the law of that State, but the tax so charged shall not exceed 5 percent of the gross amount of the royalties …"

The ATO

The ATO's approach with the DTDs (at least in this context, where residency and source converge) is to *eliminate* the concept of source when it comes to taxing capital gains attributed to an FRB by adopting a "formulaic" approach to statutory interpretation. This approach is also seen in TD 2019/D10 which was released in October 2019 (soon after the release of TD 2019/D6 and TD 2019/D7) and which discusses the foreign income tax offset (FITO) limit calculation. The ATO states that net capital gains are to

be excluded from the ambit of the income captured for the purposes of the FITO calculation as they do not have a source:

> "4. The FITO limit calculation involves a comparison between Australian tax actually payable and the Australian tax that would be payable if certain income, and deductions reasonably related to that income, were disregarded …
>
> 6. Generally, the higher the amount of income captured under paragraph 770-75(4)(a), the higher the FITO limit …
>
> 9. Amounts are included under subparagraph 770-75(4)(a)(ii) if they are amounts of 'ordinary income' or 'statutory income' from a 'source other than an Australian source'.
>
> 10. A net capital gain is an amount of statutory income. Each capital gain is not an amount of 'statutory income'.
>
> 11. *A net capital gain does not have a source. It is a product of capital gains and capital losses made during the income year from Australian and non–Australian sources, the application of unapplied net capital losses from earlier income years and applicable discounts.*
>
> 12. Subparagraph 770-75(4)(a)(ii) does not allow you to disaggregate a net capital gain (the singular amount of 'statutory income') to identify capital gains that have been included in working out your net capital gain." (emphasis added)

As with TD 2019/D6 and TD 2019/D7, TD 2019/D10 has been criticised as being contrary to policy and statute:[24]

> "It is contrary to this policy [relief against double taxation] to suggest that foreign sourced capital gains can never be taken into account in determining this limit merely because the capital gains tax regime aggregates multiple capital gains and losses and applies concessions to determine one assessable amount being a net capital gain. It would lead to artificial differences if a taxpayer could obtain a better outcome because a foreign sourced gain is assessable as ordinary income on revenue account and therefore assessable in its own right."

Further, TD 2019/D10 does not provide any support for the ATO's assertion that a net capital gain inherently cannot have a source, with this point being what the ATO's conclusion ultimately turns on in TD 2019/D10. The authors believe that the context of the income tax legislation leads to a contrary conclusion in this regard.

Conclusion

There is a disconnect between the DTDs and the relevant provisions of the ITAA36 and the ITAA97 and ATO clarification would be helpful to address these matters. Otherwise, accompanying legislative change is required if the DTDs are to be finalised in their present form. The DTDs also create international tax structuring issues. These are discussed in part 2 of this article.

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The director penalty regime and its extension to GST

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With effect from 1 April 2020, company directors will have a heightened risk of being made personally liable for their company's outstanding tax liabilities. Pursuant to the *Treasury Laws Amendment (Combating Illegal Phoenixing) Act 2020*, which received royal assent on 17 February 2020, the director penalty regime has been extended to make company directors personally liable for unpaid GST (including luxury car tax and wine equalisation tax). The measures, which were introduced as part of the government's ongoing reform of Australia's corporate insolvency regime, will impact many company directors as it is very common for businesses to have GST debts. It is critical that directors ensure that all business activity statements and GST returns are lodged before the statutory lockdown date, to ensure that they can achieve remission of their personal liabilities by placing the company into administration or appointing a liquidator.

Introduction

Pursuant to Div 268 and Div 269 of Sch 1 to the *Taxation Administration Act 1953* (Cth) (TAA), the Commissioner of Taxation is empowered to recover from company directors unpaid amounts under the pay as you go (PAYG) withholding rules and the superannuation guarantee charge. The regime places a duty on directors to ensure that their company complies with its obligation to pay to the Commissioner such amounts withheld.

Directors who fail to comply with their duty to ensure that their company complies with its obligation will become personally liable for the amounts payable through the imposition of a penalty.

In a significant extension to the regime, with effect from 1 April 2020, directors now have a personal liability for unpaid GST, luxury car tax (LCT) and wine equalisation tax (WET).[1] Under this extension, where a company has an assessed "net amount" (including estimated net amounts and GST instalments), each director will be personally obliged to ensure that the payment of this liability occurs or, if not, to put the company into administration or liquidation.

The extension of the director penalty regime to GST is significant, as it will require companies to undertake due diligence processes and to ensure that they have sufficient internal governance processes to guarantee that tax obligations are met. Additionally, any new director will need to undertake a comprehensive due diligence review process.

Background to the director penalty regime

The director penalty regime is a reflection of the public duty on directors to ensure that amounts withheld from payments to third parties are promptly forwarded to the Commissioner. The public duty arises because withheld amounts are similar in nature to amounts held on trust. That is, directors are in a position of trust and have a duty to protect those moneys until they have been forwarded to the Commissioner.[2]

Further, because the PAYG withholding rules often give a credit to the entity from which an amount has been withheld, regardless of whether the withholder has paid the amount to the Commissioner, the Commonwealth is effectively guaranteeing such amounts. Such a guarantee necessitates the imposition of penalties on directors to ensure that companies comply with their PAYG withholding obligations and to maintain the integrity of the tax system.[3]

Commencement of director penalty regime

The director penalty regime was introduced in 1993 pursuant to the *Insolvency (Tax Priorities) Legislation Amendment Act 1993* to assist the Commissioner to recover certain company liabilities. The director penalty regime abolished and replaced the priority of the Commissioner that existed under insolvency law for certain amounts withheld (particularly from salary or wages) but not paid to the Commissioner. Those debts, prior to the amendments, had priority over all other debts of a person or a company in a bankruptcy or an insolvency, irrespective of whether the other debts were preferential, secured or unsecured.

The Commissioner's priority had effectively elevated the Commissioner's right to recover unpaid pay as you earn (PAYE) liabilities in a winding-up process ahead of other secured creditors. The director penalty regime was a substitute for the Commissioner's priority following the release of the Harmer report[4] by the Australian Law Reform Commission (which broadly recommended the removal of the Commissioner's priority over all other unsecured creditors).

Under former ss 221P, 221YHJ, 221YHZD and 221YU of the *Income Tax Assessment Act 1936* (Cth) (ITAA36), the Commissioner had priority over all other creditors (whether preferential, secured or unsecured) of a person, including a company, in the recovery of unremitted amounts PAYE arrangements and under the prescribed payments system. The Commissioner also had priority for debts which arose when deductions from natural resource payments, unattributed income and deductions of withholding tax were not remitted.

The former regime imposed a duty on directors to cause the company to forward amounts that were withheld from payment to employees and certain other creditors to the

Commissioner, with this duty being enforced by penalties equal to the unpaid amounts. The penalty was automatically remitted if the company met its obligations, or promptly went into voluntary administration or liquidation.[5]

The regime has continued to evolve over time. Significantly, with effect from 30 June 2012, the regime was expanded to include superannuation guarantee obligations and associated estimates.[6] As part of this package of amendments, a PAYG withholding non-compliance tax was introduced,[7] making directors liable to this tax where the company of which they are a director has withheld more amounts from withholding payments than it has paid to the Commissioner for the director's income year.

In 2018, the government made further changes to the regime,[8] including the removal of the three-month rule which applied before director penalties with respect to unpaid superannuation guarantee charge liabilities (and estimates of these liabilities) became locked down and could no longer be remitted.[9] The three-month rule was retained for PAYG withholding liabilities and related estimates.

Overview of the director penalty regime

The director penalty regime (Div 269, Sch 1 TAA) operates to make company directors personally liable for specified taxation liabilities of the company in circumstances of non-payment. The regime previously broadly applied to a company's liabilities to pay to the Commissioner PAYG withholding amounts, superannuation guarantee charges, and estimates of these liabilities. The regime has now been expanded, with effect from 1 April 2020, to apply to liabilities to pay assessed net amounts under the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GSTA) and GST instalments.

Directors are under a general obligation to ensure that the company either satisfies the above liabilities or, recognising that the company may be insolvent, goes into administration or is wound up.[10] The obligation begins on an "initial day"[11] specified in relation to each category of underlying company liability, and continues to apply to directors who cease their directorship after the initial day.

If the company has not complied with its obligations at the end of the "due day", the penalty applies even if the director had ceased being a director before the end of the due day. Accordingly, resignation as a director after the initial day does not absolve the director of liability.[12] Further, in order to be liable, the person need not be a director as at the initial day — the person only needs to hold that position at the end of the due day.

New directors

New directors are persons who became directors after the "due day" in respect of the relevant tax liability. New directors are liable for director penalties in respect of a company's unpaid obligations if, 30 days after the director started, those obligations remain unsatisfied,[13] that is, the penalty is due and payable at the end of that 30th day.[14]

Penalty notices

The director penalty is only recoverable following a period of 21 days, beginning when the Commissioner issues a director penalty notice to a director.[15] A penalty notice is taken to be given at the time the Commissioner leaves it at, or posts it to, the director's place of business (based on information held by ASIC).[16] It is vital for taxpayers to be aware that the 21-day period commences from the date of posting rather than the date of receipt, as taxpayers may be under the misapprehension that they are still within time to satisfy the notice before the Commissioner can take enforcement action.

The Commissioner may send a copy of the director penalty notice to the director's registered tax agent.[17]

Extension of director penalty regime to GST liabilities

On 17 February 2020, the Treasury Laws Amendment (Combating Illegal Phoenixing) Bill 2019 received royal assent as Act No. 6 of 2020.

As announced in the 2018-19 Budget, the Act contains various measures as part of the government's ongoing reform of Australia's corporate insolvency regime, with a focus on illegal phoenix activity.

The Act significantly expands the director penalty regime to enable the Commissioner to collect estimates of anticipated GST liabilities and to make company directors personally liable for their company's GST liabilities in certain circumstances.[18] These amendments also apply to the LCT and WET, which are jointly administered with the GST.

The amendments commenced on the first day of the quarter following royal assent, that is, 1 April 2020.

Application of estimates regime to GST

Pursuant to the Act, the Commissioner has the power to issue and recover estimates of net amounts of GST for a tax period. Importantly, this power applies to all entities that are registered, or required to be registered, for GST, not only to companies as is currently the case with PAYG withholding and superannuation guarantee.

On 6 September 2019, the ATO issued PCG 2019/D4, which explains how the Commissioner intends to administer the expansion of the estimates regime to GST, LCT and WET. PCG 2019/D4 advises that the powers to make an estimate of an unpaid net amount will only be used in limited circumstances where there are reasonable grounds to believe that:

- the taxpayer is, or related entities are, involved in phoenix behaviour; or
- assets are being dissipated with the intention to defeat creditors, or other action is being taken to defeat creditors (which may be a precursor to phoenixing).[19]

The draft guideline lists various indicators of phoenix behaviour, including cyclically establishing, abandoning or deregistering companies to avoid paying taxes, creditors or employee entitlements, and stripping or transferring assets from the company, ahead of its abandonment, winding-up or deregistration.[20]

The restricted application of the estimates regime to circumstances involving phoenixing behaviour is welcome,

although taxpayers would have been afforded greater protection if this restriction was specified in the proposed legislation.

Obligation on directors

With effect from 1 April 2020, directors are now under an obligation to ensure that their company complies with its obligation to pay an assessed net amount or GST instalment liability (or goes into administration or begins to be wound up).[21]

The penalty will arise when the director's obligation is unsatisfied on the due day, being the day the company is required to pay the assessed net amount or GST instalment (or 30 days after the appointment of a director who is appointed after that day).[22] The amount of the penalty is the company's unpaid liability to pay the assessed net amount or GST instalment.[23]

The penalty arises automatically unless the company has gone into administration or is placed into liquidation on or before the due day. New directors who are appointed after the due day will become subject to the penalty if the obligation remains unsatisfied for a further 30 days.[22]

Directors will be subject to a penalty equal to the amount of the company's unpaid obligations. The penalty may not be collected before the Commissioner issues a director penalty notice and a further 21 days elapse.[24] Payment of either the penalty or the company's underlying liability satisfies both obligations.[25]

Directors who cease to be directors after the initial day are subject to the obligation, even if they cease to be directors before the payment due day.

Remission of director penalties

Generally, a director penalty may be remitted if, before receiving a director penalty notice, or within the 21-day notice period after a director penalty notice is issued, the company complies with its obligation (ie payment is made), an administrator is appointed, or the company begins to be wound up. However, where three months has lapsed after the due day, and the underlying liability remains unpaid and unreported, the director penalty is not remitted as a result of placing the company into administration or beginning to wind it up.[26] The penalty is then "locked down".

The table in s 269-30(2), Sch 1 TAA specifies a date (the lockdown date in column 2) before which the director may avoid the full penalty. If the company enters administration or begins to be wound up after this date, the extent to which the director's penalty is remitted is limited or abolished. The extent to which the penalty is locked down in this way is specified in column 3 of the table.

