THE JOURNAL FOR MEMBERS OF THE TAX INSTITUTE

Taxation in Australia

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Taxation of SMEs

The Tax Institute

How we could redesign a simpler, efficient tax system for SMEs

Corporate tax compliance and the RTP schedule

Patricia Muscat, CTA, and Lynda Brumm, CTA

NSW Duties Act: charging the land

Cullen Smythe, CTA

Trust law: vesting and resettlement issues

Philip Bender, ATI

Navigating transactions involving "pre-CGT" assets

Elizabeth McNamara and Michael Dean, FTI

THE TAX INSTITUTE

Contents

Invitation to write

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

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Tax News – at a glance

by TaxCounsel Pty Ltd

October – what happened in tax?

The following points highlight important federal tax developments that occurred during October 2021. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 283 (at the item number indicated).

Tax treaty network

In a media release on 15 September 2021, the Treasurer announced that the government will expand Australia's tax treaty network to support the economic recovery and ensure that Australian businesses are well placed to take advantage of the opportunities that will emerge in the coming years. **See item 1.**

ACNC and reforms

The government has released exposure draft legislation which will implement two reforms to reduce red tape for, and increase transparency of, the charity sector. **See item 2.**

Disguising undeclared foreign income

The Commissioner has released a taxpayer alert which deals with arrangements that involve Australian resident taxpayers who derive income or capital gains offshore but attempt to avoid or evade tax on their foreign assessable income by concealing the character of funds on their repatriation to Australia by disguising the funds received as a gift, or a loan, from a related overseas entity (TA 2021/2). **See item 3.**

Legal professional privilege protocol

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Electronic sales suppression tools: penalties

The Commissioner has released a draft practice statement that provides guidance on the application and remission of administrative penalties for the production, supply, possession and use of an electronic sales suppression tool (PS LA 2021/D2). **See item 5.**

Public benevolent institution

The AAT, reversing a decision of the ACNC Commissioner, has held that Global Citizen Ltd, a not-for-profit entity that was registered as a charity by the ACNC with the subtype of advancing education, was entitled to be registered with the subtype of a public benevolent institution (*Global Citizen Ltd and Commissioner of the Australian Charities and Not-for-profits Commission* [2021] AATA 3313). **See item 6.**

Commissioner's information notice upheld

The Full Federal Court (Middleton, McKerracher and Griffiths JJ) has unanimously dismissed an appeal by the taxpayer from a decision of Moshinsky J in which his Honour upheld the validity of a statutory information-gathering notice that was issued by the Commissioner on 4 March 2020 and required the taxpayer to provide certain details about documents over which the taxpayer claimed legal professional privilege (*CUB Australia Holding Pty Ltd v FCT* [2021] FCAFC 171). **See item 7.**

GST: searching for gold

In a recent decision involving what the Commissioner described in his statement of facts, issues and contentions as "a GST gold scheme case", the AAT has partially allowed the taxpayer's objections against assessments to GST and penalties (*STNK and FCT* [2021] AATA 3399). **See item 8.**

President's Report

by Peter Godber, CTA

A strategic course for the future

Celebrating our best, recovering and preparing for the future.

As Giles has noted in his report this month, we celebrated our best and brightest at the Tax Adviser of the Year Awards at the 2021 Tax Summit: Challenge Accepted. Congratulations to all award nominees and winners. Your efforts and professionalism are respected and admired, and we all benefit from having you in our membership.

The 2021 Tax Summit program was outstanding, an online triumph. It surpassed many of the benchmarks we set for ourselves at the Tax Summit 2020 in terms of participation, variation in session streams, and an appealing theme. We all refreshed and reconnected. Again, I thank everyone who participated, from the organising and program committees to our hard-working staff, our wonderful volunteers who gave their time to prepare papers, present and contribute, our sponsors and our exhibitors. And a big thank you to all attendees for supporting the event and making it such a success. It was a great way to help us reach the end of 2021.

Looking ahead, I have a couple of important things to mention in advance of The Tax Institute's Annual General Meeting, which is scheduled to be held virtually in late November, but keep a look out for the notice for it. I note that the timing of this year's AGM will set a new precedent for The Tax Institute as we have moved to a 30 June financial year end. In this and future years, we will be looking to conduct our meeting in October or November.

National Council, our board, has been working hard this year to set our future strategic course and to commit to good governance. I am very pleased with our financial record in recent years, which sees us again reporting a surplus and being in a very stable financial position. Importantly for us, across the organisation, we have implemented best practice to deal with the management of risk, and this is holding us in good stead through the current changing environment for all service offerings. We have also been able to invest in areas that support future growth and service, including a continued investment in technology and knowledge content management.

We have also been doing a lot of work of late at a state level, working with state councillors and committee members to ensure that we operate according to best practice when serving members, and implementing national strategies effectively and consistently across state boundaries and in local communities. A Strategic Advisory Committee that includes state chairs has been working through this, with some very positive outcomes to be acted on now and into 2022 and the future.

On the theme of governance and our future, I would like to note that, at the upcoming AGM, we will be asking for amendments to The Tax Institute's Constitution. Some are minor and more of a refresh, but there is one important proposal I would like to bring to your attention.

Over the course of 2020 and 2021, National Council has reviewed its governance structure to ensure best practice. In August of this year, we resolved to put to members that National Council be chaired by an independent board-appointed Chairperson. Under this revised governance model, the President and Vice President will retain their key roles as the figureheads and leaders for members and with the tax community more broadly. The Chairperson's focus will be to ensure that The Tax Institute maintains best governance practice, which is increasingly important for the Institute as a registered charity with the Australian Charities and Not-for-profits Commission. The Chairperson will bring professionalism and dedication to the role and the conduct of the board, but National Council will still be fundamentally made up of state-nominated representatives.

Constitutional amendments require approval by members by special resolution. A special resolution requires the approval of at least 75% of members present and voting, in person or by proxy. The AGM will be held virtually, but I do encourage you to attend and help celebrate our successes as the end of the 2021 calendar year approaches.

At The Tax Institute, we have achieved a lot over the past year or two. As COVID-19 restrictions ease across the country and we approach more familiar levels of normality, I hope that you also feel a little refreshed, reset and reconnected through your engagement with the Institute.

CEO's Report

by Giles Hurst

Highlights of The Tax Summit

CEO Giles Hurst talks about the importance of reflecting and refuelling and the experience at The Tax Summit: Challenge Accepted.

We recently wrapped up the biggest event of our 2021 professional development calendar, The Tax Summit: Challenge Accepted.

This event was a smorgasbord of current tax technical insight and expert analysis. It was also much more than that. This year, we set out with a few major goals in mind: to reconnect with friends and colleagues, to refuel our minds and motivation after a tough couple of years, and to reimagine how we work and where we're going as individuals and as a collective.

Alongside the insightful tax technical discussions, we had many sessions and keynotes designed to benefit your life and professional career more broadly. One of my personal highlights was hearing from Shadé Zahrai, an award-winning leadership strategist, on not only understanding our own thought and behaviour patterns, but also optimising and supercharging them for our changing world.

I also thoroughly enjoyed hearing from Dr Adam Fraser on managing peak performance while operating at speed, and from Michael McQueen about how COVID-19 has reshaped habits, expectations and our relationship with technology — perhaps for good. Michael spoke about fostering engagement, collaboration and culture while leading remote and hybrid teams, which was particularly enlightening for me, as we continue to navigate The Tax Institute's place in a digital world and plan for the easing of restrictions for those in our Sydney office.

And finally, our closing keynote left quite the impression. Todd Sampson, creator of the award-winning Discovery Science series *Redesign My Brain*, talked about the science of improving your brain and why it's never too late to boost your brainpower and unlock potential you may not even known you have. Certainly good news!

The Tax Summit, among everything else, was a crucial reminder that we can rarely get ahead by focusing all our energy on one aspect of life, to the detriment of others. Our career progresses best when balanced with mental and physical wellbeing and vice versa: feeling in control of professional aspirations helps us feel happy and motivated. I came away from the event feeling that it was beneficial in myriad ways — I trust the same is true for you.

It was admittedly disappointing that COVID-19 restrictions meant we were unable to hold the event face-to-face. The atmosphere of a large, in-person event like The Tax Summit is incredible and it would have been wonderful to see you all in person.

Having said that, the online event had a uniquely electrifying energy of its own created by the wonderful attitude and interest brought into the (virtual) room by all of our attendees. An online event also means that later access to these valuable sessions is made easier for those who were unable to attend the event itself. Keep an eye out for sessions becoming available on demand — I encourage you to explore and see what might interest you.

I'd like to extend my congratulations once again to the winners of our Tax Adviser of the Year Awards. We were searching for those who went above and beyond for their clients, peers and communities this year, and we certainly found a group of extraordinary and deserving winners.

Finally, a huge thank you to everyone who made The Tax Summit possible, from the organising and program committees and the speakers who generously volunteered their time, to the Institute team working behind the scenes and the attendees who lent such energy, engagement and enthusiasm to the week. This was our most extensive program to date, attracting our largest crowd of attendees with 2,100 people tuning in. At times like these, I feel exceptionally proud and fortunate to be part of this wonderful community.

Associate Tax Counsel's Report

by Abhishek Shekhawat, ATI

Australia's rising property prices

An overview of some of the tools in our tax and transfer system to tackle rising house prices throughout Australia.

To say that property prices are a hot topic across Australia (and have been for the past decade) would be an understatement. It seems that every week there is a news piece about record-breaking housing prices, promptly followed by other media highlighting the soaring debt levels and concerns about a potential disastrous crash of Australia's housing market and economy.

At the time of writing, we await the outcome of the inquiry into housing affordability and supply in Australia. It remains to be seen whether the government will take action in response to the inquiry, knowing that this requires strong political conviction to engage in meaningful reform. There are effective options and tools which can curb or reduce the rapidly rising house prices. Outside the tax and transfer system, these include interest rates, increasing housing supply and/or density, and more stringent restrictions on lending.

But there is also a multitude of tools available within the tax and transfer system that can potentially mitigate the issue of housing affordability, some of which are outlined below.

Removing tax incentives

One of the most commonly discussed methods is the modification of tax rules to remove incentives to invest in (residential) real estate. This can be achieved through the removal of the ability to reduce income from investment losses (ie negative gearing) and/or reductions in CGT discounts for such assets. Both options could alleviate pressures that distort economic investment choices. The Tax Institute discusses these options in further detail in chapter 8 of the Case for Change.

If these options, or indeed any others, are pursued, they should be undertaken with a view to simplify the tax law and make it more efficient. Changes are generally less effective when they apply only to small segments or sections of the tax law. Further, they should not be implemented in a manner that results in new investment distortions. For example, by introducing reforms equally across all non-salary and wage income, there may be fewer opportunities for tax outcomes to distort investment decisions.

An alternative view is that tax incentives for investment properties should be more generous than they currently are. The most common example is removing CGT on second residences and investment properties. With the impact that tax incentives can have on investment decisions, this approach could potentially encourage more people to transact in the property market, especially as investors. However, this approach could also have a significant inflationary impact due to tax incentives potentially distorting and increasing demand. As a result, while potentially increasing market activity, this approach may not necessarily make housing more affordable. Detailed economic analysis is likely needed to fully understand the impact.

Removing inefficient taxes

Stamp duties are archaic, inefficient and inequitable. Transfer duties in particular discourage the transfer of assets and homes, inhibiting families from upsizing or downsizing to better suit their circumstances. The restriction on mobility can have significant flow-on effects, including the creation of significant barriers to workplace mobility.

Replacing stamp duty with an annual property tax has the potential to reduce the cost and mobility barriers for purchasers, especially families and first home buyers. The removal of mobility and cost barriers could in turn potentially result in a greater supply in high-demand areas as owner-occupiers feel less restricted in their desire to move, especially if they move to areas further from high-demand locations.