Below is an extract of items 5 and 6 of the table in s 269-30(2) regarding assessed net amounts and estimates:

"269-30 Effect on penalty of directors' obligation ending before end of notice period

(1) Subject to subsection (2), a penalty of yours under this Division is remitted if the directors of the company stop being under the relevant obligation under section 269-15:

(a) before the Commissioner gives you notice of the penalty under section 269-25; or

(b) within 21 days after the Commissioner gives you notice of the penalty under that section.

(2) The following table has effect:

Table 1. When appointing administrator or winding up company does not affect penalty

Item	Column 1	Column 2	Column 3
	If the company's obligation is to pay to the Commissioner, on or before the due day …	and, because of paragraph 269-15(2)(b) or (c) (an administrator is appointed or the company begins to be wound up), the directors stop being under the relevant obligation after …	subsection (1) does not apply …
5[27]	an assessed net amount for a tax period	the last day of the 3 months after the due day,	(a) if the company, on or before the last day mentioned in column 2, lodges its GST return, for the tax period for the relevant net amount — the extent (if any) to which the net amount (worked out from the information in the GST return and any other information that the company gives the Commissioner on or before that last day) is less than the company's assessed net amount for the tax period; or (b) otherwise — to any extent.
6[27]	the amount of an estimate under Division 268 of a liability referred to in paragraph 268-10(1)(c) (net amount under GST Act),	the last day of the 3 months after the day by which the company was obliged to give its GST return, for the tax period for the relevant net amount, to the Commissioner in accordance with Division 31 of the GST Act,	to any extent."

In accordance with proposed item 5 above, where the company enters administration or begins to be wound up after the lockdown date, only the amount of the company's assessed net amount liability that was calculated by reference to information reported to the Commissioner before the end of the period three months after the due day is remitted.

If the assessed net amount is based on a return lodged after the lockdown date, a default assessment or an amended assessment issued by the Commissioner, this may result in the penalty being locked down in whole or in part and not being remitted.[28]

Accordingly, it is critical that the company reports its GST liability to the Commissioner by the last day of the three months after the due day.[29] Generally, where a company's GST liability is reported within the three months after the due day, remission may be obtained by placing the company into administration or beginning to wind it up at any stage before a director penalty notice is issued.

If a director is appointed to the company during or after the three-month period, the full amount of the director's penalty can be remitted within three months of their appointment.[30]

If a director complies with their obligation in relation to a GST instalment by placing the company into administration or beginning to wind up the company within 21 days of the day the Commissioner issues the director penalty notice, the penalty is remitted in full.[31]

Superannuation guarantee and PAYG withholding liabilities

Recent amendments to s 269-30, Sch 1 TAA removed the three-month rule which applied before director penalties with respect to unpaid superannuation guarantee charge liabilities (and estimates) became locked down and could no longer be remitted.[32] The three-month rule is retained for PAYG withholding liabilities and associated estimates. Consequently, a director penalty cannot be remitted if a company is placed into voluntary administration or insolvency where the company has an obligation to pay a superannuation guarantee charge and the company does not report the superannuation guarantee liability to the Commissioner on or before the due day.

Defences

A director has three defences against proceedings to recover a director penalty:

– because of *illness or for some other good reason*, it would have been unreasonable to expect the person to take part, and that the person did not take part, in the management of the company at any time when the person was a director and the directors were under the obligation under s 269-15, Sch 1 TAA;

– the person took *all reasonable steps* to ensure that the directors caused the company to comply with its obligations or to go into administration or be wound up, or there were no reasonable steps that could have been taken; and

– the *reasonably arguable* defence: in respect of the superannuation guarantee charge and GST, the company treated the *Superannuation Guarantee (Administration) Act 1992* (Cth) (SGAA) or the GSTA as applying to a matter in a way that was reasonably arguable if the company took reasonable care in connection with applying the SGAA or the GSTA to the matter.[33]

The defences have narrow application. The Commissioner is required to evaluate any defence alleged by the director pursuant to s 269-35, Sch 1 TAA. If, after considering all relevant documentation and evidence provided by the director, it is apparent that the director could satisfy the court that they have a valid defence, the Commissioner will not initiate (or continue) recovery proceedings in respect of those penalties.[34]

Illness or some other good reason

A director is not liable to a penalty if, because of illness or for some other good reason, it would have been unreasonable to expect the director to take part in the management of the company "at any time" when the individual was a director of the company. Accordingly, the director must establish good reason for non-participation of the management of the company throughout the whole period that the person is a director. The defence is not enlivened merely because the director has good reason not to participate in management on one or more discrete occasions during that entire period.[35] As such, there is a very high threshold to reach to make out this defence.

All reasonable steps

When determining whether a director took all reasonable steps under this defence, the inquiry into what is "reasonable" for a particular director is not limited to the director's personal knowledge of the options available. Rather, the inquiry extends to what a reasonable director in the director's position would have known, had proper inquiries been made.[36]

Reasonably arguable

A director is not liable to a penalty relating to the superannuation guarantee charge, or to a net amount, where they can establish that the penalty resulted from the company treating the SGAA or the GSTA as applying to a matter or identical matters in a particular way that was reasonably arguable, and the company took reasonable care in connection with applying the SGAA or the GSTA to the matter(s).[37]

There is no corresponding defence in relation to PAYG withholding obligations because they also arise if amounts are withheld but not remitted, meaning that it is more likely a company will be conscious of its unremitted PAYG withholding obligations than it will be of its superannuation guarantee and GST obligations.[38]

Exercising "reasonable care" means making a reasonable attempt to comply with the relevant law. The effort required is commensurate with all of the taxpayer's circumstances, including the taxpayer's knowledge, education, experience and skills.[39] Accordingly, the extension of the director penalty regime to GST requires directors to have more involvement and awareness of GST reporting issues, which will impact staff in charge of the GST reporting function. Further, in order to mount this defence, the directors will need a strong

awareness of any specific issues in respect of the company's GST compliance or any interpretations taken when applying the GST provisions.

Conclusion

Due to the extension of the director penalty regime to GST liabilities, directors are now at significant risk of being held to account for inadvertent oversights and systematic errors. Directors must ensure that companies have suitable tax compliance processes in place, for instance, a strong tax governance framework for which compliance is mandatory.

This extension of the regime significantly increases the extent to which directors' assets will be at risk, particularly in an insolvency.

It will be critical for new directors to conduct a thorough due diligence process in respect of the company's solvency, tax compliance history, and internal systems for remitting PAYG withholding amounts and paying superannuation guarantee and GST to ensure that these systems are adequate. While the disclosures made under a due diligence process should theoretically identify whether a company has not satisfied its tax obligations, there are broader issues that may not be captured under this process, for example:

- Has the company been operating on the basis that any of its staff members are independent contractors rather than employees?
- Has the company been correctly calculating the ordinary time earnings of its staff for superannuation guarantee purposes?
- Has the company failed to make adjustments for GST purposes, or been incorrectly claiming input tax credits, such that the net amounts for various GST quarters should be increased, with additional GST payable?

If a new director becomes aware of a recurring error in the way in which the tax legislation is interpreted, consideration should be given as to whether the company has a reasonably arguable position or has obtained advice on this issue.

Directors should also work to implement systems (if no such systems are in place) to ensure that management is made immediately aware of the Commissioner's notification of estimates of tax liability.

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References

1 Pursuant to the *Treasury Laws Amendment (Combating Illegal Phoenixing) Act 2020* (the Act).

2 Para 2.13 of the explanatory memorandum to the Tax Laws Amendment (Transfer of Provisions) Bill 2010.

3 Para 2.14 of the explanatory memorandum to the Tax Laws Amendment (Transfer of Provisions) Bill 2010.

4 Australian Law Reform Commission, *General insolvency inquiry*, report no. 45, 1988.

5 Former s 222AOG ITAA36.

6 Pursuant to the *Tax Laws Amendment (2012 Measures No. 2) Act 2012*.

7 Pursuant to the *Pay As You Go Withholding Non-compliance Tax Act 2012*.

8 Pursuant to Sch 5 of the *Treasury Laws Amendment (2018 Measures No. 4) Act 2019*.

9 Items 3 and 4 to the table in s 269-30(2), Sch 1 TAA.

10 S 269-15, Sch 1 TAA.

11 S 269-15(1), Sch 1 TAA.

12 The *Treasury Laws Amendment (Combating Illegal Phoenixing) Act 2020* also contains measures to 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.

13 S 269-20(3)(b) and (4), Sch 1 TAA.

14 S 269-20(4), Sch 1 TAA.

15 S 269-25(1), Sch 1 TAA.

16 Ss 269-25(4) and 269-50, Sch 1 TAA.

17 S 269-52, Sch 1 TAA (introduced pursuant to the *Tax Laws Amendment (2012 Measures No. 2) Act 2012*).

18 Sch 3 to the *Treasury Laws Amendment (Combating Illegal Phoenixing) Act 2020*.

19 Para 13 of PCG 2019/D4.

20 Para 14 of PCG 2019/D4.

21 S 269-15, Sch 1 TAA.

22 S 269-20, Sch 1 TAA.

23 S 269-20(5), Sch 1 TAA.

24 S 269-25, Sch 1 TAA.

25 S 269-40, Sch 1 TAA.

26 See table, s 269-30(2), Sch 1 TAA.

27 Pursuant to the *Treasury Laws Amendment (Combating Illegal Phoenixing) Act 2020*.

28 S 269-30(2), Sch 1 TAA.

29 See item 5 to the table in s 269-30(2), Sch 1 TAA.

30 S 269-30(3), Sch 1 TAA.

31 S 269-30(1), Sch 1 TAA. See paras 4.45 to 4.50 of the explanatory memorandum to the Treasury Laws Amendment (Combating Illegal Phoenixing) Bill 2019.

32 Sch 5 to the *Treasury Laws Amendment (2018 Measures No. 4) Act 2019.*

33 S 269-35, Sch 1 TAA.

34 Para 66 of PS LA 2011/18.

35 *DCT v George* 2002 ATC 4930.

36 *DCT v Saunig* 2002 ATC 5135.

37 S 269-35(3A), Sch 1 TAA (as amended by the *Treasury Laws Amendment (Combating Illegal Phoenixing) Act 2020*).

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Death and income tax – some discrete issues: part 2

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This is the final part of a two-part series examining some standalone issues about tax and deceased estates. This article looks at the intricacies of the main residence exemption as it applies to a trustee or beneficiary of the estate. It examines how the cost base of the deceased's dwelling is determined in the hands of the trustee/beneficiary and the conditions that need to be satisfied for a full exemption, including the Commissioner's safe harbour for the sale of a dwelling outside the standard two-year exemption period. Importantly, the article also considers the recent changes that can deny the main residence exemption in some cases where the deceased person or beneficiary is a foreign resident. This article also considers when an agreement will be accepted by the Commissioner as satisfying the requirements of s 128-20(1)(d) of the *Income Tax Assessment Act 1997* (Cth) as being a deed of arrangement under which an asset passes to a beneficiary.

Introduction

This is part 2 of a two-part series, and it deals with aspects of the CGT main residence exemption concerning deceased estates, as well as the practical implications of beneficiaries entering into a deed of family arrangement on a challenge to a will by a family member. As with part 1, only income tax (including CGT) is considered.

Can the family home be retained and remain eligible for the main residence exemption?

Dwelling cost base

Before considering the scope of the main residence exemption in the context of a deceased estate, it is useful to reflect on the cost base rules that apply when the owner of a dwelling dies.[1] These rules vary depending on whether the deceased acquired the dwelling before 20 September 1985 (pre-CGT) or after that date (post-CGT). For a post-CGT dwelling, there are other factors that also need to be considered.

The acquisition cost for the deceased person's legal personal representative (LPR), or a beneficiary in their estate,[2] is set out in Table 1.[3]

It will be evident from Table 1 that it is not necessary in every case to rely on the main residence exemption to exempt a capital gain from a post-CGT dwelling that accrued prior to the death of an individual — that gain is often effectively ignored by the application of the market value acquisition cost rule for the LPR/beneficiary. The focus of the main residence exemption in these cases (as it is for a pre-CGT dwelling owned by the deceased) is the gain for the period after death.

The special rule establishing the cost base of a deceased's post-CGT residence after 20 August 1996 as being its market value at date of death was introduced as a compliance saving measure. The reason was that many people do not keep the records (including, for example, insurance, rates and interest) that are necessary to establish the cost base of their home because they anticipate that any gain from it will be exempt. The cost to the LPR of obtaining this data would amount to an excessive administrative burden.

For a property that devolved to an LPR or passed to a beneficiary after 20 August 1996, the cost base uplift to market value at death is available even where the deceased historically used the dwelling to produce assessable income. The only requirements are that the dwelling be their main

Table 1. Cost base rules for dwelling owned by deceased

Dwelling	Acquisition cost
A pre-CGT dwelling	Market value of the dwelling on the date of death
A dwelling that devolved to the LPR or passed to a beneficiary after 7.30 pm on 20 August 1996,[4] and that was the deceased's main residence when they died and was not then being used to produce income	Market value of the dwelling on the date of death
A post-CGT dwelling that devolved to the LPR or passed to a beneficiary before 7.30 pm on 20 August 1996,[4] and was the deceased's main residence when they died and was not then being used to produce income	The cost base/reduced cost base of the dwelling to the deceased
A post-CGT dwelling that was not taxable Australian property (if the deceased was a foreign resident)	Market value of the dwelling on the date of death
A post-CGT dwelling that was not the deceased's main residence when they died and/or was being used to produce income	The cost base/reduced cost base of the dwelling to the deceased

residence just prior to their death and that it not be used to produce assessable income at that date. This is an invaluable concession, and not necessarily consistent with the previous reasoning, but consistent with the notion that the LPR may be completely unaware about the prior use.

In practice, if a taxpayer acquired an investment property but moved into the dwelling, making it their main residence prior to their death, there would be no CGT for the period the property was used for income-producing purposes.

Section 118-195 ITAA97

For the sake of simplicity, the following discussion considers only whether a full main residence exemption may be available.

A full main residence exemption[5] applies to the trustee of a deceased estate, or a beneficiary to whom a dwelling passes, if:

- either of the following "dwelling conditions" is satisfied:
  - the deceased acquired the dwelling prior to 20 September 1985; or
  - the deceased acquired the dwelling on or after that date and it was their main residence when they died and was not being used to produce income at that time; and
- either of the following "post-death conditions" is satisfied
  - ownership of the dwelling ends within two years of the deceased's death (or such further period as the Commissioner allows); or
  - the dwelling was occupied by certain people after the deceased's death.

Meaning of "trustee of a deceased estate"

An initial issue is what is meant by the expression "a trustee of a deceased estate'" in s 118-195 ITAA97.

In income tax law, the words "trustee of a deceased estate" are generally used to describe an LPR during the administration of the estate and so the expression would not usually apply to a trustee of a testamentary trust. However, the ATO has taken the view in ID 2006/34 that, for the purposes of s 118-195, the words are not limited to an LPR but also include the trustee of a testamentary trust.

ID 2006/34 explains that this view is supported by comments made in the explanatory memorandum to the Taxation Laws Amendment Bill 1990 which introduced changes to s 160ZZQ of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) (the provision which conferred an exemption in the ITAA36) to provide an exemption for the period a dwelling was occupied by an individual under the terms of the deceased's will:

> "The amendments are being made to allow the sole or principal residence exemption to apply to the dwelling of a deceased person for any period since the date of the deceased person's death during which the dwelling had been the sole or principal residence of the spouse of the deceased person or of a person who had the right to occupy the dwelling (life tenant) under the terms of the deceased person's will. At present no account is taken of the time during which a dwelling owned by a trustee of a deceased person's estate was the sole or principal residence of a life tenant."

ID 2006/34 concludes that, as a life tenancy would usually arise after administration of an estate has been completed, the phrase "trustee of a deceased estate" in s 118-195 must be interpreted as including the trustee of a testamentary trust to give effect to the intended policy.

Dwelling conditions

It is worth noting that, for a pre-CGT dwelling, there is no requirement that it actually be, or have been at any time, the main residence of the deceased.[6] While it is true that the LPR will acquire these dwellings for market value at the date of death, capital gains may accrue subsequently, and this is where the main residence exemption gives more exemption than is available under the normal acquisition rules for pre-CGT assets on death (that is, two years after death or such further period as allowed by the Commissioner). In practice, a full main residence exemption could potentially apply to any number of investment properties acquired by the deceased pre-CGT, in addition to a post-CGT main residence.

As noted previously, to qualify for a full exemption, a post-CGT dwelling that devolved to the LPR or passed to a beneficiary after 20 August 1996 must be the main residence of the deceased just before they died. (If the deceased acquired the ownership interest in the property before then, the dwelling must have been their main residence throughout the entire period that they owned it — not just before they died.[7])

This does not necessarily mean that the deceased must have lived in the dwelling at the time of their death. An individual can choose to continue to treat a property as their main residence for CGT purposes during a period that they are absent from it.[8]

The choice operates indefinitely if the dwelling is not being used to produce assessable income, or for a maximum of six years if it is used to produce income. If a choice is made, no other dwelling is treated as the individual's main residence.[9] This can be particularly useful for older clients moving into a nursing home who may desire to retain ownership of their home. If the residence is not generating income, but is left vacant, being used for weekend visits or to accommodate family members, the property could retain its main residence status indefinitely.

A post-CGT dwelling must also not be used to produce income at the time the deceased died, unless the absence choice completely exempts any gain on the dwelling (ie it was not used for concurrent income-producing purposes prior to the absence).[10]

Not all income-producing use will affect the main residence exemption. It will depend on whether the deceased would have been allowed a deduction for interest had they borrowed money to acquire the dwelling.[11] The deceased would not have been entitled to deduct interest expenses if, for convenience, they had used a home study to undertake work usually done at their place of work. Similarly, the deceased would not have been entitled to deduct interest expenses if they received payments from a family member for board or lodging (such payments are considered to be domestic arrangements and not rental income).[12]

Finally, an LPR or a beneficiary can ignore any income-producing use of a dwelling if the use occurred during a period for which an absence election was made under s 118-145 ITAA97, and the use did not exceed six years at the time of death.[13]

Post-death conditions: two-year rule

One of the alternative post-death conditions for a full exemption is that the LPR or beneficiary must cease to own what was the deceased's dwelling within two years of their death. More specifically, if the dwelling is sold under a contract, the settlement of the contract of sale must occur within two years.

Many practitioners assume that, because a contract for the sale of a dwelling is entered into within the first two years of the deceased's death, the requirement has been satisfied. The confusion stems from the fact that many CGT events are taken to occur as at the date of contract; this is the date that is used to determine the year of income in which the capital gain should be returned.

For the 2008-09 and later income tax years, the Commissioner has the discretion to extend the two-year period within which the main residence must be sold.

The ATO has published PCG 2019/5, which outlines the circumstances in which the discretion is likely to be exercised. It also provides a "safe-harbour" compliance approach that allows a person's tax affairs to be managed as if the Commissioner had allowed a period longer than two years in which to settle the sale of the dwelling.

In a subsequent compliance check, the ATO will ensure that the safe-harbour conditions were met (including checking that the extension period is no longer than 18 months), but will not seek to determine whether or not they would have exercised the discretion.

To qualify for the safe harbour, all of these conditions must be satisfied:

- during the first two years after the deceased's death, more than 12 months was spent addressing one or more of the following circumstances
  - the ownership of the dwelling, or the will, is challenged;
  - a life or other equitable interest given in the will delays the disposal of the dwelling;
  - the complexity of the deceased estate delays the completion of administration of the estate; or
  - settlement of the contract of sale of the dwelling is delayed or falls through for reasons outside the control of the LPR/beneficiary;
- the dwelling was listed for sale as soon as practically possible after those circumstances were resolved (and the sale was actively managed to completion);
- the sale was completed (settled) within 12 months of the dwelling being listed for sale;
- the following circumstances were immaterial to the delay in disposing of the interest:
  - waiting for the property market to pick up before selling the dwelling;
  - delays due to refurbishment of the house to improve the sale price;
  - inconvenience on the part of the LPR/beneficiary to organise the sale of the house; or
  - unexplained periods of inactivity by the LPR in attending to the administration of the estate; and
- the longer period for which the discretion would need to be exercised is no more than 18 months.

Given this last condition, the safe harbour cannot be utilised where a life interest lasts more than three and a half years from the death of the deceased. In that instance, a request will have to be made to the ATO for an exercise of the Commissioner's discretion.

Example[14]

Mrs Papageorgiou lived in her main residence until she died on 1 June 2015. Mrs Papageorgiou acquired the dwelling after 20 September 1985. It was not being used to produce assessable income when she died.

The beneficiaries of Mrs Papageorgiou's estate (her four adult children) decided to subdivide the property to increase the sale price. A plan was submitted to council on 30 November 2015. On 1 July 2016, the council advised that the plan was not approved.

The beneficiaries appealed the decision on 22 July 2016, and attended a hearing on 12 October 2016. On 28 February 2017, the tribunal advised that a new subdivision application should be lodged with the council. A new application was submitted to the council on 24 March 2017 but, by 1 June 2017, the council had not made a decision.

While the resolution of the subdivision application is beyond the control of the beneficiaries, they cannot rely on the safe harbour because the delay is due to the decision to subdivide, which is not necessary for the resolution of the estate or the disposal of the dwelling.

Where circumstances fall outside of the safe-harbour rules, a request must be made to the Commissioner to exercise the discretion. Additional factors that may be relevant to the exercise of the Commissioner's discretion (but are not relevant for the safe harbour) include, but are not limited to:

- the sensitivity of the personal circumstances of the trustee/beneficiary and/or of other surviving relatives of the deceased;
- the degree of difficulty in locating all beneficiaries required to prove the will;
- any period that the dwelling was used to produce assessable income; and
- the length of time that the trustee/beneficiary held the ownership interest in the dwelling.

In the authors' experience, the Commissioner will not consider exercising the discretion until the property sale has been settled.

The two-year concession is extremely generous. It provides LPRs with a reasonable period to administer the estate

without having to worry about tax issues from the growth in value of the deceased's former residence (or pre-CGT dwelling).

It should be noted that the concession applies during this two-year period regardless of whether the property is the main residence of any of the specified individuals referred to in s 118-195 ITAA97 or whether the dwelling is used for income-producing purposes in that time.[15]

Post-death conditions: use of dwelling following death of deceased

If the two-year rule is not satisfied, an LPR or a beneficiary may nonetheless be entitled to a full main residence exemption if, from the date of the deceased's death, the dwelling was the main residence of the deceased's spouse or an individual who was given a right to occupy the dwelling under the deceased's will.[16]

If the dwelling ultimately passes to a beneficiary, the exemption will also be available for the period that the beneficiary occupies it.

It is unclear whether the right to occupy test extends only to a named (or identified in some way) beneficiary under the will, as opposed to any person the trustee may have power to allow them to occupy. In other words, it is uncertain how narrowly or broadly "under the will" should be construed. It is understood that many adopt the second approach, presumably taking into account the fact that a full exemption would be lost anyway if the occupant was a normal commercial tenant (because of income-producing use). It is suggested that caution should be exercised here, and perhaps a private ruling sought from the Commissioner if this is an issue.

The terms of the will must also be examined to determine what occupancy right has actually been conferred.

Example

Malcolm purchased a dwelling prior to 20 September 1985. He died on 1 July 2010.

When he died, he was living in the dwelling with his son Bruce. Malcolm's will provided that Bruce could occupy the dwelling for five years following his death.

Bruce continued to reside in the dwelling until it was sold by the trustee on 1 July 2019.

A full main residence exemption is not available because Bruce did not have a right to occupy the property under the will from 2015 to 2019.

The reference to a spouse[17] of the deceased does not include a spouse who was permanently separated from the deceased when they died.[18]

Although it is unclear from the legislation, it appears that the ATO takes the view[19] that the requirement that a dwelling be the main residence of a person specified in s 118-195(1) ITAA97 does not apply during the period that an estate is being administered, provided that person moves in as soon as practicable after the administration is completed.

Example[20]

Peter bought a house prior to 20 September 1985. He died in February 1992 and the house passed to the beneficiary under his will, Bob.

Under Peter's will, Patti had a right to occupy the house. However, Patti couldn't move in until probate and administration of the estate was granted. During this period, the house was vacant. Probate and administration of the estate was granted in September 1992 and Patti moved in immediately. Patti used the house as her main residence until Bob disposed of it in March 2019. Patti did not have an ownership interest in any other dwelling from the date of Peter's death.

As Patti moved into the house when it was first practicable to do so, it is treated as Patti's main residence from the time of Peter's death until Bob sold it.

Bob is entitled to a full main residence exemption.

If the spouse or other person occupying the property dies, it will often be the case that a full main residence exemption ceases to be available. Contrary to popular belief, there is no two-year rule that applies after their death. An exception to this rule would be where the property passes to a beneficiary who uses it as their own main residence.

In practice, LPRs often apply to the ATO to extend the main residence exemption to cover the period between the death of the spouse or other person occupying the property and the sale date. While there is no legislative basis for this, the authors have certainly seen cases where such an application has been successful.

What happens if the deceased is a non-resident?

Until recently, non-residents were not treated differently from residents in relation to obtaining the main residence exemption on an Australian dwelling. A common situation was that a person resided in Australia, owned a post-CGT Australian home and lived there for years, then became a non-resident, either leaving the Australian home vacant or renting it out. On making an absence choice, a full main residence exemption on sale was often obtained by the LPR, or the home passed to resident beneficiaries with a market value acquisition cost at the date of death. This is no longer the case.