Incentive schemes

Both state and federal governments have introduced schemes that are intended to incentivise purchasers, especially first home buyers. Examples of such incentives include stamp duty reductions for first homeowners or new homes, the First Home Super Saver Scheme, or purchaser support schemes where the government guarantees or supports a portion of the deposit. Although these schemes are often advertised as improving affordability for segments of the population, they often introduce an inflationary impact on house prices which reduces housing affordability for the population overall.

Government incentive schemes should instead be better targeted at reducing and spreading demand. For example, incentives could be provided to purchasers who relocate their main residence to a regional or rural area. The increasing transition to digital workplaces makes this a desirable option for some, and could be further incentivised with investment into infrastructure to support the digital office. Governments may also see better results by investing in, or incentivising, more affordable housing for those who are vulnerable.

The next steps

The range of options available to government is broad and capable of being implemented in stages or in a nuanced manner, balancing the need for housing affordability while potentially preventing an inadvertent over-correction in the market. Let us know in The Tax Institute's Community what you think are the ideal tax reform options for making housing more affordable in Australia.

Tax News – the details

by TaxCounsel Pty Ltd

October – what happened in tax?

The following points highlight important federal tax developments that occurred during October 2021.

Government initiatives

1. Tax treaty network

In a media release on 15 September 2021, the Treasurer announced that the government will expand Australia's tax treaty network to support the economic recovery and ensure that Australian businesses are well placed to take advantage of the opportunities that will emerge in the coming years.

The government's plan will allow Australia to enter into 10 new and updated tax treaties by 2023, building on Australia's existing network of 45 bilateral tax treaties. This will ensure that Australia's tax treaty network will cover 80% of foreign investment in Australia and about $6.3t of Australia's two-way trade and investment.

Negotiations with India, Luxembourg and Iceland are occurring this year as part of the first phase of the program. Negotiations with Greece, Portugal and Slovenia are scheduled to occur next year as part of the second phase.

The Treasury is seeking submissions to inform the negotiations and will be consulting with interested stakeholders.

It may be noted that, in the 2020-21 and 2021-22 Budgets, $11.6m was provided to Treasury and the ATO to support this expansion of the tax treaty network.

2. ACNC and reforms

The government has released exposure draft legislation which will implement two reforms to reduce red tape for, and increase transparency of, the charity sector.

The reforms, which arise from the government's agreement to recommendations in the Australian Charities and Not-for-profits Commission Legislation Review 2018, are broadly:

- to increase the annual revenue thresholds defining small, medium and large registered charities; and
- to require all registered charities to disclose related-party transactions, with small registered charities to make a simplified disclosure involving a brief description of related-party transactions.

The new annual revenue threshold levels (which are to apply for the 2021-22 and later financial years) are to be less than $500,000 (for small registered entities), $500,000 to less than $3m (for medium registered entities), and $3m or more (for large registered entities).

It may be noted that amending legislation that, among other things, will require all deductible gift recipients (DGRs) to be ACNC registered charities, is now law (see the *Treasury Laws Amendment (2021 Measures No. 2) Act 2021*).There are transitional rules that apply to existing DGRs to give them a longer period to comply with the new requirements.

The Commissioner's perspective

3. Disguising undeclared foreign income

The Commissioner has released a taxpayer alert which deals with arrangements that involve Australian resident taxpayers who derive income or capital gains offshore but attempt to avoid or evade tax on their foreign assessable income by concealing the character of funds on their repatriation to Australia by disguising the funds received as a gift, or a loan, from a related overseas entity (TA 2021/2).

The arrangements typically involve an Australian resident taxpayer deriving foreign assessable income and not declaring it in their Australian income tax return. The amounts derived may be:

- actual amounts of foreign assessable income, such as income from employment, interest, dividends, or a capital gain on the disposal of assets, such as shares in a foreign company;
- deemed amounts of foreign assessable income, such as amounts assessable under the controlled foreign company provisions in Pt X of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) or under the transferor trust provisions in Div 6AAA of Pt III ITAA36; or
- amounts assessable as dividends as a result of s 47A or Div 7A of Pt III ITAA36 applying, or amounts from trusts assessable under s 99B ITAA36.

The foreign assessable income is repatriated (in a single lump sum or in instalments) to the taxpayer, or an associate of the taxpayer, in Australia. The repatriation is achieved by a related overseas entity transferring the funds directly to the taxpayer (or an associate), or by using the services of an offshore financial intermediary to transfer the funds. The related overseas entity is typically a family member, a friend or some other kind of associate (such as a related company or trust).

The true character of the foreign assessable income is concealed on its repatriation to Australia under the guise that the foreign assessable income is instead a gift or a loan from the related overseas entity.

In some cases, documentation is prepared that purports to show that the repatriated funds have the character of a gift, or an advance of funds by way of a loan, but that occurs in circumstances where the objectively ascertainable facts do not support that characterisation.

Where a purported loan is used by the Australian resident taxpayer for the purposes of gaining or producing assessable income, the taxpayer claims a deduction for amounts of interest that are said to have been incurred. Although withholding tax calculated on the amount of the claimed interest incurred may be remitted to the Commissioner, often no amount of interest or principal is ever paid to the related overseas entity. Instead, the claimed interest liability is capitalised, resulting in continuously increasing claims for deductions in respect of the purported interest liability.

TA 2021/2 also notes that, while outside the scope of the alert, care should still be taken in relation to genuine gifts or loans received in these circumstances as there may be Australian tax consequences, for example, s 99B ITAA36 may apply if the amounts are paid by or through trusts.

4. Legal professional privilege protocol

The Commissioner has released for public consultation a draft legal professional privilege (LPP) protocol which contains the ATO's recommended approach for identifying communications covered by LPP and for making LPP claims to the ATO.

Interestingly, it is noted that one area that the ATO will be further exploring is the use of computer-assisted technology in LPP claims.

The draft LPP protocol explains that, where a claim of LPP is made, the ATO needs to decide whether to accept or challenge that claim. To make an informed decision, the ATO needs information about the communication and the basis on which LPP is claimed. Sometimes not enough information is given to the ATO to make this decision, and at other times, there is a team of people with different roles involved in the communication and it is not clear to the ATO why a particular communication is privileged.

Where the protocol is followed, the ATO will usually have all of the information it needs to be able to make a decision on what to do next. In many cases, it is likely that the ATO will accept the claim without any further enquiries.

However, following the protocol does not mean that the ATO will never have concerns about the claims or challenge the claims. In these types of cases, it means that the ATO will be able to more readily identify what concerns the ATO has and ask specific questions about those concerns. For example, the ATO may be concerned that:

– the requisite lawyer/client relationship is not established; or
– the areas of concern referred to in the protocol are present (see below).

If the recommended approach is not followed, there is no presumption that the LPP claims are invalid. However, the ATO is likely to ask for further information in order to determine whether the claims can be accepted.

The areas of concern referred to above relate to LPP claims made over communications arising out of the following arrangements:

– contrived arrangements or relationships which purport to attract LPP where there is a purpose of concealing communications from the ATO. The ATO will pay close attention to circumstances where LPP is actively promoted as a feature of tax advice. This is different to where an advisory firm is merely pointing out that privilege is an ordinary feature of communications that are for the sole or dominant purpose of giving or receiving legal advice or advice for litigation;
– routing advice through a lawyer merely for the purpose of obtaining privilege. Communications having the purpose of obtaining privilege are not for the sole or dominant purpose of giving or receiving legal advice or for litigation;
– legal engagements entered into after the substance of advice was provided by non-legal persons;
– concepts and ideas proactively promoted or marketed, or presented by a person or firm, whether lawyer/law firm or otherwise, prior to a legal engagement and unsolicited by the taxpayer;
– communications exclusively between non-legal persons in circumstances where the involvement of a lawyer is not apparent; or
– unclear (and potentially overlapping or inconsistent) capacities and relationships designated to different members of the firm. For example, non-legal persons purporting to be an agent of the client when dealing with legal staff, an agent of the lawyer when dealing with the client, as well as potentially being an independent expert on tax law matters.

For a recent decision of the Full Federal Court on issues relating to LPP, see item 7 below.

5. Electronic sales suppression tools: penalties

The Commissioner has released a draft practice statement that provides guidance on the application and remission of administrative penalties for the production, supply, possession and use of an electronic sales suppression tool (ESST) (PS LA 2021/D2).

Electronic sales suppression tools are designed to interfere with electronic sales records, that is, they can falsify, manipulate, hide, obfuscate, destroy or prevent the creation of electronic sales records, often without an audit trail showing the interference. They can take various forms and are constantly evolving, but some examples include:

– software that deletes or modifies point of sale (POS) records;
– storage devices (such as back-up drives) containing software that deletes or modifies records; and
– POS devices with software that deletes or modifies records.

An ESST may be a device, software program or other thing, a part of any such thing, or a combination of any such things or parts that has the capability and a principal function of interfering with sales records electronically.

Penalties apply for producing, supplying, possessing and incorrectly keeping records using ESSTs, as well as aiding or abetting another to do so.

PS LA 2021/D2 states that an ATO officer who discovers that an entity has possession of or is using an ESST, in addition to considering whether a penalty applies, should work with the entity to ensure that the ESST is removed so that the entity will no longer engage in conduct that can attract a penalty.

In addition to explaining what an ESST is and when an ESST penalty applies, PS LA 2021/D2 considers:

– the factors that ATO officers should consider when deciding whether to remit an ESST penalty; and
– the notification of an entity of the penalty.

The ESST administrative penalties are provided for by provisions contained in Div 288 of Pt 4-25 of Sch 1 to the *Taxation Administration Act 1953* (Cth). That Act also contains offence provisions in Subdiv BAA of Div 2 of Pt III.

Recent case decisions

6. Public benevolent institution

The AAT, reversing a decision of the ACNC Commissioner, has held that Global Citizen Ltd (GCL), a not-for-profit entity that was registered as a charity by the ACNC with the subtype of advancing education, was entitled to be registered with the subtype of a public benevolent institution (PBI) (*Global Citizen Ltd and Commissioner of the Australian Charities and Not-for-profits Commission*[1]).

GCL was incorporated as a company limited by guarantee on 14 April 2010. Its sole member and parent entity is Global Poverty Project Inc which trades as Global Citizen (GPP US). GPP US is a non-profit entity that is eligible to receive tax deductible contributions on the basis that it is a public charity in the United States. GCL and GPP US are part of a global network of entities operating as part of the Global Citizen Network (GC Network). In addition to Australia and the US, the GC Network includes entities in the United Kingdom, Canada, South Africa and Nigeria.

The ACNC Commissioner contended that GCL was not eligible to be registered as a PBI on the basis that:

- GCL had an independent purpose, or purposes, of education and/or advocacy that prevented it from being a PBI; and
- GCL did not provide relief directly, or through related entities, to those in need.

The AAT, in rejecting the ACNC Commissioner's contentions, said:

> "127. We are satisfied GCL is organised for the purpose of relieving poverty. It undertakes a range of activities, together with other entities in the GC Network, and in collaboration with other entities both in Australia and overseas, so that monies are directed to international organisations that are involved in the direct delivery of aid and assistance in the relief of poverty. The role of GCL and other GC Network entities has been acknowledged by those international actors [international organisations that had provided letters relating to the role played by GCL] and within government. Given the reasoning evident in the modern authorities, we accept GCL can appropriately be described as an institution that is 'organised' for, or 'conducted for' or that 'promotes' the relief of poverty. It is therefore entitled to be registered as a charity with the subtype PBI under s 25-5(5) of the ACNC Act."

The AAT acknowledged that its decision on the law raised potentially important and difficult questions of public policy. The evidence clearly established that most large PBIs engaged with the political process as a regular and indispensable part of their work because governments are invariably key players in delivering the relief that is sought. Once that reality is accepted, there is potentially a blurring of the distinction between a PBI that participates in the political process as part of its activities in providing benevolent relief and an entity that is pursuing political outcomes for their own sake.

7. Commissioner's information notice upheld

The Full Federal Court (Middleton, McKerracher and Griffiths JJ) has unanimously dismissed an appeal by the taxpayer from a decision of Moshinsky J in which his Honour upheld the validity of a statutory information-gathering notice that was issued by the Commissioner on 4 March 2020 and required the taxpayer to provide certain details about documents over which the taxpayer claimed legal professional privilege (LPP) (*CUB Australia Holding Pty Ltd v FCT*[2]).

The heart of the taxpayer's case before Moshinsky J and on appeal was that the Commissioner's "primary purpose, or alternatively substantial purpose" for issuing the notice was improper. In particular, the taxpayer argued that the Commissioner's "true purpose, or in the alternative … at least, a substantial purpose" was to arrogate to himself the determination of whether or not the taxpayer's LPP claims were made out when (as was agreed) such a determination could only be made by a court. Moshinsky J disagreed that the Commissioner had such a purpose (or substantial purpose).

Moshinsky J held that the Commissioner's purpose (or substantial purpose) in issuing the information notice was to obtain information that he considered necessary to determine whether to accept or challenge the taxpayer's LPP claims in respect of the relevant documents.

In its judgment dismissing the taxpayer's appeal from the decision of Moshinsky J, the Full Court set out the following as being the applicable legal principles:

- a purported exercise of statutory power by a public authority is not authorised and is therefore beyond power and invalid if it is exercised for an improper purpose or for improper purposes. Every statutory power, however widely expressed, is limited by the text, subject matter, scope and purpose of the statute. The purpose of the grant of a power or the purpose for which the power may be exercised and the outer limits of the exercise of the power are generally speaking, to be derived from the statute conferring it. The notion of impropriety in this context does not necessarily mean that the repository of the power was acting mala fide or dishonestly, and an action can be improper without the repository being aware that the conduct was improper;
- the relevant purpose or purposes for which a power is exercised is a question of fact. It is to be determined objectively by reference to admissible evidence. Where a statutory power is exercised for multiple purposes and one of those purposes is improper, the exercise of the power will be vitiated if the improper purpose was a substantial purpose. An improper purpose does not become a proper purpose merely by asserting that the power was exercised for a proper purpose;
- the doctrine of LPP affords an immunity from providing certain documents or information concerning legal matters, the production of which might otherwise be compellable. In the absence of a specific statutory regime, it is for a court of competent jurisdiction to determine the validity of disputed LPP claims; and

– in the present situation, there was no challenge to the entitlement to issue the notice. It was also accepted that it was for the taxpayer to establish that the notice was issued for an improper purpose, but the taxpayer also argued (correctly) that, in exercising a coercive power, the Commissioner should not impinge on rights which are not clearly abrogated by the grant of the power.

In its judgment, the Full Court said that the entire process of the exchanges between the taxpayer and the Commissioner revealed commendable attempts by which the parties might have been able to resolve the question of privilege without a formal challenge in court. That the notice was ultimately issued in the form it was, was consistent only with the fact that, after considerable efforts, the parties could not agree as to the quantity of information that should be supplied by the taxpayer. The actual content of the notice ultimately issued, in terms of what was sought from the taxpayer, was not consistent with the asserted purpose of the Commissioner himself actually determining (in the sense of adjudicating) the LPP claims.

For details of the Commissioner's draft LPP protocol, see item 4 above.

8. GST: searching for gold

In a recent decision involving what the Commissioner described in his statement of facts, issues and contentions as "a GST gold scheme case", the AAT has partially allowed the taxpayer's objections against assessments to GST and penalties (*STNK and FCT*[3]).

The Commissioner alleged that the case followed the pattern of GST gold schemes in which:

1. gold bars that satisfy the definition of "precious metal" in the *A New Tax System (Goods and Services Tax Act) 1999* (Cth) (GSTA99) are acquired by an entity and adulterated, such that they no longer satisfy that definition;
2. that entity (sometimes called a "missing trader") makes taxable supplies of the scrap gold but does not pay the GST on those supplies;
3. the scrap gold is then passed through a number of intermediaries, each claiming input tax credits on their acquisitions of the scrap gold and remitting GST on their subsequent taxable supplies of scrap gold; and
4. the scrap gold finally reaches an entity (in the case before the AAT, the taxpayer) which would claim input tax credits and purport to refine the scrap gold, or cause it to be refined on its behalf, and make supplies of the resulting gold bullion that were GST-free under s 38-385 GSTA99 (supplies of precious metals).

The Commissioner did not allege that the taxpayer was aware of the adulteration of the bullion bars and non-payment of GST, or was a participant in a fraud. Nor did the Commissioner allege that the taxpayer was engaged in sham transactions. Rather, the Commissioner disputed the character of the taxpayer's supplies. The Commissioner contended that those supplies did not satisfy the statutory requirements for GST-free supplies. Alternatively, the Commissioner argued that the general anti-avoidance provisions (Div 165 GSTA99) applied.

The taxpayer contended that, in the period August 2016 to November 2016 (referred to as "the first period"), it had made creditable acquisitions of scrap gold and supplies of gold bullion that were GST-free under s 38-385 GSTA99 (supplies of precious metals). For the period December 2016 to January 2017 (referred to as "the second period"), the taxpayer contended that it had made supplies that were GST-free under s 38-185 GSTA99 as exports.

For the first period, the AAT held that, even if the taxpayer supplied gold bullion to the recipients of the supplies, it would not follow that the taxpayer had discharged the burden of proving that such supplies were GST-free. That would require the AAT to be satisfied that the recipients were each a "dealer in precious metal" (as required by s 38-385(c) GSTA99) at the relevant times. That would require a conclusion that a principal part of the enterprise of each of the recipients was the regular supply and acquisition of precious metal. The AAT held that the taxpayer had not discharged its onus of proof in this respect. The Commissioner accepted that the taxpayer acquired the scrap gold in the course of its enterprise (and, so, the taxpayer was entitled to input tax credits).

In relation to the second period, the AAT, although it considered that the issue was finely balanced, accepted that, consistent with the relevant invoicing and the export documentation and the evidence of the taxpayer's director, the taxpayer was entitled to and did export the scrap gold, even if the taxpayer did not hold title to the scrap gold when the gold left Australia.

The AAT also held that the taxpayer had discharged the burden of proving that it would not be concluded that any entity had a dominant purpose of securing the taxpayer's input tax credits in the second period and that, therefore, the provisions of Div 165 GSTA99 were not attracted.

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References

1 [2021] AATA 3313.

2 [2021] FCAFC 171.

3 [2021] AATA 3399.

Tax Tips

by TaxCounsel Pty Ltd

Main residence exemption: deceased estates

This article considers aspects of the operation of what may be called the two-year CGT deceased estate main residence rules.

Background

The provisions that govern the CGT main residence exemption are among the CGT provisions that are most frequently encountered in practice. However, the operation of the provisions can raise significant issues, both of fact and of statutory construction.

In the context of a deceased estate, not only must the general CGT rules that apply in relation to deceased estates be considered but, in the case of a dwelling (or an ownership interest in a dwelling) owned by the deceased at the time of their death, there are special CGT provisions that can potentially apply to such a dwelling that must be considered.

These special CGT provisions include rules that may apply where a dwelling (or an ownership interest in a dwelling) owned by the deceased at the time of their death is disposed of within two years of the deceased's death, or within a longer period allowed by the Commissioner. Some aspects of these rules are considered in this article.

For convenience, these special provisions are referred to in this article as the two-year CGT deceased estate main residence rules or, simply, as the two-year rules.

Importantly, the Commissioner has issued a practical compliance guideline which addresses issues relating to the exercise by him of the discretion to extend the two-year period (PCG 2019/5). The guideline includes a safe harbour compliance approach that taxpayers can rely on.

The two-year rules: the legislation

The two-year CGT deceased estate main residence rules are provided for in ss 118-195 and 118-197 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97). To the extent relevant, these sections provide as follows:

> "**118–195 Dwelling acquired from a deceased estate**
>
> (1) A capital gain or capital loss you make from a CGT event that happens in relation to a dwelling or your ownership interest in it is disregarded if:
>
> (a) you are an individual and the interest passed to you as a beneficiary in a deceased estate, or you owned it as the trustee of a deceased estate; and
>
> (b) at least one of the items in column 2 and at least one of the items in column 3 of the table are satisfied; and
>
> (c) the deceased was not an excluded foreign resident just before the deceased's death.[1]

Beneficiary or trustee of deceased estate acquiring interest

Item	One of these items is satisfied	And also one of these items
1	the deceased acquired the ownership interest on or after 20 September 1985 and the dwelling was the deceased's main residence just before the deceased's death and was not then being used for the purpose of producing assessable income	your ownership interest ends within 2 years of the deceased's death, or within a longer period allowed by the Commissioner
2	the deceased acquired the ownership interest before 20 September 1985	the dwelling was, from the deceased's death until your ownership interest ends, the main residence of one or more of: (a) the spouse of the deceased immediately before the death (except a spouse who was living permanently separately and apart from the deceased); or (b) an individual who had a right to occupy the dwelling under the deceased's will; or (c) if the CGT event was brought about by the individual to whom the ownership interest passed as a beneficiary–that individual

> Note 1: You may make a capital gain or capital loss if the dwelling was used for the purpose of producing assessable income: see section 118-190.
>
> Note 2: In some cases the use of a dwelling to produce assessable income can be disregarded: see sections 118-145 and 118-190.
>
> Note 3: There are special rules for dwellings acquired before 7.30 pm on 20 August 1996. These rules also affect the operation of section 118-192 and subsections 118-190(4) and 118-200(4): see section 118-195 of the *Income Tax (Transitional Provisions) Act 1997*.
>
> …
>
> (2) Only these CGT events are relevant:
>
> (a) CGT events A1, B1, C1, C2, E1, E2, F2, K3, K4 and K6 (except one involving the forfeiting of a deposit); and

(b) a CGT event that involves the forfeiting of a deposit as part of an uninterrupted sequence of transactions ending in one of the events specified in paragraph (a) subsequently happening.

Note: The full list of CGT events is in section 104-5.

118–197 Special rule for surviving joint tenant

This Subdivision applies to you as if the ownership interest of another individual in a dwelling had passed to you as a beneficiary in a deceased estate if:

(a) you and the other individual owned ownership interests in the dwelling as joint tenants; and

(b) the other individual dies."

Eligible entities

The terms of para (a) of s 118-195(1) ITAA97 mean that the taxpayer claiming the benefit of the two-year rules must be either an individual to whom the relevant ownership interest passed as a beneficiary in a deceased estate or the trustee of a deceased estate.[2] The trustee need not be an individual and could, for example, be a trustee company. If there were any doubt at all about this, it is answered by the terms of the relevant corresponding former provisions of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) which had separate provisions for each situation.[3]

Dwelling

In somewhat broad terms, a "dwelling" for the purposes of the CGT main residence exemption includes a unit of accommodation that is a building or is contained in a building and consists wholly or mainly of residential accommodation (s 118-115 ITAA97). Provision is made for the inclusion of adjacent land (subject to a maximum area limitation) and, in the case of a flat or home unit, an adjacent garage, storeroom or other structure (s 118-120 ITAA97).

Ownership interest

A fundamental concept in the provisions quoted above is that of an ownership interest in land or a dwelling.