Amendments to the law have now come into effect that will prevent foreign residents from claiming the benefit of the CGT main residence exemption for properties that they own in Australia. The amendments were foreshadowed in the federal Budget on 9 May 2017 and broadly apply to CGT events happening from that date (subject to some transitional arrangements set out below).

The amendments may also deny the exemption to the estate of a deceased foreign resident, although a less draconian approach has been taken there.

As far as individuals are concerned, the main residence exemption will be denied unless the individual was a foreign resident for six years or less at the time of the CGT event

and, during their foreign residency, the individual, their spouse or minor child had a terminal medical condition, the spouse or child dies, or the CGT event arose from a relevant family law settlement.

In contrast, a trustee or beneficiary of a deceased estate will have access to the main residence exemption provided the deceased had been a foreign resident just before their death for a continuous period of six years or less.

Example[21]

Edwina acquired a dwelling on 7 February 2011, moving into it and establishing it as her main residence as soon as it was first practicable to do so. Edwina used the property as follows:

- residing in the dwelling until 25 September 2016 while an Australian resident; and
- renting the property out from 26 September 2016, at which time Edwina moved to Johannesburg.

Edwina passed away on 20 January 2018. At the time of her death, Edwina was a foreign resident for taxation purposes. However, as Edwina was a foreign resident for less than six years, she is not an excluded foreign resident.

Rebecca, an Australian resident, inherits the dwelling from Edwina. Rebecca moves into the dwelling and establishes it as her main residence on 21 April 2018. She continues to reside in it and use it as her main residence until she sells it. She signs the contract to sell the dwelling on 2 February 2021, with settlement occurring on 2 March 2021.

Rebecca is able to access the main residence exception for the whole period of ownership because:

- Edwina was not an excluded foreign resident at the time of her death. This means that the main residence exemption she accrued while she used the dwelling as her main residence is available to Rebecca; and
- the whole period between when Edwina passed away and when Rebecca moved into the dwelling and established it as her main residence is less than two years.

Rebecca is also able to access the main residence exemption for the period from when she moved into the property until she signed the contract for sale as she used the property as her main residence at all times and was an Australian resident at the time of the sale.

Therefore, Rebecca is able to access the main residence exemption for the entire ownership period.

If the deceased was a foreign resident for more than six years before death, no exemption will be available, even for periods where the Australian dwelling was actually the main residence of the deceased. Similarly, there will be no cost base uplift possibility at the time of death for a post-CGT dwelling.

Under transitional arrangements, the amendments will not affect the application of the main residence exemption to a capital gain or loss from a property that was acquired before 7.30 pm, by legal time in the Australian Capital Territory, on 9 May 2017 if the relevant gain or loss was from a CGT event that happened on or before 30 June 2020. (In the case of a dwelling acquired by a beneficiary after 9 May 2017, the transitional rule will apply if the dwelling was owned by the deceased or the trustee of their estate before that time.[22])

These arrangements may mean that actions need to be taken promptly to preserve main residence exemption entitlements that existed previously.

When an asset passes to a beneficiary under a deed of family arrangement

In certain circumstances, a family member may wish to challenge a will so that they can participate in the distribution of the deceased's estate, and it is agreed among the beneficiaries that they all enter into a deed of family agreement to avoid legal action.

As most people are aware, capital gains and losses that arise from the death of an owner of an asset are disregarded,[23] as are most gains and losses that the deceased's LPR makes if an asset "passes" to a beneficiary.[24]

An asset passes to a beneficiary in the circumstances set out in s 128-20 ITAA97, that is, most commonly when the beneficiary becomes the owner under a will (including as varied by a court) or under an intestacy (including as varied by a court).

Section 128-20(1)(d) provides that an asset also passes to a beneficiary in the estate of a deceased person if the beneficiary becomes the owner of the asset under a deed of arrangement, provided that:

- the beneficiary entered into the deed to settle a claim to participate in the estate; and
- the consideration given by the beneficiary consisted only of the variation or waiver of a claim to an asset or assets that formed part of the estate.

TR 2006/14 takes the view that a person is not required to commence legal proceedings in order to establish, for the purposes of s 128-20(1)(d), that they have a valid claim to participate in the distribution of the assets of the estate. A claim may be established by a potential beneficiary communicating their dissatisfaction with the will to the LPR.

This is said to be consistent with the policy outlined in the explanatory memorandum which introduced the equivalent provision in the ITAA36:[25]

> "In some cases a dispute may arise between claimants to the assets of a deceased estate. The dispute may lead to litigation which eventually results in an order of the court to vary the will. Alternatively, the parties to the dispute may reach a compromise agreement, which binds the parties to an agreement setting out their respective entitlements to assets. This agreement is reached without recourse to litigation and results in the execution of a deed of settlement; alternatively known as a deed of family arrangement or a deed of compromise. Because such a deed does not constitute an order of a court in terms of section 160J, the rollover under section 160X does not apply."

Because the law was changed to recognise a deed of arrangement as an alternative to a court order as a means of varying a will, the Commissioner takes the view that, for the

purposes of s 128-20(1)(d), a deed of arrangement must be entered into in circumstances when a court might consider an application to vary the deceased's will. That is, the deed:

- must be made to settle a claim made by a person eligible to make an application for family provision; and
- must be entered into within the relevant timeframes for the making of an application to a court.

The latter point is determined in accordance with the succession laws of the relevant jurisdiction, and different jurisdictions have different periods — some periods run from the date of death (in Queensland, the period is nine months after death) and others run from the date of grant of representation (in the Australian Capital Territory, the period is 12 months from the date of grant). The courts in each jurisdiction may extend the time.

A difficult question is whether an application can still be brought where the LPR has completed their duties and holds property for beneficiaries as trustee. The High Court in *Easterbrook v Young*[26] found, in respect of the New South Wales provisions, that it could, and indicated that it would also apply to determine the meaning and effect of comparable provisions elsewhere. However, it is unclear whether this is actually the case.

The Commissioner therefore considers that, for s 128-20(1)(d) to apply, the taxpayer must generally enter into a deed of family arrangement in respect of an asset *prior* to administration being completed in respect of that asset.[27] The Commissioner acknowledges that, in some cases, an asset may pass under an agreement entered into after this point, but the beneficiary must be able to demonstrate that a court would have been likely to have entertained the application or to have granted an extension of time.

The authors consider the Commissioner's approach to be conservative, but not unreasonable, given the state of the general law and all of the circumstances. In cases where the Commissioner cannot be convinced, it may be necessary to demonstrate that an application would have been entertained or an extension of time granted by actually bringing the matter before the court.

Conclusion

This concludes the two-part series on death and income tax. Most of the issues examined are navigable by practitioners under the legislation, but some uncertainties remain and, in some cases, it will be prudent to get a private ruling from the Commissioner.

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This article is an edited and updated version of "Death and taxes – some discrete issues" presented at The Tax Institute's Tasmanian State Convention held in Launceston on 17 to 18 October 2019.

References

1. This discussion assumes that the deceased died after 19 September 1985. If the deceased died before that date, the dwelling would be a pre-CGT asset of their legal personal representative or beneficiary. The main residence exemption would be irrelevant in this instance.
2. There are different rules for an interest in a dwelling that passed by survivorship to other joint tenants (see s 128-50 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97)).
3. S 128-15(4) ITAA97.
4. S 128-15 of the In*come Tax (Transitional Provisions) Act 1997*.
5. S 118-195 ITAA97.
6. Column 2, item 2 of the table in s 118-195(1) ITAA97.
7. S 118-195 of the *Income Tax (Transitional Provisions) Act 1997*.
8. S 118-145 ITAA97.
9. S 118-145(4) ITAA97.
10. Column 2, item 1 of the table in s 118-195(1) ITAA97.
11. S 118-190 ITAA97.
12. IT 2167.
13. S 118-190(4) ITAA97.
14. This is example 4 from PCG 2019/5.
15. See s 118-190 ITAA97 (in particular, the example following s 118-190(1)) and TD 1999/70.
16. It is not clear whether this last category only applies to a person actually named in the will, or whether it could extend to a person subsequently nominated by the trustee. Care should be taken here, and perhaps a private ruling sought to remove any doubt.
17. "Spouse" is defined in s 995-1(1) ITAA97 to included de facto and registered partners (whether of the same or different sex).
18. Column 3, item 2 of the table in s 118-195(1) ITAA97.
19. See www.ato.gov.au/General/Capital-gains-tax/Deceased-estates-and-inheritances/Inherited-dwellings/CGT-exemptions-for-inherited-dwellings.
20. See www.ato.gov.au/General/Capital-gains-tax/Deceased-estates-and-inheritances/Inherited-dwellings/CGT-exemptions-for-inherited-dwellings/#Workoutifyourinheriteddwellingisexempt.
21. This is example 1.7 in the explanatory memorandum to the Treasury Laws Amendment (Reducing Pressure on Housing Affordability Measures) Bill 2019.
22. S 118-110 of the *Income Tax (Transitional Provisions) Act 1997*.
23. S 128-10 ITAA97.
24. S 128-15(3) ITAA97.
25. Explanatory memorandum to the Taxation Laws Amendment Bill (No. 2) 1992.
26. [1977] HCA 16.
27. TR 2006/14.

SMSF death benefit distributions: lessons from Marsella v Wareham

by Courtney van Zyl, Manager – Tax Advisory, Findex

Careful attention to succession planning for a self-managed superannuation fund (SMSF) can ensure a smooth transfer of wealth following the death of a member. A key part of the execution of any succession plan is the SMSF trustee(s). When the interests of the SMSF beneficiaries are not put first by the trustee(s), serious ramifications can result. The decision in *Marsella v Wareham* looked at both the actions of the trustees and the documentation (including correspondence between the parties) to assess whether the trustees had indeed breached their fiduciary duties. This case highlights key lessons for SMSF trustees, members and advisers in the planning and execution of SMSF administration after the death of a member.

Introduction

Succession planning for a self-managed superannuation funds (SMSFs) is a crucial matter for SMSF trustees and members. Where succession planning is properly documented and executed carefully and correctly, it can ensure a smooth passing of wealth after death. However, a variety of factors can complicate the administration of an SMSF after death, and there are regular court cases which highlight the need for careful attention to SMSF succession planning.

The recent case *Marsella v Wareham*,[1] referred to as the *Swanson Superannuation Fund* case, resulted in the distribution of death benefits by the trustees being overturned and the trustees being removed from office. This case focused on the responsibilities of the trustees of an SMSF, their obligation to exercise absolute and unfettered discretion in good faith with real and genuine consideration, and the point at which a trustee should be removed where their behaviour and decisions compromise the welfare of the SMSF beneficiaries.

This article analyses the *Swanson Superannuation Fund* case, firstly examining the legislative processes and obligations on the death of an SMSF member. Secondly, the elements of the *Swanson Superannuation Fund* case are discussed and the key contributing factors to McMillan J's judgment are identified. Lastly, insight is provided on the key lessons for SMSF trustees and advisers, and suggestions made for how SMSF trustees and advisers can prevent similar problems arising in future.

Death of an SMSF member

There are three important elements that interact in regard to the regulation of a superannuation fund when a member of that fund dies: the superannuation legislation, the fund's governing documents (ie the fund's trust deed), and the documentation provided by the member(s) in regard to how their member balance is to be addressed on their death.

First, from a legislative perspective: a superannuation fund that has a sole member is considered to be an SMSF (which is critical to being able to access the various tax concessions available to complying superannuation funds (s 42A of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA)) pursuant to s 17A(2) SISA, providing that:

- where the trustees are individuals, there are two trustees, one of whom is the SMSF member, and the other trustee can be a relative of the member or an unrelated person who is not an employee of the other trustee; and
- for SMSFs with corporate trustees, the sole member may be the sole director of the trustee. Where there are two directors, the non-member director can be a relative of the member or an unrelated person who is not an employee of the other director.

When the sole member of an SMSF dies, they cease to be a trustee of the SMSF. This leaves the other non-member trustee as the sole trustee of the SMSF, which at first instance breaches s 17A(2). However, superannuation legislation provides that s 17A(2) is not breached when the sole member dies where certain conditions are met. This includes where the remaining non-member trustee appoints an eligible second trustee, or two new eligible trustees are appointed, within six months of the death of the sole member (s 17A(4)(b) SISA).

Second, working alongside the above legislative requirements is the governing document of the fund, the trust deed, which sets out the process that must be followed to achieve the required legislative outcome. The superannuation legislation does not in itself appoint the legal personal representative or new trustees after the death of a member. Rather, the superannuation legislation only states the outcome of such an appointment once it has been made in accordance with the trust deed.

In addition, legal personal representatives are not automatically appointed as trustees of the SMSF simply due to their capacity as executors of the deceased estate (as confirmed in *Wooster v Morris*,[2] and *Ioppolo & Hesford v Conti*[3]).

The reason that understanding and complying with the trust deed is so important is that, if the processes and restrictions of the trust deed are not observed (ie the incorrect process is followed to appoint a trustee, or an ineligible person under the deed is appointed as trustee), the appointed legal personal representative and/or new trustee(s) of the SMSF

may not satisfy s 17A(2). This would mean that the SMSF will cease to be an SMSF.