In the case of land or a dwelling that is not a flat or home unit, an ownership interest is a legal or equitable interest in the land or the land on which the dwelling is erected, or a licence or right to occupy it (s 118-130(1) ITAA97). In the case of a flat or home unit, an ownership interest is a legal or equitable interest in a stratum unit in it, a licence or right to occupy it, or a share in a company that owns a legal or equitable interest in the land on which the flat or home unit is erected and that gives a right to occupy it.

Acquisition and ending of ownership interests

It will be seen from the provisions quoted above that the way the two-year rules operate depends on whether the particular ownership interest of the deceased in the dwelling was acquired pre-CGT (that is, before 20 September 1985) or post-CGT (that is, on or after 20 September 1985). In all cases, the particular ownership interest of the deceased must end within two years of the deceased's death (or within a longer period allowed by the Commissioner).

The determination of the time of acquisition of an ownership interest in land or a dwelling by the deceased is not governed by the normal CGT time of acquisition of asset rules but by special rules.

Under these rules, where, for example, the particular ownership interest was acquired under a contract, the date of obtaining legal ownership would be when the ownership interest of the purchaser would commence (s 118-130(2) ITAA97). Conversely, where a dwelling is disposed of under a contract, the vendor would have an ownership interest in it until the vendor's legal ownership of it ends (s 118-130(3) ITAA97). The time when legal ownership would be obtained or would end would typically be when the relevant contract was completed.

As pointed out below, a deceased individual may, at the time of their death, have more than one ownership interest in a dwelling. In that event, the special two-year rules operate in relation to each ownership interest separately.

The relevant situations

What are relevant for the purposes of this article are item 1 of column 3 and items 1 and 2 of column 2 of the table in s 118-195(1) ITAA97. The operation of item 2 of column 3 is not considered in this article.

The following examples illustrates the way the provisions apply.

Example 1

Brian acquired a dwelling in February 1984 (dwelling 1) and another dwelling in July 2012 (dwelling 2). Brian died in August 2021 and both dwellings were still owned by him. At all relevant times, dwelling 1 has been an investment property and, so, let to tenants, and dwelling 2 has been Brian's main residence.

This means that dwelling 1 would potentially fall within item 2 of column 2, and dwelling 1 would potentially fall within item 1 of column 2.

Example 2

Assume the same facts as in example 1 save that the order in which the dwellings were acquired were to be reversed, so that dwelling 2 was acquired in February 1984 and was Brian's main residence at the time of his death, and that dwelling 1 was acquired in July 2012 and was rented out at the time of his death.

This would mean that dwelling 1 would not fall within either item 1 or item 2 of column 2, and dwelling 2 would potentially fall within item 1 of column 2.

It should be noted that, as explained below, for the one dwelling both item 1 and item 2 of column 2 can apply in relation to item 1 of column 3.

Where the deceased's ownership interest was acquired *post-CGT*, there are two requirements that must be met for item 1 of column 2 to be satisfied.

The first of those requirements is that the dwelling was the deceased's main residence just before their death. This requirement could be satisfied where the making of a choice has the effect that the dwelling is treated as being the deceased's main residence at the relevant time. This could, for example, be the case where the circumstances are such that the absence choice (under s 118-145 ITAA97) can be and is made in respect to a period ending at the time of the deceased's death.

The second requirement is that the dwelling must not have been used for the purposes of producing assessable income just before the deceased's death. It would seem that the issue would not be overcome if, say, the absence choice were made. This is because the absence choice has the effect of treating a dwelling as being (contrary to fact) the main residence of the person making the choice but does not have any effect on the fact that the dwelling may have been used for income-producing purposes. The way this exclusion is worded means, it is submitted, that it would be immaterial who is using the dwelling for the purposes of producing assessable income just before the deceased's death.

Example 3

Tim and his spouse Sarah acquired a dwelling in November 1982 which they thereafter used as their main residence. Tim also had at all times used two rooms of the dwelling to carry on a home-based business. Sarah died on 15 September 2019 and her interest in the dwelling passed to Tim under her will. Tim sells the dwelling under a contract that is completed in August 2021. It would seem that, for the purposes of applying item 1 of column 2, while it could be said that the dwelling was Sarah's main residence just before her death, it could not be said that the dwelling was not then being used for the purposes of producing assessable income. The words of the item do not, in their terms, require that the use for the purposes of producing assessable income be use by the deceased (that is, Sarah in the example).

The Commissioner's view on this issue is not known.

All ownership interests in dwellings acquired by the deceased pre-CGT can potentially qualify for the exemption afforded by item 2 of column 2 in conjunction with item 1 of column 3.

More than one ownership interest in a dwelling

On the view taken by the Commissioner in TD 2000/31, it would seem that a deceased individual may, at the time of their death, have more than one ownership interest in particular land or in a particular dwelling for the purposes of applying the CGT main residence provisions.

Example 4

Keith and his spouse Mabel acquired a dwelling as joint tenants in September 1984. Keith and Mabel used this dwelling as their main residence. Keith died on 16 May 2015 and Mabel acquired his interest in the dwelling by survivorship, with the consequence that the operation of s 118-197 ITAA97 (see above) would be attracted. Mabel died on 10 December 2020 and, under her will, the dwelling was left to her executor to sell and to distribute the net proceeds equally between her three children.

Example 4 (cont)

At the time of her death, Mabel would have two ownership interests in the dwelling, namely:

- a pre-CGT ownership interest, being the interest she acquired in September 1984 — item 2 in column 2 would be relevant to this interest; and
- a post-CGT ownership interest, being the interest of Keith that she acquired on his death in December 2020 — item 1 in column 2 would be relevant to this interest.

Example 5

Assume the same facts as in example 4 and that Mabel's estate also included another dwelling (dwelling 2) which she and Keith had acquired as joint tenants in March 1985 and that at all times this dwelling has been rented out.

At the time of her death, Mabel would have two ownership interests in dwelling 2, namely:

- a pre-CGT ownership interest, being the interest she acquired in March 1985 — item 2 in column 2 would be relevant to this interest; and
- a post-CGT ownership interest, being the interest of Keith that she acquired on his death — neither item 1 nor item 2 in column 2 would be relevant to this interest.

Commissioner's discretion to extend two-year period

As mentioned above, the Commissioner has a discretion to extend the period within which an ownership interest must end for the two-year CGT deceased estate main residence rules to apply (see item 1 of column 3 of the table in s 118-195(1) ITAA97). The discretion is conferred on the Commissioner in unconfined terms; there is no indication given as to the matters that should be taken into account by the Commissioner when considering the exercise of the discretion.

A taxpayer seeking an exercise by the Commissioner of the discretion to allow a longer period could seek a private binding ruling from the Commissioner. The edited private advice published on the ATO legal database contains a considerable number of edited private advices dealing with the exercise of the discretion.

If the Commissioner were to decline to exercise the discretion favourably in a particular case, then, on a review of the Commissioner's decision, the AAT would be able to itself exercise of the discretion on the merits of the case.

PCG 2019/5

As also earlier noted, the Commissioner has issued PCG 2019/5 which addresses issues relating to the exercise by him of the discretion to extend the two-year period.[4]

The main points made in PCG 2019/5 are:

- generally, the Commissioner will allow a longer period where the dwelling could not be sold and settled within two years of the deceased's death due to reasons beyond the control of the executor or beneficiary that existed for a significant portion of the first two years;

- the provision of a safe harbour compliance approach that allows the executor or beneficiary to manage their tax affairs as if the Commissioner had exercised the discretion to allow a longer period; and
- an outline of the factors that the Commissioner will consider when deciding whether to exercise the discretion to extend the two-year period.

Safe harbour compliance approach

If the safe harbour conditions listed below are met, the executor or beneficiary can manage their tax affairs as if the Commissioner had allowed a period that is longer than two years.

If it is decided to rely on the safe harbour and there is a subsequent ATO compliance check, the ATO will seek to ensure that the relevant conditions are satisfied, including checking that the additional period is no longer than 18 months. The ATO will not seek to determine whether or not the Commissioner would have actually exercised the discretion. It is important to maintain all records necessary to support a claim for eligibility for the safe harbour.

Safe harbour conditions

To qualify for the safe harbour, *all* of the following 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 circumstances listed below under the heading "Circumstances that took more than 12 months to resolve";
- 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;
- if any of the circumstances described below under the heading "Circumstances that cannot be material to delays in disposal" were applicable, they were immaterial to the delay in disposing of the interest; and
- the longer period for which the exercise of the discretion is needed is no more than 18 months.

Circumstances that took more than 12 months to resolve

The circumstances referred to in the first dash point above are:

- 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 of the control of the executor or beneficiary.

Circumstances that cannot be material to delays in disposal

To qualify for the safe harbour, none of the following circumstances can have been material to the delay in disposing of the interest:

- waiting for the property market to pick up before selling the dwelling;
- delay due to refurbishment of the dwelling to improve the sale price;
- inconvenience on the part of the trustee or beneficiary to organise the sale of the dwelling; or
- unexplained periods of inactivity by the executor in attending to the administration of the estate.

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

When considering whether to extend the two-year period, the Commissioner weighs up all of the factors (both favourable and adverse) having regard to the facts and circumstances of the case.

Factors that would weigh in favour of the Commissioner allowing a longer period include those listed above under "Circumstances that took more than 12 months to resolve".

Factors that would weigh against the Commissioner allowing a longer period include those listed above under the heading "Circumstances that cannot be material to delays in disposal".

PCG 2019/5 also lists other factors that may be relevant to the exercise of the Commissioner's discretion but are not relevant for the safe harbour, including the degree of difficulty in locating all beneficiaries required to prove the will and any period the dwelling was used to produce assessable income.

PCG 2019/5 provides a number of examples of its intended operation.

Partial exemption

It should be noted that, where the circumstances are such that a full CGT exemption is not provided for by s 118-195 ITAA97, a partial exemption may be available to the trustee or a beneficiary of the deceased estate (s 118-200 ITAA97).

Capital loss

As is the case with the CGT main residence rules generally, if a capital loss is made in circumstances such that a capital gain would have been disregarded under the two-year CGT deceased estate main residence rules, the capital loss is disregarded. Accordingly, if a capital loss would be made as a result of the operation of the two-year rules, it may be the better course to ensure that the rules do not apply so that the capital loss will be able to be potentially utilised.

TaxCounsel Pty Ltd

References

1 There are other provisions that are relevant where the deceased was an excluded foreign resident. The position where the deceased was an excluded foreign resident is not considered in this article.

2 The circumstances in which a CGT asset will pass to a beneficiary of a deceased estate are defined in s 128-20 ITAA97.

3 See former s 160ZZQ(14) and (15) ITAA36. The explanatory memorandum to the amending Bill that proposed the enactment of what is now s 118-195 ITAA97 does not indicate that there was any intended change so that s 1-3 ITAA97 supports the view that no change has been made.

4 PCG 2019/5 is only concerned with CGT event A1.

Mid Market Focus

by Andrew Burns, CTA, HLB Mann Judd

Environmental protection activities

TR 2020/2 provides guidance on when expenditure incurred in the course of environmental protection activities is deductible, and raises a number of practical issues.

TR 2020/2

In July 2020, the ATO issued TR 2020/2, explaining some of the key requirements for the immediate deduction of environmental protection expenditure under s 40-755 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).

Section 40-755 provides for an immediate deduction for expenditure incurred for the sole or dominant purpose of carrying out environmental protection activities. These activities are defined as preventing, fighting or remedying pollution, and treating, cleaning up, removing and storing waste in relation to the following:

- the taxpayer's earning activities;
- the site of the taxpayer's earning activities; or
- a site where another entity carried on a business which the taxpayer has acquired and carries on substantially unchanged.

In a note to s 40-755(4), it is made clear that, if a taxpayer's income earning activities consist of passively leasing land (or similar), they can still claim a deduction for environmental protection activities that they incur in relation to the site, even if the pollution or waste was caused by another entity which used the site.

TR 2020/2 provides definitions of terms such as "pollution", "preventing, fighting or remedying pollution", "waste", and "treating, cleaning up, removing or storing waste". The ruling also considers when the expenditure will be carried out for the "sole or dominant purpose" of environmental protection activities.

While the examples in TR 2020/2 provide guidance on the application of s 40-755, there are a number of additional practical considerations to be kept in mind.

Pollution and waste

The terms "pollution" and "waste" are not defined in s 40-755, and therefore take their ordinary meanings.

TR 2020/2 contains the following definition of "pollution":

> "Pollution is contamination by the direct or indirect introduction of substances (physical or gaseous), noise (for example, vibrations) or energy (for example, radiation) which has harmful or poisonous effects on the environment."

Compared to this relatively limited definition, "waste" is defined quite broadly to include:

> "… anything left over or superfluous, such as excess material and by-products, which is not of use for the work at hand."

There is no requirement that the items included within this definition be harmful to the environment.

This broad definition of "waste" allows virtually anything to be classified as waste, and to be potentially eligible for a deduction under s 40-755. However, it must still meet the other requirements set out in the legislation, and in the ruling. For example, it is arguable that the removal of stumps and offcuts left over from the harvesting of timber falls within the definition of waste removal. Therefore, any expenditure that is incurred in this activity will be deductible under s 40-755, provided that all of the other requirements for the deduction have been satisfied.

Connection with earning activity

As stated above, in order for expenditure on environmental protection activities to be deductible under s 40-755, these activities must be related to the taxpayer's earning activity, to the site of their earning activity, or to the site of a business which they have acquired and intend to carry on in much the same form as before.

TR 2020/2 defines the taxpayer's "earning activities" to include an activity that is currently being carried on, one which used to be carried on, or one which is proposed to be carried on for the purpose of producing assessable income, exploration or prospecting, or mining site rehabilitation.

In order to obtain a deduction for environmental protection expenditure incurred in relation to an activity which is intended to be carried on, the taxpayer merely has to have the intention to carry on the earning activity at the time that the expenditure is incurred. This allows expenditure which would ordinarily be classified as being incurred "too soon" to be deductible.

While TR 2020/2 does not include a specific example of environmental protection expenditure incurred prior to the commencement of an income earning activity, PBR 4120039511517 (issued in February 2018) allows the taxpayer to claim a deduction for costs associated with the removal of asbestos discovered when doing landscaping work to their former main residence in preparation for its future use as a rental property.

Even though the taxpayer had previously used the property for private purposes, the fact that they had the intention to use the property to earn assessable income at the time that the asbestos was removed is sufficient to satisfy the requirements of s 40-755.

At the opposite end of the spectrum, a deduction under s 40-755 will also be available for environmental protection expenditure incurred after the earning activities have ceased.

The most common example of this type of expenditure would be in relation to the removal of pollutants and waste from land in preparation for its sale.

Sole or dominant purpose

For an amount to be deductible under s 40-755, expenditure must be incurred for the sole or dominant purpose of carrying on the environmental protection activity.

TR 2020/2 provides guidance on when expenditure will be considered to have been incurred for the sole or dominant purpose of carrying on environmental protection activities. This guidance includes the explanation that, where an activity achieves another outcome (other than the protection of the environment), the sole or dominant purpose test can still be satisfied despite the other benefits.

In example 3 to TR 2020/2, the visual improvement to the backyard of a rental property resulting from the removal of a dilapidated shed clad in damaged asbestos sheeting is considered to be merely incidental to the dominant purpose of removing the asbestos pollution threatening the health of the tenants.

Similarly, example 5 to TR 2020/2 concludes that the planting of vegetation along the side of a creek running through a commercial investment property in order to prevent sediment from erosion being washed into the nearby river, had the dominant purpose of protecting the fish and native vegetation in the river from the harmful sediment. This is despite the additional benefit of the newly planted vegetation beautifying the site.

Where the expenditure relates to multiple activities but can be reasonably be apportioned between these activities, TR 2020/2 provides that the portion of the expenditure which relates to activities which satisfy the sole or dominant purpose of environmental protection will be deductible under s 40-755, despite the other activities having other dominant purposes.

Where the expenditure cannot be apportioned between activities, it is necessary to consider the dominant purpose of the overall expenditure.

In example 6 to TR 2020/2, Sarah purchased a property to be used in her childcare centre business, and paid a contractor a single lump sum to convert an existing car park into a playground. Even though this work included the cleaning up and removal of oil by-products that had been stored on the site, Sarah could not claim a deduction for environmental protection activities as the dominant purpose of incurring the expenditure was the building of the playground.

TR 2020/2 does not expand on this example. However, it would be reasonable to conclude that, had Sarah asked the contractor to itemise the removal of the waste oil in their invoice, rather than simply paying an undivided lump sum, she would have been able to claim a deduction for that portion of the expenditure.

Limits to s 40-755

Section 40-760 ITAA97 sets out a number of types of expenditure which cannot be deducted under s 40-755. These include:

- expenditure for acquiring land;
- capital expenditure for constructing a building, structure or structural improvement;
- capital expenditure for constructing an extension, alteration or improvement to a building, structure or structural improvement;
- a bond or security for performing environmental protection activities; and
- expenditure to the extent that it can be deducted under another provision of the ITAA97.

As with expenditure related to multiple activities, it may be possible to apportion the total expenditure between an amount which is excluded from s 40-755 by s 40-760, and amounts which are not excluded.

TR 2020/2 provides several examples where the deduction for environmental protection expenditure is limited by s 40-760.

Example 7 provides that the owner and operator of a petrol station can claim a deduction under s 40-755 for the removal of a leaking fuel tank, its concrete covering, and the clearing of contaminated soil. However, s 40-760 will apply to deny a deduction under s 40-755 for the installation of a replacement fuel tank as the new tank will be considered to be a structure or structural improvement.

Examples 8 and 9 both consider the removal and replacement of asbestos material, with different results depending on whether the replacement material is considered to be an improvement.

Example 8 involves the removal of a roof containing asbestos material, and its replacement with a superior product. The expenditure related to the removal of the roof and the safe disposal of the asbestos will be deductible under s 40-755. However, as the replacement roof is superior to the old one, it will be considered an improvement and therefore excluded by s 40-760.

Example 9 involves the removal of asbestos sheeting from the walls of a residential rental property, and replacement with a safe material of similar condition and quality. As the replacement materials are of similar quality to the old sheeting, there will be no improvement to the structure. Therefore, s 40-760 will not apply to limit the deduction available under s 40-755.

Section 40-760 only applies to deny a deduction for expenditure under s 40-755. It does not limit deductions which may be claimed under other provisions of either the ITAA97, or the *Income Tax Assessment Act 1936* (Cth). For example, the replacement roof which was not deductible as an environmental protection activity due to the application of s 40-760 may still be deductible over time under Div 43 ITAA97.

Similarly, the replacement fuel tank in example 7 to TR 2020/2 may be a depreciable asset that is deductible under Subdiv 40-B ITAA97. Depending on when the expenditure was incurred, it may be eligible for the temporary full expensing for depreciable assets under Subdiv 40-BB of the *Income Tax (Transitional Provisions) Act 1997* (Cth). Alternatively, the small business depreciation rules contained in Subdiv 328-D ITAA97 may apply.

Conclusion

Through the careful consideration of the provisions relating to environmental protection activities contained in s 40-755, it may be possible to claim a tax deduction for expenditure which would otherwise be considered to be capital in nature, producing a much different tax outcome.

Andrew Burns, CTA
Manager
HLB Mann Judd

Higher Education

Becoming a well-rounded tax lawyer

The dux of CTA2A Advanced in Study Period 1 2021 explains how the CTA Program has enabled him to efficiently identify tax issues for clients.

DJ Alexander, Lawyer, MinterEllison, Queensland

How did you begin your career in tax?

My career in tax is just beginning. In 2019, I completed a Bachelor of Laws and Commerce. I was able to incorporate five tax subjects into my degree and work as a research clerk in the tax team at MinterEllison during my studies.

I recently completed my graduate rotations at MinterEllison (in the tax, workplace and dispute resolution teams) and have settled back into the tax team.

Why did you choose a career in tax law?

Numbers have always come naturally to me, so tax law was an obvious choice when deciding on an area of law to practice. I have quickly become a "tax nerd" and, as a result, my new favourite books are the three volumes of the tax Acts — fantastic bedtime reading!

What was the reason for undertaking CTA2A Advanced?

I undertook CTA2A Advanced as one of the four required subjects of the Chartered Tax Adviser (CTA) Program. After completing my practical legal training and being admitted as a lawyer, I started the CTA Program to set myself up to become a well-rounded tax lawyer.

What skill or knowledge areas have you gained by undertaking this subject?

I now have a greater understanding of a broad range of tax topics and can more efficiently identify important tax issues for my clients.

How did you juggle study, work and other commitments and perform so well?

My approach to CTA2A Advanced was to study consistently. I usually studied for 1 to 2 hours before and after work each day, and more on the weekends. This strict schedule ensured I was able to manage my study and work commitments effectively. However, it resulted in significantly fewer hours of sleep. So the break after the final exam came as a welcome reprieve!

Where to now for you when it comes to continuing tax education?

I will complete the CTA Program in February next year. From there, I may complete a Master of Taxation degree and the individual subjects offered by The Tax Institute (such as Corporate Tax).

What advice do you have for other tax professionals considering the CTA Program?

I strongly encourage other junior tax professionals to complete the CTA Program as it will expose them to a wide variety of tax issues that consistently arise in practice.

Taxation of SMEs

by The Tax Institute

In this article, the first *Case for Change* chapter on small to medium-sized enterprises (SMEs) is reproduced. In it, we explore how the taxation of SMEs could be redesigned to liberate the flow of capital, reduce compliance costs, and reduce complexity while maintaining integrity in the system. The taxation of SMEs is unnecessarily complex, and the design of the law produces anomalous outcomes depending on the choice of business structure. In addition, existing structure options come with their own issues: multiple tax rates for corporates, the complexities and dangers with business income flowing through trusts. Is there a better way? For example, is it possible to tax all business income at the same rate? How should this interact with the personal tax system? And what about investment income taxation? There are no easy answers but various options are considered.

Role of SMEs in the Australian economy

According to a report by the ASBFEO, *Small business counts — December 2020*,[1] small businesses:

- account for between 97.4% and 98.4% of all businesses, depending on whether 'small business' is defined based on the number of employees or turnover;
- contributed almost $418b to GDP in 2018-19, equivalent to over 32% of Australia's total economy;
- employ over 4.7 million people and 41% of the business workforce;
- employed, as at December 2019, 165,197 apprentices and trainees, which represents 61% of Australia's apprentices and trainees; and
- accounted for 22% of total tax revenue from companies in 2017-18, according to ATO data.

Around two-thirds of The Tax Institute members represent or act for small to medium-sized enterprises (SMEs).

In acknowledging the importance of small businesses to the Australian economy and society, for many decades, governments have enacted various tax policies which have sought to balance revenue with the particular needs of small businesses.

Summary of key issues: taxation of SMEs

This chapter of the *Case for Change* paper considers how the taxation of SMEs could be redesigned to:

- liberate the flow of capital;
- reduce compliance costs; and
- reduce complexity while maintaining integrity in the system.

The taxation of SMEs is unnecessarily complex, and the design of the law produces anomalous outcomes depending on the choice of business structure.

The key issues examined in this chapter are:

- taxation of entities: whether business income should be taxed the same, irrespective of the legal structure;
- taxation on a flow-through basis: whether income should be taxed at the shareholder or beneficiary level (akin to partnerships);
- corporate tax rate and imputation regime: appropriateness of current settings;
- trusts: overdue reform of Div 6 of Pt III of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) and associated provisions; and
- reform of Div 7A of Pt III ITAA36 and its interaction with Div 6.