The third element of dealing with death benefits is the documentation detailing how a member's balance is to be dealt with on their death, such as reversionary pension nominations and death benefit nominations. It is critical that, when preparing these documents, proper advice is obtained to ensure that they are valid and effective under the relevant legislation and the SMSF trust deed. If they are later determined invalid or ineffective, the determination on how the deceased member's balance is dealt with reverts to the SMSF trustee(s), which can result in a distribution differing from what the deceased member wanted.

Distribution of death benefit payments

Following the death of an SMSF member, that member's balance in the SMSF must be paid out to the relevant beneficiary(ies) as soon as practicable after the member's death (reg 6.21(1) of the *Superannuation Industry (Supervision) Regulations 1994* (Cth) (SISR)). These payments are generally known as death benefit payments.

In the case of a deceased member, the SMSF cannot "cash" (ie pay) benefits in respect of that member unless:

- the benefit is cashed in favour of either or both of the member's legal personal representative or one or more of the member's dependants (reg 6.22(2) SISR); or
- the trustee has not, after making reasonable enquiries, found either a legal personal representative, or a dependant (as defined in s 10 SISA), of the member (reg 6.22(3)(a) SISR); and
- the person in whose favour benefits are cashed is an individual (reg 6.22(3)(b) SISR).

Following satisfaction of the above, death benefit payments are typically distributed as reversionary pensions or lump sum payments. Similar to trustee appointments, it is critical that distributions are made in accordance with all relevant legislation and, of course, the trust deed, particularly where the deceased member has not had in place valid nominations to direct the distribution of the death benefits.

Where no nominations have been made, full power to determine the distribution of the death benefits typically falls to the trustee(s) in their full discretion (pending the terms of the trust deed).

Responsibilities of SMSF trustees

As stated by McMillan J in *Swanson Superannuation Fund*:[4]

> "In accepting office, a trustee becomes bound by certain duties, including becoming familiar with the terms of the trust instrument, and exercising her or his powers in the best interests of the beneficiaries."

Generally, a trust instrument (ie a trust deed) bestows on the trustee discretion, in many cases absolute discretion, regarding decisions on the assets and distribution of income of the trust.

In exercising their discretion, a trustee has a fiduciary duty to act "in good faith, on real and genuine consideration and in accordance with the purposes for which the discretion was conferred".[5] This includes where SMSF trustees are making decisions about the distribution of a deceased member's SMSF balance.[6]

This is all made more complicated by factors such as confusing or complexly worded trust deeds, less-than-optimal family relationships, and lacklustre (or no) estate planning undertaken by the member(s) regarding who might be the succeeding trustee(s) of their SMSF and/or to whom their death benefits should be paid.

In addition, conflicts of interest of the trustee(s) must be carefully considered, given the likelihood of the post-death SMSF trustee having a personal interest in the estate and/or SMSF death benefits. Generally, an individual with fiduciary duties is not permitted to engage in an arrangement where there is a conflict of interest between the fiduciary's personal interests and the interests of those whom the fiduciary is bound to protect.[7]

However, the exception to this is where:[8]

> "… a testator or settlor, with knowledge of the facts, imposes on a trustee a duty which is inconsistent with a pre-existing interest or duty which he has in another capacity. In that situation the trustee is not thereby debarred from accepting the trust or from performing the duties which are imposed under it."

This exception is limited to the initial appointment; a trustee cannot then further voluntarily put themselves into a "new position of conflict".[9]

It has also been suggested that the obligation for care is increased for an individual with fiduciary powers where that individual's powers are being exercised in their own favour.[10]

Removal of SMSF trustees

The longstanding principle from *Karger v Paul*[11] is that, where a trustee discloses the reasons for the exercise of their discretion, the validity of such can be examined by the courts. Where a trustee does not disclose such reasoning, the trustee's discretion can only be examined to the extent of determining whether the trustee acted in good faith with real and genuine consideration, and in accordance with the purposes for which the discretion was conferred.

Based on this principle from *Karger v Paul*, it was stated in *Attorney-General (Cth) v Breckler*[12] (and reiterated in the *Swanson Superannuation Fund* case[13]) that, where a trustee does not disclose the reasoning behind the exercise of their discretion, a court cannot challenge the trustee's discretion based on an unfair, unreasonable or unwise outcome. Rather, the court must consider whether the trustee's discretion was in bad faith, or was arbitrarily, manipulatively or recklessly exercised without giving real and genuine consideration.[14]

Similarly, the removal of a trustee requires more than a lapse in judgment by, or a lack of good faith from, the trustee. Rather, it requires intentional actions of bad faith or deliberate disregard for the duties and obligations of the position of a trustee.

McMillan J commented in the *Swanson Superannuation Fund* case that the welfare of beneficiaries is the leading consideration when determining whether a trustee should be removed.[15] Such a decision is based on a variety of factors, centered around the premise of whether there has been "satisfactory execution of the trust and the faithful and sound exercise of the powers conferred on the trustee".[16]

Specific behaviours or actions of the trustee such as a breach of trust (ie a lack of good faith and real and genuine consideration), or the existence of a conflict of interest, may not necessarily on their own justify removal of the trustee, pending the severity of such behaviour or actions.[16]

Based on the above, it is possible for a determination by a trustee of an SMSF regarding the distribution of death benefits to be reversed or voided by the courts, without such a decision resulting in the removal of said trustee.

> *"... a trustee has a fiduciary duty to act in good faith, with real and genuine consideration."*

The Swanson Superannuation Fund case

Background

The *Swanson Superannuation Fund* case looked at the actions of the trustees of the Swanson Superannuation Fund (the fund) when dealing with the death benefit distributions of the fund following the death of the sole member, Helen Marsella (Helen).

The fund was established in May 2003 by deed (the deed). The deceased died on 27 April 2016, at which time Helen had been married to and lived with Riccardo Marsella (Riccardo) for approximately 32 years.

Following Helen's death, her daughter Caroline Wareham (Caroline) was appointed as sole trustee in accordance with the deed.

On 17 April 2017, Caroline resolved, as "surviving trustee", to pay the entire death benefit from the fund to herself. On this date, Caroline also appointed her husband Martin Wareham (Martin, collectively the trustees) as a second trustee of the fund whereby both trustees then resolved to pay the entire death benefit from the fund to Caroline.

The dispute

Riccardo, in both a personal capacity as well as in his capacity as executor of Helen's estate, disagreed with Caroline's distribution of the death benefit to herself. He asserted that Caroline and Martin did not give "real and genuine consideration" to his interests and did not act in good faith when determining the distribution of the death benefit.

On this basis, he sought to have the distributed death benefit repaid into the fund (with interest), and also to have Caroline and Martin removed as trustees of the fund.

The key questions

McMillan J's judgment addressed two key questions:[16]

1. whether the trustees of the fund properly exercised their discretion (in good faith and with real and genuine consideration) in resolving to distribute the death benefit from the fund; and
2. whether the trustees should be removed and replaced with an independent trustee.

The judgment

Good faith, and real and genuine consideration

According to cl 10.1 of the trust deed, the trustee(s) of the fund did indeed have absolute and unfettered discretion. In accordance with the *Karger v Paul* principle, on the basis that the trustees did not disclose their reasons for the exercise of their absolute discretion, it needed to be shown that the trustees had acted beyond mere carelessness with an unreasonable or unfair outcome.

After examination of all evidence, the court found that there was in fact a lack of real and genuine consideration by the trustees when making the death benefit distribution determination.[17]

The key contributing factors to this decision included:

- Riccardo's substantial and lengthy relationship with Helen;
- Riccardo's relatively limited financial circumstances;
- the relationship between Caroline and Riccardo, which had deteriorated since Helen's death;
- the submission by Caroline that Helen intended her children and grandchildren to receive the benefit of any death benefit distributions, but Caroline proceeded to distribute solely to herself; and
- a lack of specialist advice obtained by Caroline regarding the number of trustees required by the deed to make decisions regarding the fund, even where such advice was recommended by Caroline's accountant.

A submission was made by Caroline that the trustee minutes showed that due consideration was given, via the statement in the resolution that refers to consideration of:[18]

> "the possible interests of all Dependants of the deceased member, the potential Beneficiaries of the Member, and the Member's Estate, the Member's Estate."

However, in the context of the factors listed above, McMillan J concluded that the wording of the resolution in question was formulaic and did not in fact represent or reflect the actual actions of the trustees.[19] Furthermore, such formulaic wording was mirrored in the second set of minutes.

McMillan J was concerned by the timing of Martin's appointment as trustee and the second minute, as the timing indicated that the effective decision to distribute the death benefit entirely to Caroline was made prior to the second trustee (Martin) becoming involved. As such, Martin could not have given real and genuine consideration to the distribution in that timeframe.

Overall, the weight of evidence that was presented pointed to the lack of real and genuine consideration by the trustees when making the death benefit distribution determination. In fact, McMillan J stated that Caroline acted beyond simply a lack of good faith and real and genuine consideration; rather, Caroline acted arbitrarily with ignorance of, or insolence towards, her duties as trustee.[20] This amounted to, in McMillan J's opinion, Caroline's conduct being

beyond mere carelessness or honest blundering. Instead of Caroline properly informing herself and thus exercising "active" discretion,[21] she effectively entirely disregarded Riccardo and any claim or entitlement that he may have to the death benefit, and had acted in bad faith in her capacity as trustee, resulting in a "grotesquely unreasonable" outcome.[22]

Martin, in his capacity as trustee, was not found to be acting in bad faith. Although he could not be said to have acted in good faith given the grotesquely unreasonable outcome of the death benefit distribution, there was a lack of evidence that showed the additional level of recklessness or arbitrariness required to demonstrate bad faith. Instead, the court concluded that his role "came down to mere carelessness".[23]

Conflict of interest

It was clear that Caroline's position as a trustee of the SMSF and as a potential beneficiary of the SMSF created a position of conflict for her. Caroline relied on the conflict of interest exception on the basis that it was Helen who placed Caroline in the position that created the conflict of interest. Caroline submitted that Helen knew that this conflict would arise and appointed Caroline anyway, thereby Helen was effectively accepting that Caroline could make the decision to distribute the death benefit entirely to herself.

Although McMillan J seemed to accept that the conflict of interest exception applied for Caroline to a degree, the level of acrimony between Caroline and Riccardo after Helen's death was not taken into account by Helen prior to her passing. This therefore increased the risk of Caroline's position of conflict impacting her decisions as trustee.

Caroline also submitted that the appointment of Martin as co-trustee was primarily to satisfy the requirements of s 17A(4)(b) SISA, and to satisfy what was purported to be ambiguous wording of the trust deed. However, the subsequent appointment of Martin as co-trustee did not fall within the conflict of interest exception, and certainly did not serve to reduce the existing conflict of interest. Rather, the appointment of Martin as co-trustee was seen by McMillan J as demonstrating "ignorance or insolence to the circumstances at hand".[24]

Removal of the trustees

With respect to the second question as to whether the trustees should be removed, McMillan J concluded in the affirmative. The key reason given was that the trustees:[25]

> "… failed [to give] real and genuine consideration to the interests of [Riccardo] … they arbitrarily dealt with the entirety of the property subject to the trust. They did so in the context of substantial personal conflict with [Riccardo]."

McMillan J's judgment combined Caroline's bad faith and conflict of interest to conclude that the welfare of the beneficiaries of the SMSF was compromised; the trustees had not satisfactorily executed their duties as trustees through faithful and sound exercise of the powers conferred on them and should be removed from their positions as trustees of the fund.

Lessons for SMSF trustees, members and advisers

Death benefit nominations

Arguably, the simplest takeaway from *Swanson Superannuation Fund* is that valid documentation should have been in place at the time of Helen's death. If this had been the case, the trustees would have had far less discretion and less opportunity to take the actions that they did.

The ideal documentation to have had in place would have been a binding death benefit nomination. With such a nomination in place, the distribution of death benefits outside the directions of the nomination should be supported by unforeseen circumstances and strong reasoning, which reduces the opportunity and incentive for the deceased's wishes to be altered or disregarded.

It is important to note that, as demonstrated in various cases such as *Wooster v Morris*[26] and *Katz v Grossman*,[27] it is the control of the SMSF which can ultimately determine the final distribution of death benefits. However, in many cases, having the correct documentation in place can go a long way towards reducing distribution problems for the stakeholders.

Exercising discretion

One of the most critical lessons from the *Swanson Superannuation Fund* case is the importance of trustees acting (and being able to show that they have acted) in good faith and with real and genuine consideration. Although trustees with absolute and unfettered discretion do not need to justify their reasons for exercising their discretion (and there is certainly argument that doing so would open up opportunity for challenges), best practice would be to ensure that there is a record or support of some kind to show that appropriate enquiries were made, and that all relevant facts were considered by the trustee(s).

The records proffered by Caroline in *Swanson Superannuation Fund* did not stand up to scrutiny due to the facts surrounding the documentation. Specifically, the integrity of the supporting documentation was comprised, given:

- the uncertainty surrounding the wording of certain clauses of the trust deed, the lack of advice sought to resolve this uncertainty, and the trustees acting to distribute the death benefits even in the face of this unresolved uncertainty;
- that the second resolution (signed by Martin as co-trustee) with very similar wording to the first minute, "confirming" the distribution of funds, was signed and dated the same day that Martin was appointed as co-trustee; and
- the "dismissive tenor" of correspondence from Caroline (via her solicitor) as to consideration of Riccardo's circumstances, his potential claim on the fund, and the conflict of interest that existed for Caroline and Martin.

Ultimately, the decision made by the court in the *Swanson Superannuation Fund* case not only considered the documentary evidence produced by the trustees, but a holistic assessment of all contextual evidence, including the behaviour of and relationships between the relevant parties.

Conflicts of interest

The level of a conflict of interest, and the context and circumstances of that conflict, is an important consideration for SMSF members, trustees and advisers. As seen in *Swanson Superannuation Fund*, the conflict of interest "exception" principle from *Mordecai v Mordecai*[28] has limited application and cannot be relied on to cover all actions of the trustee(s) in question.

Where circumstances after the deceased's passing are different to the circumstances prior to death (such as declines in or breakdowns of family relationships), this can significantly increase the position of conflict. This is on the basis that the level of conflict accepted by the deceased at the time of choosing the trustee might have amplified to a level that may not have been acceptable to the deceased.

Furthermore, the exception does not cover the trustee voluntarily putting themselves into a "new position of conflict". This includes actions such as appointing an additional trustee that has a neutral effect on the position of conflict, or even inflates, the position of conflict.

In Caroline's circumstances, a trio of missteps resulted in an untenable position of conflict for her as trustee: the deteriorating relationship with Riccardo following Helen's death; appointing her husband as co-trustee; and exercising her discretion as trustee in her own favour.

One key step that Caroline could have taken to reduce her position of conflict was to appoint an independent, non-conflicted person as co-trustee instead of Martin. Even if the death benefit had then been wholly distributed to Caroline, there would have been far less inclination that there had been no good faith or real and genuine consideration in the trustees' decision, as the independent trustee would have no personal stake in making a decision in Caroline's favour (unlike Martin).

Seeking advice

One of the contributing factors considered in McMillan J's conclusion was that Caroline did not seek professional advice on the uncertainties of the trust deed, even given the context of the pending significant financial decision. This lack of action by Caroline, particularly in light of specific recommendations by her accountant to obtain such advice, contributed to the view that Caroline acted beyond mere carelessness or honest blundering.[29]

The key takeaway here is that obtaining written specialist advice can be critical where there are uncertainties or discrepancies regarding the administration of an SMSF. Without doing so, the trustee risks being considered as not having properly exercised their discretion and not having acted in good faith in their capacity as trustee.

Wording of an SMSF trust deed

The reason given by Caroline for having two sets of trustee minutes prepared and signed for effectively the same resolution was due to "uncertainty surrounding clause 8 of the fund deed".[30] Caroline attempted to cover both interpretations of this cl 8 by preparing a set of trustee minutes for each interpretation. This raises the prospect that, if the fund's deed had been clearer or more direct, such misapprehension about the meaning of clauses in the deed may not have been a problem for the trustees.

Another consideration is that the wording of a trust deed could be utilised to limit the class of beneficiaries that a trustee must consider (without limiting the trustee's discretionary power). If the member(s) does not wish a specific person, or group of people, to be able to receive any death benefits from an SMSF, the trust deed could either specifically exclude them, or simply be drafted in such a way that they do not fall within the class of potential beneficiaries.

This enables the trustee to immediately eliminate those persons from the potential beneficiaries needing consideration and closes the door to those persons being able to challenge the discretion exercised by the trustee. Of course, care would need to be taken to ensure that this does not unnecessarily or inappropriately limit the trustee's discretion or accidentally exclude the wrong person(s).

Conclusion

The *Swanson Superannuation Fund* case has highlighted the importance of careful succession planning for SMSFs. This case provided much insight into the extent of the courts' powers to assess the exercise of the absolute and unfettered discretion of SMSF trustees, even where the reasons for the trustees' decisions are not recorded.

The primary lessons for not only SMSF trustees and their advisers, but also SMSF members, include how crucial it can be for trustees and their advisers to take steps to reduce potential conflicts of interest, and to demonstrate good faith and real and genuine consideration when exercising discretion.

This may include ensuring that the correct documentation is in place (both prior to and after death), considering whether the actions of the trustees do indeed reflect the claimed good faith and real and genuine consideration, and taking steps to reduce any positions of conflict and not blindly relying on common law principles that may operate to disregard such a position.

It is also important that SMSF trustees, members and their advisers not only consider, but also actively seek, specialist advice where there may be uncertainty on a position or an interpretation of critical elements of a death benefit distribution. Finally, the trust deed is a potentially overlooked tool that can be of assistance in reducing conflict and difficulties in the execution of SMSF succession.

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21 *Marsella v Wareham (No. 2)* [2019] VSC 65 at [38], quoting *Karger v Paul* [1984] VicRp 13 at 161 and 164, quoting *Partridge v Equity Trustees Executors and Agency Co Ltd* [1947] HCA 42.

22 *Marsella v Wareham (No. 2)* [2019] VSC 65at [57]-[58].

23 *Marsella v Wareham (No. 2)* [2019] VSC 65 at [58]-[59].

24 *Marsella v Wareham (No. 2)* [2019] VSC 65 at [67].

25 *Marsella v Wareham (No. 2)* [2019] VSC 65 at [73].

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27 [2005] NSWSC 934.

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A Matter of Trusts

by Denise Tan, ATI, Sladen Legal

Transfer to a trustee found to be non-dutiable

This article examines the application of a Victorian duty exemption for transfers of land to trustees where there is no change in beneficial ownership.

The recent Victorian Court of Appeal's decision in *MD Commercial Pty Ltd v Commissioner of State Revenue*[1] was a culmination of the battle between the Victorian Commissioner of State Revenue and the taxpayers' statutory interpretation of a duty exemption contained in s 35 of the *Duties Act 2000* (Vic) and whether the trustee had to be in a "bare trustee" relationship with no active powers being held by the trustee.

This time, the taxpayers have won, with the Victorian Court of Appeal providing a much-needed practical and literal approach to interpreting the legislation. Consequently, the trustees qualified for the duty exemption, as the beneficial ownership remained unchanged despite having powers to develop and sell the property.

The Victorian s 35 exemption

Under s 35 of the *Duties Act 2000*, a duty exemption is available where land is transferred to a trustee *to be held solely* as trustee or nominee of the transferor *without any change in the beneficial ownership of property.*[2]

Background

In 2011, the mother of Anthony and Matthew Fox passed away and, as part of her estate, devised and bequeathed a 50% interest in the subject land to each of her sons, Anthony and Matthew.

On 10 August 2012, the subject land was then transferred by Anthony and Matthew as follows:

- 50% interest to MD Commercial Pty Ltd as trustee of the M David Trust, with Matthew as the beneficiary; and
- 50% interest to AJ Commercial Pty Ltd as trustee of the A James Trust, with Anthony as the beneficiary.

The deeds of the trusts, which contained similar wording, contained a variety of provisions such as;

- cl 1: the trustee acknowledged that "it is registered or entitled to become registered as the proprietor of a one half interest in the property" and that, pursuant to the will of Christine Fox, the beneficiary is the beneficial owner of the interest held by the trustee in the property (subject land);
- cl 2(a): the trustee covenanted that it "holds its interest in the Property in trust for the Beneficiary and will transfer and deal with its interest in the Property and any income and all other rights which may accrue by virtue thereof (collectively referred to herein as 'the Trust Fund') in such manner as the Beneficiary may from time to time direct";
- cl 3: the trustee irrevocably appointed the beneficiary as its attorney "for the purpose of doing everything which the Beneficiary may deem desirable in order to effect a transfer of the Trustee's interest in the Property to the Beneficiary or to a purchaser from the Beneficiary and for carrying out any of the provisions of this Deed";
- cl 6(g): the trustee was empowered, at the direction or with the written consent of the beneficiary, "to hold, use, purchase, construct, demolish, maintain, repair, renovate, reconstruct, develop, improve, sell, transfer, convey, surrender, let, lease, exchange, take and grant options or rights in, alienate, mortgage, charge, pledge, reconvey, release or discharge or otherwise deal with any real or personal property";
- cl 6(h): the trustee was empowered, at the direction or with the written consent of the beneficiary, "to partition or agree to the partition of, or to subdivide or agree to the subdivision of any land or other property which may for the time being be subject to the trusts hereof"; and
- cl 7(a): which precluded the possibility of the introduction of new beneficiaries.

The transfers to the trustees were initially stamped as exempt from duty under s 35(1)(a) of the Duties Act. Following the development, subdivision and sale of the subject land to third parties, the Commissioner commenced an investigation in 2016 and decided to revoke the exemptions and issued a duty assessment on the transfers of the subject land. Subsequent appeals by the taxpayers to the Victorian Civil and Administrative Tribunal and the Supreme Court were initially rejected, but ultimately those decisions were overturned by the Court of Appeal in favour of the taxpayers.

Evolution of s 35 and the Commissioner's view

The predecessor of s 35 was exemption (18) in the Third Schedule of the *Stamps Act 1958* (Vic), which read:

> "Any instrument for the conveyance of real property which is made by the transferor to a trustee or nominee to be held solely as trustee or nominee of the transferor without any change in beneficial ownership or made by way of re-transfer to such transferor."

The full court of the Victorian Court of Appeal in *Comptroller of Stamps v Yellowco Five Pty Ltd*[3] (*Yellowco*) and *Commissioner for State Revenue v Victoria Gardens Developments Pty Ltd*[4] (*Victoria Gardens*) previously contemplated the predecessor exemption (18), with the current s 35 being the focus of the decision in *White Rock Properties Pty Ltd v Commissioner of State Revenue*[5] (*White Rock*). All decisions in effect agreed that the exemption had a very limited scope of operation.[6]

The Victorian State Revenue Office has historically taken the view that the duty exemption afforded under s 35 is in relation to trustees holding properties in a "bare trust" relationship, which means that there should be very few active powers, and that the trustee's relationship to the transferor should merely encompass that "the trustee [do] nothing more than [guard] the property until directed to transfer it back or to transfer it to the purchaser from the beneficiary".[7]

The Commissioner's "reading in" of requirements, on top of what is specified in s 35, stems from the explanatory memorandum[8] introducing the provisions, which provided that:

> "Section 35 is concerned only with transactions which arise in the course of a property being placed into and removed out of, a bare trust … Under this bare trust arrangement, there must be no change in the beneficial ownership and the transferor, as the beneficiary, must retain the entire beneficial interest in the property.
>
> Accordingly, [as to s 35(1)(a)] the exemption is available only where —
>
> – a transferor transfers their dutiable property to a trustee or nominee, to hold on bare trust for the transferor …"

Notably, this interpretation was always problematic, given the "reading in" of requirements which go beyond the actual words of the legislation and the complexities of defining a "bare trust'" from a common law perspective.

The decision

In a joint decision by Tate, Whelan and Niall JJA in *MD Commercial Pty Ltd v Commissioner of State Revenue*, the Victorian Court of Appeal examined the phrase "held solely as trustee … of a beneficiary" and made the following findings:

- the critical question is: who is the beneficial owner as long as the trust exists? In this case, the transfers to the trustees and the provisions within the trust deed did not alter the beneficial ownership of the underlying property;
- the determinative issue was: for whom is the property to be held? The court ultimately agreed with the taxpayers' submission on this point, accepting that the trust deeds in question precluded the possibility of the introduction of new beneficiaries under cl 7(a) (unlike *Yellowco* and *White Rock*) and that there was also no change in beneficial ownership due to the transfers in question (unlike *White Rock* and *Victoria Gardens*);
- the court rejected the Commissioner's primary contention that a trustee empowered to do anything more than "guard" the property may not be "holding" the property. This contention was notably inconsistent with *Yellowco* and *White Rock*, which relevantly had provision for powers in relation to the receipt of income and subdivision by a trustee; and
- the power to sell a property held does not preclude the exemption. The Commissioner could not rely on the power of sale at the direction of a beneficiary to disqualify the trustees from receiving a duty exemption under s 35. Where any future sale was contemplated, Phillips J in *Yellowco* had made it clear that it was an irrelevant consideration that did not affect the terms on which the trust property was held, as long as the trust existed.

Interpretation of legislation

It is encouraging that the court interpreted these provisions with a literal approach where there is no ambiguity or inconsistency[9] in the wording of the statute, noting that a purposive approach should only be necessary where ambiguity or inconsistency exists.