Issues

Base rate entity rules

While many SMEs currently benefit from a lower tax rate under the base rate entity rules, various challenges and anomalous outcomes arise due to the design of those rules. Anomalies arise where the aggregated turnover is less than $50m and there is no significant passive income, for example:

- business income derived by a company that is distributed to another company via a trust is taxed at the higher rate (assuming there is no other income), but income distributed directly to another company is taxed at the lower rate;
- a company carrying on a business of plant or equipment hire is taxed at the higher rate, yet a dormant company must frank its distributions at the lower rate; and
- a company that derives both business income and rent suffers a massive decline in its business revenue due to the COVID-19 pandemic may extraordinarily find itself being taxed at the higher rate as a result.

Unnecessary complexity exists due to the potential misalignment of a company's tax rate and its maximum franking rate, resulting in top-up tax or trapped franking credits where dividends flow between companies that are base rate entities and those that are not. The misalignment is compounded by companies being required to use current year figures to determine their tax rate but prior year figures to determine their franking rate. Further complexities arise where distributions flow through trusts. These issues are discussed further below.

Potential variation in franking rate from year to year

Just as a corporate tax entity's (CTE's) tax rate can vary from year to year depending on the amount of the entity's aggregated turnover and proportion of base rate entity passive income (BREPI) to the entity's assessable income, its franking rate is also dependent on aggregated turnover and BREPI but in respect of the previous income year.

While the rules determining an entity's maximum franking rate were purposely designed to overcome the difficulty that an entity does not determine its aggregated turnover and BREPI for an income year until after the end of that income year, the practical effect of the franking rules is that:

- the two-tier system is complex;
- the complex base rate entity rules mean an entity's maximum franking rate can vary from its corporate tax rate and from year to year; and
- SME corporate taxpayers suffer increased compliance costs, are subject to anomalies, and there is an increased risk of errors in calculating the entity's corporate tax rate and maximum franking rate.

Imputation system

Further issues with the imputation system exist beyond those associated with the base rate entity rules discussed above, including as follows.

Integrity and administrative measures

There is a range of complex integrity measures, including:

- anti-streaming rules;
- anti-avoidance rules: franking credit schemes;
- benchmark franking rules, franking account return, franking deficit tax;
- debt/equity rules;
- 'exempting entity' and 'former exempting entity' rules;
- holding period and related payment rules; and
- share capital tainting rules.

The complexity of these rules results in increased compliance costs, anomalies and errors. This is exacerbated by the fact that many of these integrity rules have been repealed and are only included by inference in the current law. Further, those rules were drafted in the mid-1990s and reflect the thinking of the financial markets at the time. Much has changed in the financial markets since then and, in addition to being complex, these provisions have been shown to be dated.

Loss of concessionary treatment of tax-advantaged income

The nature of the imputation system is such that there is a loss of concessionary treatment on distribution of tax-advantaged income by a CTE to shareholders. This includes the R&D tax incentive, offshore income, non-assessable non-exempt income, capital gains sheltered by the 50% small business reduction in Subdiv 152-C of the *Income Tax Assessment Act 1997* (Cth) (ITAA97), and the recent cash flow boost.

Such amounts are assessable to shareholders as dividends, which negates the concessionary treatment afforded to the company, turning what should have been a benefit into a timing difference.

Interaction with settings in the superannuation system

During the 2019 federal election campaign, a policy proposal was aired to deny refundable excess franking credits, other than for those entities that would fall within a narrow set of exclusions (eg pensioner guarantee).

There was little evidence that the concerns emanated from the availability of refundable excess franking credits for low income earners. Rather, the concerns related to high-balance SMSFs in pension phase that benefit from large refunds of excess franking credits due to the tax-free income derived from assets set aside to pay a superannuation income stream and the generally lower tax rate that applies to superannuation funds.

The interaction of the proposal with the policy of tax-free earnings while a fund is in pension phase and the operation of the transfer balance cap (TBC) is highly complex. Ironically, the operation of the proposed measure would have disproportionately affected smaller SMSFs more so than SMSFs (and other funds) with substantially larger member balances in excess of the TBC. This was because the tax liabilities arising from having to hold significant assets in accumulation phase (subject to tax) meant larger balance funds would be able to avail themselves of a greater proportion of the refundable franking credits than smaller balance funds which stood to lose access to up to 100% of their refundable franking credits.[2] It is perhaps an example of policy design needing to be fully aired and discussed to ensure it has the desired impact, rather than having the opposite effect to that intended.

Before a conclusion is drawn that the deficiency lies in the design of the imputation rules, consideration could be given to the appropriateness of the superannuation settings and their interaction with the imputation system.

The introduction of the $1.6m general TBC from 1 July 2017 partially mitigated the availability of full refunds of excess franking credits, as income from fund balances above $1.6m are now subject to a form of taxation, albeit at a rate lower than the corporate tax rate.[3]

Entity taxation

Currently, the manner in which an entity's business income is taxed depends on:

- the legal form of the entity through which the income is derived;
- whether the income is business or 'active income' versus passive income; and
- whether the income has a revenue or capital character.

Net business income that is derived by a:

- CTE[4] is taxed at the entity's corporate tax rate (currently either 30% or 25% (from 1 July 2021));
- trust is taxed to the beneficiary — to the extent that the beneficiary is presently entitled to a share of the income of the trust estate, and based on the 'proportionate approach'.[5] Otherwise the taxable income is assessable to the trustee at the top marginal tax rate plus Medicare levy;
- partnership is included in the assessable income of each of the partners and taxed at the rate applicable to each partner; or
- sole trader is assessable to the individual and subject to marginal tax rates.

This creates uneven tax outcomes depending on the type of entity and provides an incentive for businesses to be carried on by companies to benefit from the lower tax rate.[6] This results in increased exposure to Div 7A and the personal services income rules. Attempts have been made over the years, including the entity taxation model released on 12 October 2000 which proposed to tax non-fixed trusts as companies from 1 July 2001,[7] but none have successfully removed the inconsistency in the tax treatment of business income across entity types.

Many problems are caused by the divergence of the top marginal tax rate plus Medicare levy which applies under s 99A ITAA36, where income is retained by the trustee of a trust or is distributed to beneficiaries whose taxable incomes exceed $180,000. This has led to the incorporation of thousands of corporate beneficiaries to ensure trust income is taxed at no more than the corporate rate.

Taxation of trusts

The wide use of trusts for investment and business purposes is an Australian anomaly. The use of discretionary trusts and unit trusts is particularly prevalent in the SME sector. The laws affecting trusts are confusing and lack clarity, particularly given the unavoidable interaction of trust law with tax law. Each trust is governed by its own particular trust deed and the relevant state Trustee Act.

This distinguishes Australia from other jurisdictions. Business is looking for a simple and flexible structure with limited liability. Partnerships were used extensively for decades before the uptake of trusts from the 1960s to the 1970s; however, partnerships were unable to provide limited liability. Limited partnerships have been used extensively as look-through investment vehicles in other jurisdictions, and look-through or disregarded companies (S-corps in the US) have been adopted elsewhere. We had the window but missed the opportunity to offer a simple protected structure to taxpayers. We could repeal Div 5A of Pt III ITAA36 and allow limited partnerships to be taxed like ordinary partnerships. This would be attractive to many SMEs.

Copious articles have been written over the decades by the best minds in the judiciary and legal/accounting profession who have identified, dissected and debated the problems inherent in Div 6.[8] Attempts to reform Div 6 have been largely unsuccessful, notably in 2010 following the High Court's decision in *FCT v Bamford*[9] which finally provided some certainty in relation to some long-debated but relatively narrow issues regarding the taxation of trusts.[10]

There was a flurry of activity following the *Bamford* decision, including a consultation paper[11] in 2011 and a policy options paper in 2012 which set out proposed reforms to the taxation of trust income.[12] However, only some limited trust streaming provisions relating to capital gains and franked distributions emerged from the extensive and earnest efforts to reform Div 6.

Section 100A ITAA36, which deals with reimbursement agreements, has been in the law since 1981 and treats a beneficiary as not being presently entitled where the present entitlement arose out of a reimbursement agreement. The exclusion in s 100A(13) for 'an agreement, arrangement or understanding entered into in the course of ordinary family or commercial dealing' has been calling out for judicial clarification for decades.

In the meantime, the profession sought interpretive guidance from the ATO, which was first provided in the form of a non-binding document titled *Trust taxation — reimbursement agreement* on 2 July 2014.[13] Since then, the profession has continued to seek binding guidance from the ATO. The ATO's Advice under development program[14] advises that a draft ruling will set out the Commissioner's preliminary views on the exclusions from a 'reimbursement agreement' for agreements:

- not entered into with a purpose of eliminating or reducing someone's income tax; and
- entered into in the course of ordinary family or commercial dealings.

The expected completion is yet to be advised but targeted consultation on this issue has commenced.

A number of issues regarding the taxation of trusts remain, including the following.

- two significant draft ATO rulings relevant to the taxation of trusts remain unfinalised after many years (TR 2004/D25[15] and TR 2012/D1[16]);
- the rule against perpetuities in all states/territories other than South Australia, which commonly limits the effective life of a trust under trust law to 80 years.[17] Large numbers of trusts are expected to vest over the next few decades which will result in significant tax liabilities, including CGT liabilities, assessable balancing adjustments under Div 40 ITAA97, and stamp duty liabilities;
- recent court decisions have highlighted issues with the interaction of the CGT discount and international matters, including the treatment of foreign beneficiaries of Australian non-fixed trusts with non-taxable Australian real property CGT assets[18] and foreign income tax offsets.[19] This is also addressed further in chapter 2 – Large business and international;[20]
- there are multiple reporting and loss recoupment regimes which were each designed to target a perceived mischief, but which are complex in their operation and interaction and are, in many cases, poorly understood and applied. These are set out below; and
- broader, non-tax specific problems include:
  - a lack of codification of trust law and a wide range of trust deeds; and
  - a lack of transparency due to the absence of an external regulator and a central register (there is no equivalent to the Australian Securities and Investments Commission for trusts).

More than 30 separate sets of rules affect trusts (many of which themselves contain dozens more rules). Any examination of that extensive list shows that the interplay and application of the legislative provisions affecting trusts is unworkable, and almost impossible to fully comply with.

An obvious area of reform is the sets of provisions applying to closely held trusts. There is both an overlap of and mutual exclusivity between:

- the trustee beneficiary reporting rules in Div 6D of Pt III ITAA36;

- the TFN reporting rules for closely held trusts in ss 12-175 and 12-180 of Sch 1 to the *Taxation Administration Act 1953* (Cth) (TAA53); and
- the trust loss provisions in Sch 2F ITAA36, which includes the rules governing family trust elections, interposed entity elections and family trust distribution tax.

> *"Business wants a simple, flexible, flow-through structure with limited liability … Limited partnerships have been used extensively elsewhere … We could repeal Div 5A."*

Options

Corporate tax rate and imputation system

Throughout The Tax Institute's The Tax Summit: Project Reform event series, there was widespread:

- criticism of the current two-tiered corporate tax rate system which leads to complexity and anomalous outcomes; and
- support for reducing the corporate tax rate to 25% and aligning the corporate tax rate and the franking rate for all CTEs, regardless of size, activity or income type (see further discussion below).

Alternative arrangements could include:

- the abolition of imputation (completely or partially), associated with:
  - lowering the corporate tax rate for all CTEs to 15%; and
  - introducing a partial exemption from income tax for dividend income;
- denying refundable excess franking credits only for superannuation funds where the members' TBCs exceed $1.6m;[21]
- adopting international arrangements such as those existing in the US and UK tax systems which generally exempt company-to-company dividends (as did Australia prior to 1987); or
- adopting a potential flow-through design, whereby tax is imposed at the shareholder level not on the CTE. A single-rate withholding tax system could be introduced which would result in fewer distortions with respect to offshore income.