In the author's view, this practical approach to statutory interpretation by the courts is a much needed reprieve in light of how tax legislation is evolving and becoming increasingly broad in its drafting. This often results in unintended consequences and onerous obligations being placed on ordinary taxpayers. It is difficult for a layperson to comprehend and deal with legislation that is drafted with a catch-all approach, often with significant Commissioner's discretion in implementation, which creates taxing obligations that are ambiguous and not easily understood.

Takeaways

MD Commercial Pty Ltd v Commissioner of State Revenue clearly demonstrates that care must be taken where a s 35 Victorian duty exemption (or similar concessions or exemptions in New South Wales,[10] Tasmania[11] and the Australian Capital Territory)[12] is sought.

Many factors will need to be taken into consideration by taxpayers and their advisers where similar exemptions are sought, including:

- the Victorian Court of Appeal's judgment and interpretation that a trust deed permits certain broader powers, including the ability to develop and sell the underlying property or to derive income, as long as the beneficial ownership remains unchanged;
- the relevant trust deed cannot shift the beneficial ownership of the underlying property, either by:
  - altering the nature of a beneficiary's entitlement, such as by creating a right to income and removing a right to distribution on vesting; or
  - diluting a beneficiary's interest by allowing a variation of beneficiaries either by discretion of the trustee or by direction of the beneficiary;
- whether the case is subject to a further appeal, and if so, if it is overturned by the High Court; and
- whether any amending legislation is introduced that alters the position.

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References

1 [2019] VSCA 295.

2 Notably, the New South Wales, Tasmanian and Australian Capital Territory provisions provide a duty exemption, or only charge nominal duty, where there is such a transfer with no change in beneficial ownership. Western Australia is the only state that uniquely specifies that nominal duty will be charged where there is a transfer of dutiable property from a person to another person to hold solely as bare trustee for the transferor, with a legislative definition of a "bare trustee".

3 [1993] VicRp 90.

4 [2000] VSCA 233.

5 [2015] VSCA 77.

6 *MD Commercial Pty Ltd v Commissioner of State Revenue* [2019] VSCA 295 at [33].

7 *MD Commercial Pty Ltd v Commissioner of State Revenue* [2019] VSCA 295 at [71].

8 Explanatory memorandum to the State Taxation Acts Further Amendment Bill 2008, p 10.

9 There is a general acceptance that a purposive approach is only applied where an attempt to apply a literal approach produces ambiguity or inconsistency: DC Pearce and RS Geddes, *Statutory interpretation in Australia*, 5th ed, Butterworths Australia, 2001, p 22; *Mills v Meeking* [1990] HCA 6 at [18] to [19] per Dawson J.

10 S 56 of the *Duties Act 1997* (NSW).

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Superannuation

by Daniel Butler, CTA, and William Fettes, DBA Lawyers

How the CGT rules work when a pension is in play

How the CGT rules interact with the pension exemption is somewhat complex so tax advisers should carefully review the legislative schema rather than relying on general rules of thumb.

Many SMSF advisers approach capital gains tax (CGT) questions that arise for self-managed superannuation funds (SMSFs) with a simple rule of thumb in mind: namely, capital gains made by a fund in connection with a CGT event happening are subject to an effective 10% rate of tax (ie where the asset has been held for more than 12 months), or potentially nil tax if the asset is covered by the pension exemption.

Though such an approach can provide useful top-level thinking about how net capital gains are taxed in an SMSF, it is important to recognise its limitations. In particular, the above is an oversimplification of how the tax law operates. Indeed, tax agents and tax advisers (including registered tax agents and registered tax financial advisers) need to provide accurate advice and treatment, so the above general rule of thumb should not be relied on as a substitute for appropriate tax advice.

This article outlines key aspects of how the CGT rules apply to SMSFs. (All legislative references are to the *Income Tax Assessment Act 1997* (Cth) unless otherwise stated.)

CGT is the primary taxing code for SMSFs

For SMSFs, the distinction between items of a revenue or capital nature is less controversial. Broadly, s 295-85 provides that the CGT rules are the primary code for determining the tax treatment of gains or losses generated on the disposal of an asset by an SMSF.

This is a major “paradigm” shift for most tax advisers to come to grips with as the usual tax rules apply very differently to SMSFs (as explained below). Broadly, most gains on the sale of assets in an SMSF are on capital account, even for assets (eg shares), where there is substantial trading activity by the fund or where the fund trustee has an intention to derive a gain on resale of the asset. For most other taxpayers, this would clearly be on revenue account.

For many different types of resident taxpayers, working out the income tax consequences of a CGT event occurring can be a complex exercise because, unless a specific exclusion applies, the relevant gain that arises must first be analysed as ordinary concepts income under s 6-5 separately to the analysis under s 6-10. Though gains from asset disposals that come home to such taxpayers due to a “mere realisation” will generally be treated on capital account, consideration will always need to be given as to whether the gain was actually on revenue account. For example, receipts from ordinary business operations or commercial transactions carrying out a profit-making scheme generally constitute ordinary income for a non-SMSF taxpayer, notwithstanding the statutory income consequences of any relevant CGT event.[1] In that situation, the anti-overlap rule in s 118-20(1) will need to be applied to address any potential double taxation of the gain.

Fortunately, this kind of two-pronged analysis based on the revenue/capital distinction is generally not required for superannuation funds, as s 295-85 provides that the CGT rules are the primary code for determining the tax treatment of gains or losses derived by an SMSF trustee in relation to a CGT event happening.

For instance, in relation to an SMSF disposing of shares, even where there is a substantial pattern of trading activity or where the fund trustee had a clear intention of maximising profit on resale of the shares, the disposal would nonetheless be on capital account.

Note: The exclusivity of the CGT code for SMSFs is subject to very limited exceptions, eg assets that form part of trading stock acquired prior to 7.30 pm on 10 May 2011.

The relevant CGT event and asset

Due to the primacy of the CGT code, it is also important to identify the relevant CGT event that applies.

As with any other taxpayer, multiple CGT events can occur based on the same set of facts, and the CGT event that applies is the one that is most specific to the situation under s 102-25.

Note: This article focuses on CGT events in respect of fund assets and does not consider the CGT rules in relation to member interests in the fund as distinct CGT assets. However, in broad terms, s 118-305 provides that any capital gain or loss made from a CGT event happening in relation to a member’s interest in the fund is disregarded.

Calculation of net capital gain

Once the relevant CGT event is identified, and assuming the gain is not disregarded as a segregated pension asset, the SMSF trustee will need to calculate the net capital gain that arises under s 102-5 as part of ascertaining its assessable income for the relevant financial year.

In broad terms, a fund must work out the relevant net capital gain by taking the capital gain that arises under the particular CGT event and applying the following reduction steps:

- step 1: applying current year capital losses to reduce the gain;
- step 2: applying any carried-forward net capital losses (as calculated under s 102-10); and
- step 3: applying the one-third general CGT discount percentage that is available to superannuation funds where the asset has been held for more than 12 months.

An SMSF is typically entitled to a one-third discount on a capital gain, provided the asset was held for at least 12 months at the time of the CGT event happening: ss 115-25 and 115-100(b).

Note that the one-third discount is not available if the transitional CGT cost base reset relief had been used for FY2017 in respect of an asset, unless a further period of 12 months had elapsed since the cost base reset (with a deemed acquisition date of immediately before 1 July 2017 or at some time between 9 November 2016 and 30 June 2017 inclusive).

Also note that, when applying the above method statement, the ATO generally does not accept that the small business CGT concessions in Div 152 can apply to an asset disposed of by an SMSF, so no further reductions are available after step 3.

Exempt income: the unsegregated method

The unsegregated method is the most commonly used method for SMSFs claiming exempt income under the "exempt current pension income" (ECPI) exemption.

If a fund is paying one or more (retirement phase) pensions in the relevant income year of the CGT event, and the fund is using the unsegregated method in s 295-390 to calculate its exempt income, the net capital gain will broadly be exempt to the extent that the fund's assets are used to support current (retirement phase) pension liabilities.

This exemption applies prior to the fund combining its ordinary and statutory income to ascertain its assessable income, and thus also prior to any calculation of the fund's taxable income.

The unsegregated method is based on the proportion of the average value of current pension liabilities of the fund compared to the average of the fund's superannuation liabilities as determined in accordance with the following formula in s 295-390(3):

$$\frac{\text{Average value of current pension liabilities}}{\text{Average value of superannuation liabilities}}$$

where:

- average value of current pension liabilities is the average value for the income year of the fund's current liabilities (contingent or not) in respect of the retirement phase superannuation income stream benefits of the fund at any time in that year. This does not include liabilities for which segregated current pension assets are held; and
- average value of superannuation liabilities is the average value for the income year of the fund's current and future liabilities (contingent or not) in respect of superannuation benefits in respect of which contributions have, or were liable to have, been made. This does not include liabilities for which segregated current pension assets or segregated non-current assets are held.

Note that an actuarial certificate is required to certify the exempt percentage that is used to support the fund's claim of exempt income in the fund's annual tax/statutory return.

Exempt income: the segregated method

The segregated method is the other method available to SMSFs for claiming exempt income or ECPI. The segregated method requires the fund's assets funding pensions to be solely used to provide pensions (these assets are known as segregated current pension assets) and other assets (such as assets in accumulation phase).

Active segregation is not that common and a considerable number of SMSFs are segregated as a result of being deemed segregated (ie where 100% of fund assets are funding pension liabilities).

Active segregation depends on appropriate record-keeping. For example, it would be best practice to have trustee resolutions recording:

- the specific assets that have been specifically identified as funding the pension liabilities; or
- the specific assets that are not funding pension liabilities, eg an SMSF may have all of its assets funding a pension apart from certain assets which are not funding a pension. It may be easier to record the non-pension assets (eg cash in a separate bank account) rather than the pension assets (which may be far more comprehensive, eg a diversified portfolio of investments).

Importantly, if a CGT event happens in relation to a CGT asset of an SMSF that is also a segregated current pension asset under s 295-385, any capital gain (or loss) is disregarded under s 118-320. Thus, any resulting net capital gain or capital loss is disregarded and is not reflected in the method statement analysis under s 102-5 (discussed above).

The segregated method is not discussed in any further detail here as this method of claiming exempt income is rarely applied in practice. Note that, since 1 July 2017, where at least one SMSF member has at least a total superannuation balance of $1.6m, the segregated method is not available to an SMSF (refer to the disregarded small fund assets rule in s 295-387).

Taxable income and tax payable

Broadly, for an SMSF that is covered by the unsegregated method of claiming ECPI, any net capital gain that arises under the method statement in s 102-5 (ie the non-exempt proportion) is included in the fund's assessable income for the relevant income year under s 6-10 as statutory income (noting that the exempt portion is excluded from statutory income).

After the fund ascertains its assessable income (ie its ordinary income under s 6-5 and its statutory income under s 6-10), the fund's taxable income can be calculated.

Naturally, tax advisers need to check that the correct amount or proportion of deductions has been claimed where an SMSF claims a pension exemption. In particular, to the extent that expenditure is incurred in gaining or producing exempt income, it is not deductible under s 8-1. Section 8-1(2) expressly provides:

> "(2) However, you cannot deduct a loss or outgoing under this section to the extent that:
>
> …
>
> (c) it is incurred in relation to gaining or producing your exempt income …;"

For example, where an expense is incurred by an SMSF which is 60% exempt under the unsegregated method in s 295-390, only 40% of the expense is deductible. Thus, expenditure that is incurred partly in gaining or producing exempt income and partly in gaining or producing assessable

income must be appropriately apportioned. The ATO provides some guidance in TR 93/17 in this regard.

Also, an interesting modification rule applies in relation to the treatment of contributions when determining what is deductible to an SMSF. Broadly, s 295-95(1) modifies the deduction provisions for "contributions" made to complying superannuation funds since "all contributions" are treated as if they are included in the fund's assessable income for the purposes of working out the amount of any deductions (eg non-concessional contributions (NCCs) are treated as assessable when calculating deductions). As such, this modification rule can provide an SMSF with a greater deduction if it receives significant NCCs in a financial year (even though NCCs are not included in assessable income) as s 295-95(1) deems them to be assessable.

Tax advisers should carefully review deduction claims as the ATO has previously noted that some tax agents claim a pension exemption for their SMSF clients without adjusting the amount of deductions claimed. This suggests that there are numerous tax agents that may not be aware of how this aspect of the pension exemption applies to SMSFs.

Applying the method statement to calculate tax payable

Under s 295-10(1), the following method is used for calculating the tax payable by the fund:

> "Step 1. For a superannuation fund, work out the no-TFN contributions income. Apply the applicable rates as set out in the *Income Tax Rates Act 1986* to that income.
>
> Step 2. Work out the entity's *assessable income* and *deductions* taking account of the special rules in this Division. The *special rules modify* some provisions of this Act. They also include amounts in assessable income, allow deductions and exempt amounts from income tax.
>
> Step 3. Work out the entity's taxable income as if its trustee:
>
> (a) were an Australian resident (except where paragraph (b) applies); or
>
> (b) …
>
> Step 4. Work out the *low tax component* and *non–arm's length component* of the taxable income of a complying superannuation fund …
>
> Step 5. *Apply the applicable rates* as set out in the *Income Tax Rates Act 1986* to the components, or to the taxable income of a non-complying superannuation fund …
>
> Step 6. *Subtract the entity's tax offsets* from the step 5 amount or, for a superannuation fund, from the sum of the fund's step 1 and step 5 amounts."