It was uniformly agreed that the collection and administration of tax should be reformed by simplifying the franking administrative rules.

Entity taxation

Throughout The Tax Institute's The Tax Summit: Project Reform event series, there was also widespread support for a significant reform which would tax business income at a lower rate than non-business or passive income.

The entity taxation model released on 12 October 2000 which proposed to tax non-fixed trusts as companies from 1 July 2001 faced opposition and had a number of drawbacks including that, if implemented, the imputation system and Div 7A would apply to trusts.[22]

In addressing the perennial discussion of whether trusts should be taxed like companies, and the inconsistency in the tax treatment of business income across entity types, the reforms discussed below could be considered.

Single business tax rate

Business or 'active' income could be taxed at a single business tax rate, such as 25%. The key features of this reform are as follows:

- passive or non-business income could be subject to a different tax rate;
- the lower business rate would apply to capital gains from active assets and other statutory income from business, as well as ordinary income derived in the ordinary course of carrying on a business;
- applying a lower rate for business/active income would, in many cases, eliminate a primary reason for establishing corporate beneficiaries;
- no CGT discount would be available on the business profits or gains as access to the lower tax rate would counter the loss of the 50% CGT discount for trusts and partnerships; and
- the business tax rate would be 'agnostic' across entity types, that is, there would be no differentiation in the tax treatment of business/active income derived by a company, a trustee of a trust, a partnership or a sole trader.

Alternative arrangements could include the following:

- taxing companies, trusts and partnerships on a flow-through basis, akin to the treatment of corporate limited partnerships in the US, rather than taxing the income at the entity level;
- basing joint tax returns on the family unit — this, combined with the business tax rate for all business operators regardless of entity type (including sole traders), would overcome personal services income issues, income splitting arrangements via trusts, and artificial arrangements in partnerships. This would be limited to business income, so limits should still apply to splitting personal exertion income; and
- subjecting the business income of sole traders (eg gig economy) to tax at no more than 25%, in cases where their marginal tax rate is higher. This would ensure that the business income of sole traders is taxed at the same business tax rate that would apply to other types of entities, such as companies and trusts. While this would allow sole traders to have their business income taxed at a rate that is less than salary or wage income earned by employees, the lower rate would:
  - acknowledge that they carry more risk than employees;
  - reward entrepreneurial activity; and
  - remove income-splitting incentives to divert sole trader income to other entities.

The lower business tax rate could apply to funds left in a business bank account and not withdrawn or applied for private use. This would address concerns about ensuring that the lower tax rate would not be applied to all of the individual's taxable income (eg passive or employment income). It is also acknowledged that there are difficulties when dealing with fungible assets such as bank accounts, as well as practical implementation issues.

Derivation of passive income by business entities

To ensure that the lower business tax rate applies only to business or active income and not passive income, a BREPI-style test could apply so that the entity is taxed at a higher rate if more than 80% of its assessable income is passive in nature. Alternatively, the higher tax rate could apply only to the passive income, with the lower business tax rate applying to the business income, but this approach comes with the drawback that more than one tax rate could apply to a single entity, which increases the complexity.

In determining what constitutes business or active income versus passive income, sensible and workable definitions of passive income — particularly around the meaning of non-portfolio dividends and royalties — should apply. This would have the benefit of addressing the existing anomalous outcomes under the BREPI rules. Alternatively, the meaning of 'active income' in the controlled foreign company (CFC) rules could be adopted more widely, though most SME practitioners are not familiar with the operation of the CFC rules so this approach could be more complex for taxpayers.

Treatment of funds

Cash retained by the business entity is typically used to fund the working capital and acquisition of income-producing assets. This includes funds retained by the trustee of a trust, which is currently subject to the highest marginal tax rate plus Medicare levy, or funds which are retained or lent back to the trustee of a trust by a company, notwithstanding the distribution of the underlying profits to a corporate beneficiary.[23]

All funds retained and applied for a taxable purpose by a business entity should be taxed at the lower business tax rate. This includes funds retained by the trustee of a trust. This could be achieved by either amending the applicable rate under s 99A to tax retained business income at the lower business tax rate, or taxing these amounts under another new/amended provision.[24] This would ensure that business income taxed at the trustee rate is equivalent to the reduced 'entity' business tax rate.

Funds applied for a taxable purpose by a company (eg funds lent to a related entity for working capital) should not be subject to Div 7A if the loan is managed on complying loan terms, and should not constitute an assessable distribution.

Funds applied for a non-taxable purpose (eg private consumption) should be treated as a liberation of funds and an assessable distribution. Exceptions should apply to repayments of credit loans, returns of capital, repayments of unpaid present entitlements, and similar amounts on which tax has already been paid under any former regime. Regard would need to be had to practical implementation.

Introducing a lower business tax rate across all entities would have the following additional benefits:

- income distributed to trust beneficiaries would be taxed at their marginal rates on receipt of cash funds, rather than on a present entitlement to a share of the income of the trust estate;
- issues associated with Div 7A and s 100A would be greatly reduced, if not eliminated; and
- there would be no streaming issues[25] as all income is 'entity' income and taxed at a flat rate, with a credit for the tax paid attached to distributions to stakeholders.

Cash flow taxation model

Reform of the taxation of SMEs could take the form of a cash flow taxation model, which is based on the premise that SMEs below a prescribed aggregated turnover threshold could choose to account for their:

- income and capital gains on a cash receipts basis; and
- deductions on a cash payments basis.

This simpler system would overcome the perennial revenue–capital dichotomy of having to characterise receipts and outgoings on revenue or capital account, and would remove the accruals basis of reporting income for tax purposes for these entities. It means, in practice, that these businesses could effectively determine their taxable income based on their bank statements, rather than having to apply complex tax law to ascertain their assessable income and allowable deductions, which are often affected by timing differences that have no permanent impact on the revenue collection of the government. It would also aid in the removal of most, if not all, 'tax reconciliation items' whereby businesses reconcile their financial statements/accounts with their income tax return.

In particular, adopting a cash flow taxation model would support businesses operationally by permanently allowing full expensing of:

- depreciating assets in the income year in which they are paid for — this would eliminate the complex pooling rules in Subdiv 328-D ITAA97;[26] and
- prepayments in the income year in which they are made — this would eliminate the prepayment rules for eligible entities.

Consideration would need to be given to a suitable aggregated turnover threshold below which an entity would be eligible for cash flow taxation. The Tax Institute suggests that the threshold should be no less than $20m, but a $50m threshold would be more appropriate, so that a greater of number of SMEs could choose to adopt cash flow taxation and the threshold would align with other existing SME concession thresholds.

Under a cash flow taxation model, a business would, among other things:

- claim a deduction for:
  - all trading stock purchases without having to account for opening and closing stock each year;
  - all depreciating assets (including intangible assets such as patents, registered designs, copyright and software)

  - that have a taxable purpose (or to the extent of their taxable purpose), regardless of their effective life; and
  - all prepayments, regardless of their eligible service period;
- not have to deal with tax reconciliation items such as capital works claims under Div 43 ITAA97 because the building would be fully deductible at the time of purchase;
- be assessed on all receipts, whether of a revenue or capital nature,[27] including the proceeds from capital gains and unearned income received in advance; and
- account for capital gains when the capital proceeds are received, not some other timing (such as the date the contract is entered into under CGT event A1).

An exception would need to be made for certain CGT asset acquisitions, such as business real property.[28]

Taxation of trusts

Possible reforms to the taxation of trusts include the following:

- **section 99A:** if the rate payable on retained business/active income under s 99A is capped at the lower business tax rate, there would likely be less impetus to establish corporate beneficiaries. Further, the rate could be imposed on all business/active income outside Div 6 so the s 99A rate could be confined to retained passive income;
- **repeal antiquated trustee beneficiary reporting rules:** the duplicate layers of trustee reporting (ie trustee beneficiary reporting rules, TFN reporting, trust loss rules, and family trust elections) should be removed and the reporting streamlined. The trustee beneficiary reporting rules in Div 6D were introduced before the introduction of the TFN reporting rules[29] for closely held trusts. The trustee beneficiary reporting rules are not well understood or applied by taxpayers and practitioners — label P in the distribution statement in the trust tax return ('tax-preferred amounts'[30]) is invariably incorrectly completed, and label Q in the distribution statement ('untaxed part of a share of the net income'[31] of a closely held trust) reports information in the tax return that is already reported elsewhere in the return. The trustee beneficiary reporting rules should be repealed and greater reliance placed on the more effective and efficient TFN reporting rules; and
- **establish a central regulator:** consideration should be given to how the tax system could deal with non-tax issues, given the absence of an external regulator akin to ASIC and a central registry of trusts (including bare trusts). The ATO or the Registrar of the Australian Business Register could be responsible for the governance of such a system, and consideration given to whether any or all of the registry should be publicly visible. The introduction of a registration system for trusts could possibly be extended to include partnerships, in association with stronger regulatory requirements.

Better design of loss provisions

As noted in chapter 2 of the *Case for Change* paper,[20] the current structure of the company and trust loss rules is unnecessarily complicated and often hard to apply — even if there is a clear intention that the losses should be available. Those rules impact disproportionately in terms of their complexity and compliance cost on small businesses. The suggestions contained in that chapter would provide proportionately greater benefit to such small businesses.

No doubt, other options could also be explored.

Options for reform

- Reduce the corporate tax rate to 25% and align the corporate tax rate and the franking rate for all CTEs, regardless of size, activity or income type.
- Completely or partially abolish imputation associated with lowering the corporate tax rate for all CTEs to 15% and introduce a partial exemption from income tax for dividend income.
- Adopt a potential flow-through design whereby tax is imposed at the shareholder level not on the CTE, accompanied by the introduction of a single-rate withholding tax system.
- Align the taxation of trusts and companies — this would include extending Div 7A to trusts.
- Provide an ability for trusts to accumulate business income without penalty tax rates applying. This would be associated with:
  - aligning the s 99A rate with the corporate tax rate, which would resolve most Div 7A issues; and
  - allowing tax paid by the trust to be passed to beneficiaries in the form of a franking credit.
- Allow for the accumulation of income based on the trustee's choice, eg at the corporate tax rate or, alternatively, tax beneficiaries based on present entitlement attribution, or another alternative.
- All business or 'active' income could be taxed at a single business tax rate, such as 25%, irrespective of the type of legal entity through which it is derived.
- Taxing companies, trusts and partnerships on a flow-through basis, akin to the treatment of corporate limited partnerships in the US, rather than taxing the income at the entity level.
- To ensure that the lower business tax rate applies only to business or active income and not passive income, a BREPI-style test could apply so that the entity is taxed at a higher rate if more than 80% of its assessable income is passive in nature.
- Alternatively, the higher tax rate could apply only to the passive income, with the lower business tax rate applying to the business income.
- Reform of the taxation of SMEs could take the form of a cash flow taxation model.
- Extend the attribution approach to trusts — extend Div 276 ITAA97 (attribution managed investment trust rules) to other trusts, with appropriate modifications.
- Repeal the trustee beneficiary reporting rules and rely more heavily on the TFN reporting rules.
- Establish a central registry of trusts (including bare trusts).

- Consider a roll-over for CGT assets and depreciating assets that are active business assets to address the federal tax implications of hundreds of thousands of trusts reaching the end of their perpetuity period.
- Allow losses to be recouped over a set number of years or on a straight-line basis, without the need for the complex continuity of ownership test and similar business tests.