Thus, in broad terms, any non-exempt portion of the net capital gain would be subject to the usual rate of tax that applies to complying superannuation funds (ie 15%). People who say that net capital gains are taxed at a 10% tax rate are assuming that the one-third CGT discount applies. However, the correct tax rate is 15% of the discounted net capital gain (which is 15%).

A practical example

The following example helps to illustrate the above rules:

- an SMSF makes a $220,000 capital gain on the sale of shares which have been held for more than 12 months;
- the SMSF regularly trades in shares and has always had the intent of acquiring shares to resell at a profit;
- the SMSF is 60% in (exempt) pension phase for the 2020 financial year and this percentage is certified by the fund's actuary;
- the sale contract relating to the sale of shares is entered into on 31 January 2020;
- the SMSF has $10,000 in carried-forward capital losses from prior financial years; and
- there is no other income for FY2020, and deductions or offsets/franking credits are ignored for the sake of simplicity.

The net capital gain for the disposal of shares is calculated as follows:

- apply relevant capital losses: $220,000 less $10,000 = $210,000;
- apply the general one-third CGT discount: $210,000 x 1/3 = $70,000;
- the amount at step 3 of the method statement in s 102-5 is therefore: $210,000 – $70,000 = $140,000.

The non-exempt proportion (ie 100% – 60% ECPI = 40%) of the fund's net capital gain is included in the fund's assessable income as follows:

$140,000 x 40% = $56,000

Thus, $56,000 of statutory income from the disposal of the shares will be included in the SMSF's assessable income for FY2020 and taxed at the usual 15% rate of tax. This results in a tax liability on the disposal of the shares as follows:

$56,000 x 15% = $8,400

It should be noted that:

- the CGT regime is the primary code for taxing complying superannuation funds and the fact that the SMSF trustee regularly trades in shares and has always had the intent of acquiring shares to resell at a profit is irrelevant; and
- the SMSF would need to carefully consider the deductions that can be claimed since the SMSF's exempt portion is 60%. Broadly, only around 40% of general expenses would be deductible under s 8(1). Further, NCCs are treated as assessable income under s 295-95(1) when determining the proportion that can be claimed as a deduction.

Conclusion

How the CGT rules interact with the pension exemption is quite interesting and, at times, somewhat complex. As can be seen from the technical tax detail outlined above, tax and SMSF advisers should carefully review the legislative schema and the ATO's publications rather than relying on general rules of thumb.

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Reference

1 See *FCT v Myer Emporium Ltd* [1987] HCA 18, and TR 92/3.

Alternative Assets Insights

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TA 2020/1: intangible assets

The ATO continues its focus on cross-border arrangements involving intangible assets with the release of TA 2020/1.

In brief

On 22 January 2020, the Australian Taxation Office released a new taxpayer alert (TA 2020/1) on international arrangements involving the development, enhancement, maintenance, protection and exploitation (hereafter referred to as DEMPE) of intangible assets.

Specifically, TA 2020/1 outlines the ATO's concerns in relation to non-arm's length arrangements and schemes connected with the DEMPE of intangible assets. The ATO also illustrates typical features of those arrangements through three examples.

TA 2020/1 is intended to capture arrangements that display a potential misalignment between the contribution of Australian entities to DEMPE functions and the remuneration of those entities. It is also intended to capture arrangements that appear to lack commercial rationale (and/or substance), or not be consistent with the economic interests of the relevant Australian entities.

The potential consequences for taxpayers include:

- application of the transfer pricing rules to deny any transfer pricing benefit (which may include reconstruction of the arrangements);
- application of the anti-avoidance rules, including the general anti-avoidance rule (GAAR) and the diverted profits tax (DPT); and
- double taxation in cases of inconsistent interpretations by countries or application of the anti-avoidance rules.

While the examples and points of emphasis within TA 2020/1 are consistent with the focus around the alignment of substance and profit as found within the OECD transfer pricing guidelines (which are incorporated in the Australian transfer pricing rules) and across the Australian anti-avoidance provisions, the taxpayer alert is another example of the ATO putting taxpayers on notice in relation to specific cross-border arrangements, which are a key focus. In addition to TA 2020/1, we understand that the ATO is developing a practical compliance guideline outlining its compliance approach in respect of cross-border arrangements involving intangibles.

As a result, taxpayers with arrangements involving the cross-border development and/or exploitation of intangible assets should conduct a detailed review of their current arrangements to determine whether they fall into the circumstances described in the taxpayer alert and whether any appropriate action should be taken. The review of such arrangements should include whether sufficient evidence has been prepared through the annual transfer pricing documentation process to demonstrate the alignment of profits to DEMPE functions across the value chain. This is in addition to a consideration of future disclosure requirements in the reportable tax position (RTP) schedule and the international dealings schedule that may be required to be lodged with Australian tax returns, as well as country-by-country (CBC) documentation.

In detail

TA 2020/1 outlines the ATO's concerns in relation to international arrangements that mischaracterise Australian activities connected with the DEMPE of intangible assets. More specifically, the ATO's concerns relate primarily to the following:

- whether the activities performed by Australian entities in relation to the DEMPE of intangible assets are appropriately recognised and rewarded with reference to transfer pricing principles; and
- whether any migration of intangible assets complies with Australian laws, including under the transfer pricing rules as well as the CGT and depreciation rules.

The ATO also notes that transactions that lack evidence of commercial rationale and/or substance can trigger the application of other provisions, including the "reconstruction" provision in the transfer pricing rules and anti-avoidance provisions such as the GAAR or DPT.

In TA 2020/1, the ATO briefly outlines some of the typical features of arrangements that may be of concern. A number of those features are set out in the three examples included in TA 2020/1 (the examples are summarised further below). The key features which are of interest to the ATO include the following:

- a lack of substance in the foreign entity, including limited direction and control over the DEMPE of the intangible assets, limited qualified staff, lack and/or inability to manage/assume risks and/or contribute assets;
- a misalignment between the substance and form of the arrangement, in particular, where an Australian entity performs activities, assumes risks and contributes assets beyond those contemplated by the legal form of the arrangement;
- an absence of compensation for the "migration" or transfers of intangibles assets, whether at a given point in time or over time;
- a lack of commercial rationale for the arrangement; and
- inconsistency between the substance of the arrangements and the best economic interest of an Australian entity.

Interestingly, the ATO notes in TA 2020/1 that it is in the process of developing its technical position in relation to these types of arrangements and that it will continue to do so through engagement with taxpayers. In this context, TA 2020/1 is not intended to provide the ATO's technical view on the various matters detailed therein. The examples are based on arrangements of concern, but arrangements are not limited to those described in the taxpayer alert and "are not confined to a specific form of arrangement".

The ATO also notes that taxpayers who enter into the type of arrangements described in TA 2020/1 will be subject to increased scrutiny and the ATO encourages taxpayers to proactively engage with it. We expect further guidance to be issued by the ATO, which is likely to be a practical compliance guideline. Taxpayers can expect the ATO to have regard to the practical compliance guideline when tailoring its engagement with taxpayers.

Examples

The ATO provides three examples in TA 2020/1 to illustrate typical arrangements that may be a cause for concern.

Example 1: Arrangements involving the bifurcation of intangible assets and the mischaracterisation of Australian DEMPE activities. In this example, an Australian entity owning intangible assets (the "existing intangibles") enters into a contract R&D arrangement with a foreign related party for the development of new intangibles intrinsically linked to the existing intangibles. The foreign related party performs limited activities related to the development of the new intangibles, while the Australian entity's activities in relation to the new intangibles are not materially different from those it performed in relation to the existing intangibles. In addition, the value of the existing intangibles decreases over time as no more DEMPE functions are performed in relation to those intangibles.

As well as the potential mischaracterisation of the Australian DEMPE functions, the ATO has also indicated that the above "migration" may alternatively be characterised as a disposal for the purposes of the CGT and capital allowance provisions and therefore give rise to a CGT event or balancing adjustment event, respectively.

The ATO's concerns regarding the migration of intangibles were also addressed in the context of the DPT in PCG 2018/5. In the draft version of PCG 2018/5, the ATO described an arrangement (which was nearly the same as that in TA 2020/1, example 1) as an example of high-risk, "run up, run down" intangibles migration. PCG 2018/5 also described a modified low-risk example where the transfer pricing rules, CGT rules and R&D integrity rules were applied appropriately.

The second and third examples in TA 2020/1 relate to arrangements involving the non-recognition of Australian DEMPE activities.

Example 2: An Australian entity is a party to a cost contribution arrangement (CCA) in relation to the DEMPE functions for intangible assets. In substance, the Australian entity's contributions exceed those provided for in the relevant CCA agreement and the corresponding benefit received is not commensurate with this contribution vis-à-vis other related parties within the CCA.

Example 3: An Australian entity pays a royalty to a foreign related party for the use of intangible assets. The global group stores intangible assets in an online database. The Australian entity and the foreign related party also enter into an arrangement for the provision of contract R&D services by the Australian entity. The Australian entity is required to share all know-how developed in the course of its activities. The foreign entity has limited operations, staff and assets, while the Australian entity performs the DEMPE functions associated with the intangible assets with limited management and control from the foreign entity.

The ATO's stated response

The ATO is in the process of reviewing these arrangements and engaging with taxpayers who have entered into, or are considering entering into, these arrangements. The ATO's engagement and assurance activities will continue while the ATO develops its technical position on these arrangements.

The ATO is encouraging taxpayers who have entered into, or are contemplating entering into, an arrangement of the type covered by TA 2020/1 to discuss their situation with the ATO by emailing PGIIntangiblesMigration@ato.gov.au.

Observations

Scope. The potential scope of TA 2020/1 is broad, conceivably calling into question a wide range of transactions, including cross-border related party contract R&D arrangements, licensing arrangements, and any other arrangements involving the performance of DEMPE activities by an Australian taxpayer in connection with intangible assets.

Transparency. Information required to identify arrangements in scope is already available to the ATO (for example, through the international dealings schedule and/or the CBC local file/master file). Taxpayers with arrangements potentially within the scope of TA 2020/1 should therefore evaluate their position and options to mitigate any potential risk.

Additional disclosure. It is likely that arrangements targeted by TA 2020/1 or the anticipated practical compliance guideline will need to be disclosed in the RTP schedule in the future. The ATO's RTP schedule instructions call for a very wide interpretation of taxpayer alerts, which may result in a number of taxpayers being required to disclose relatively lower risk arrangements involving intangibles, including contract R&D arrangements.

Evidence. While TA 2020/1 states that arrangements of concern are not limited to the examples, the examples contained in TA 2020/1 are relatively polarised in order to draw out key points of ATO emphasis. Taxpayers who review their relevant scenarios may find that their own arrangements reflect more complex and less binary fact patterns. As a result, taxpayers should undertake a detailed facts-based analysis, collating evidence of key assertions and the commercial rationale underpinning their arrangements, in order to determine the appropriateness of any filing position from an Australian tax perspective, and they should prepare for potential ATO engagement.

The takeaway

Taxpayer alerts provide clear signals of current and continuing ATO areas of focus. Given the heightened transparency levels and disclosure requirements, taxpayers potentially within the scope of TA 2020/1 should proactively analyse their arrangements, collate factual evidence around key assertions, assess their filing position, and determine their tax authority engagement strategy to ensure that they are prepared for any potential ATO engagement.

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Events Calendar

April/May 2020

STATE / EVENT	DATE	CPD
Online		
April Morning Tax Club 2020	7/4/20	1.5
Superannuation Series – Session 1: General Update	8/4/20	1
COVID-19 Stimulus Package – Practical Implications – Webinar	9/4/20	1.5
Payroll Tax game changer for Medical and Health practices? The impact of the decision in Optical Superstore – Webinar	15/4/20	2
COVID-19 Stimulus Package – Accessing the Tax Benefits – Webinar Part 2	16/4/20	1.5
Superannuation Series – Session 2: Contributions Workshop	22/4/20	1.5
Superannuation Series – Session 3: NALI and NALE	29/4/20	1
Superannuation Series – Session 4: Property and SMSFs	6/5/20	1

For information on upcoming events, visit **taxinstitute.com.au/cpd**.

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Taxation *in Australia*®
ISSN 0494-8343

Publishing House
The Tax Institute
ABN 45 008 392 372

Level 37, 100 Miller Street
North Sydney, NSW 2060

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Typesetter
Midland Typesetters, Australia

Advertising
Wayne Flekser 02 8223 0071

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The Tax Institute would like to thank the following presenters from our March 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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