Conclusion

The complexities of the current taxation regime facing SMEs and their advisers is unwarranted and disproportionate to the nature of the businesses. It is unsurprising that small businesses, confronted with such complex rules, either through exasperation or mere error fail to meet the rigors of such a system. As outlined above, there are alternatives and these should be debated to help establish a coherent framework for the taxation of small business. Any new framework should minimise red tape (compliance costs) and rebuild credibility and adherence to the system. Next month, the *Case for Change* chapter on concessions for small and family business will be reproduced in *Taxation in Australia*, further demonstrating the complexities SMEs face.

The Tax Institute

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2 Based on modelling undertaken by The Tax Institute, a fund with a balance of $800,000, and assuming a 5% return on investment (wholly invested in equities), would have foregone 100% of its franking credits, whereas a fund with a balance of $100m would have foregone only 50.5% of its franking credits. That modelling also shows that funds with investments spread across equities, property and fixed interest would similarly result in 100% loss of franking credits in a fund of $800,000 but *no* loss of franking credits for a fund size of around $10m.

3 The general TBC has been indexed to $1.7m from 1 July 2021.

4 This includes 'deemed' companies such as public trading trusts covered by Div 6C of Pt III ITAA36 and limited partnerships covered by Div 5A of Pt III ITAA36.

5 Confirmed by *FCT v Bamford; Bamford v FCT* [2010] HCA 10.

6 As compared with marginal tax rates.

7 Released by the Howard Government as an exposure draft of the New Business Tax System (Entity Taxation) Bill 2000.

8 And this is without addressing the many other provisions and special rules that affect the taxation of trusts.

9 *FCT v Bamford; Bamford v FCT* [2010] HCA 10.

10 *Bamford* definitional problem of the meaning of 'income of the trust estate' as used in s 97 ITAA36 and confirmed the so-called 'proportionate approach' in applying the term 'share of the income of the trust estate'.

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15 ATO, TR 2004/D25 — Income tax: capital gains: meaning of the words 'absolutely entitled to a CGT asset as against the trustee of a trust' as used in Pts 3-1 and 3-3 of the *Income Tax Assessment Act 1997*.

16 ATO, TR 2012/D1 — Income tax: meaning of 'income of the trust estate' in Division 6 of Part III of the *Income Tax Assessment Act 1936* and related provisions.

17 A trust's perpetuity period may be shorter than 80 years pursuant to the trust deed.

18 *Peter Greensill Family Co Pty Ltd (trustee) v FCT* [2020] FCA 559.

19 *Burton v FCT* [2019] FCAFC 141.

20 Parts 1 and 2 of chapter 2 of the *Case for Change* paper were published in the September and October issues of *Taxation in Australia*. Available at https://tticdn.blob.core.windows.net/ttifiles/dmfile/0688nat_project_reform_paper-case-for-change_v17_online.pdf.

21 The general TBC has been indexed to $1.7m from 1 July 2021.

22 Released by the Howard Government as an exposure draft of the New Business Tax System (Entity Taxation) Bill 2000.

23 S 99A ITAA36.

24 It is likely that a s 99A rate would not be relevant in many cases as the new business tax rate would be levied at the entity level, not under Div 6.

25 Subdivs 115-C and 207-B ITAA97.

26 The pooling rules in Subdiv 328-D ITAA97 may have been intended to provide simpler depreciation rules for smaller businesses, but the interaction of the pooling rules with the instant asset write-off, the new full expensing of depreciating assets measure, the backing business investment incentive, and the various exclusions (including those assets that are subject to Subdiv 40-E and those that are let predominantly on a depreciating asset lease) has made this area of the law unintentionally very complicated. Further, special rules that adjust the pool balance where there is a change in the taxable purpose proportion of an asset allocated to the pool deal with disposals of assets and prescribe when the pool balance is required to be fully deducted are often poorly understood.

27 There would also be no need to distinguish between ordinary and statutory income, although a rethink of the calculation to determine aggregated turnover in s 328-120 ITAA97 would be required as it includes only ordinary income derived in the ordinary course of carrying on a business.

28 This would also extend to goodwill and intangible assets that generally do not have an effective life, such as trademarks.

29 Ss 12-175 and 12-180 in Sch 1 TAA53.

30 S 102UI ITAA36.

31 S 102UE ITAA36.

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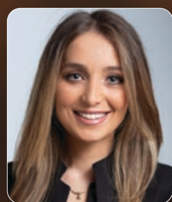

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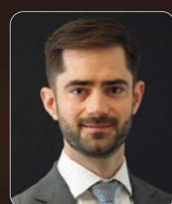

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Corporate tax compliance and the RTP schedule

by Patricia Muscat, CTA, Director, and Lynda Brumm, CTA, Principal, PwC

The reportable tax position schedule was introduced by the ATO in 2011, with its aim to gather information on uncertain tax positions from the largest public and multinational companies. Since then, the scope and content of the schedule has been significantly expanded and it now covers not only large public and foreign-owned companies but, most recently, also privately owned companies. The ATO has indicated that it uses disclosures in this schedule to tailor its engagement and work with taxpayers to resolve concerns and provide assurance over high-risk arrangements, improve its understanding of the risk profile and corporate governance of taxpayers, and identify areas to provide further clarification or certainty on the correct treatment of transactions. The schedule covers a wide range of complex tax issues, and taxpayers should not underestimate the amount of work that may be needed to complete it.

Introduction

The reportable tax position (RTP) schedule is a schedule to the company income tax return which requires certain large companies to disclose to the ATO their most contestable and material positions. This covers arrangements that result in tax uncertainty in financial statements and/or the income tax return, as well as specifically determined arrangements for which the ATO requests disclosure.

Who needs to complete the RTP schedule?

It is only companies that are potentially required to complete and lodge the RTP schedule with their income tax return.

Broadly, for the 2021 income year, the RTP schedule must be completed by a *public company* or a *foreign-owned company* with:

- total business income of A$250m or more in the current year; or
- total business income of A$25m or more in the current year, where the company is part of a public or foreign-owned economic group with total business income of A$250m or more in the current year.

The RTP schedule is not required if the company is not required to lodge a company tax return for the income year or it has an annual compliance arrangement with the ATO for the relevant income year.

Any other company must complete the RTP schedule if it is notified to do so by the ATO. In 2020, the ATO notified a number of large private groups to complete the RTP schedule with their 2021 company tax return.

However, effective from the 2021-22 income year, the ATO has indicated that *privately owned companies* must *self-assess* the requirement to lodge the RTP schedule for each income year in the same way (and using the same total business income thresholds) as public and foreign-owned companies (except for large private companies with an early balancing substituted accounting period, which will have to self-assess from the 2022-23 income year).

The authors' experience to date suggests that some companies have difficulty determining whether the RTP schedule is required to be lodged with their tax return. Unfortunately, the triggers that require the RTP schedule use different grouping and size concepts to other well-known concepts such as "significant global entity" and "aggregated turnover". Issues that frequently arise include:

- **determining which entities are part of an economic group:** an economic group includes all entities (not just companies) that lodge an Australian tax return under a direct or indirect Australian or foreign ultimate holding company or other majority controlling interest. This includes all entities under a single ultimate holding company or under the ownership of a single individual, trust or partnership. With the expansion of the RTP schedule to private groups, additional complexities may arise where a group potentially includes discretionary trusts and/or superannuation funds;
- **determining total business income:** according to the ATO's current instructions for the RTP schedule, the total business income of a company is the amount reported at the "total income" label of the company income tax return. The total business income of an economic group is the sum of the amount reported at all income labels in the Australian tax return for each and every group member. Since there is no total income label on the trust and partnership tax returns, this needs to be calculated manually, covering all income labels. All Australian income of group members is included in the calculation, with foreign income only included where the entity generating that income is an Australian resident entity. Where an individual holds the ownership interest that connects entities into one economic group, the income on their individual tax return is excluded from group total business income calculations for the purposes of determining the RTP schedule lodgment obligation of the economic group; and
- **double counting of business income across economic group members:** the concept of total business income (as set out above) does not provide for "intra-group" transactions to be ignored. This means, for example, the income of a partnership or trust will be counted more than once when determining whether the economic group,

which includes a partner or trust beneficiary, meets the A$250m threshold.

What is a reportable tax position?

Taxpayers that are required to complete the RTP schedule are required to disclose certain positions — known as reportable tax positions — in the schedule. Currently, there are three types of RTPs that the ATO requires to be disclosed in the RTP schedule, as discussed below.

Category A: Tax uncertainty in your income tax return

A Category A RTP is a position where it would be concluded, based on relevant authorities, that a material position taken in the tax return is about "as likely to be correct as incorrect", or is "less likely to be correct than incorrect". In addition to situations where the technical application of the law may be unclear, this may also include:

– positions based on anticipated legislation;
– positions contrary to a public ruling;
– positions relating to the exercise of a Commissioner's discretion;
– positions covered by an industry or administrative practice; and
– positions where the law is clear but the facts are uncertain (for example, uncertainty relating to valuation).

Special rules apply when determining whether a transfer pricing position is a Category A RTP. In particular, a company is required to disclose any position that is not covered by transfer pricing documentation to the standard required by the tax law.

A Category A RTP only needs to be disclosed if the position is material. A position will be material where the potential adjustment, should the position not be sustained, is equal to or exceeds the company's materiality amount, which is broadly 5% of its Australian current tax expense, except where:

– 5% of its Australian current tax expense exceeds A$30m — the materiality amount is then A$30m;
– 5% of its Australian current tax expense is less than A$3m — the materiality amount is then A$3m; or
– it has no Australian current tax expense — the materiality amount is then A$3m.

Category B: Tax uncertainty in financial statements

A Category B RTP is a position in respect of which uncertainty about taxes payable or recoverable is recognised and/or disclosed in the company's financial statements in accordance with AASB Interpretation 23 *Uncertainty over income tax treatments.*

The ATO has acknowledged that private companies often prepare less comprehensive financial statements than public and foreign-owned companies and may not consider or report tax uncertainty in their financial statements. To this end, the ATO has indicated that, providing the financial statements meet the requirements for that company, there is no need to look beyond the company's financial statements for Category B disclosures. However, an uncertain position that is not recorded in the financial statements likely meets the requirements of a Category A RTP.

Category C: Reportable arrangements

A Category C RTP will arise if the company answers "yes" to any of the Category C questions set out by the ATO in the RTP instructions for the applicable income year. Each question refers to specific arrangements described in an ATO tax ruling or determination, taxpayer alert or a practice compliance guideline (PCG), and other positions considered to be high-risk by the ATO. For 2021, there are 35 Category C questions. The ATO has instructed taxpayers to interpret these questions and the accompanying guidance broadly.

Category C questions typically relate to tax avoidance, profit shifting and other practices that pose systemic risk to the corporate tax base. The 35 questions for 2021 represent a significant increase on the prior year with 12 new questions, and at least seven questions carried over from 2020 now requiring additional information to be provided. These new questions highlight the ATO's continued use of PCGs in the context of potential tax risks, and focus on a wide range of issues, including:

– the hybrid mismatch rules;
– private companies and the deemed dividend rules (Div 7A of the *Income Tax Assessment Act 1936* (Cth)) in the context of a tax consolidated group;
– private companies with trustee shareholders;
– foreign income tax offsets;
– arrangements involving the development, enhancement, maintenance, protection or exploitation of intangible assets;
– cross-border financing, including the arm's length debt test;
– restructuring involving unit trusts or trust splitting; and
– multiple entry consolidated group restructuring.

There is also a new "catch-all" Category C question which requires companies to make a disclosure if they have an arrangement covered by a final PCG that is published after the RTP instructions were released and the arrangement falls within the high-risk zone of the PCG or the company has not applied the PCG. This means there is an ongoing obligation to review all new PCGs and their potential application right up until the time of lodgment of the tax return.

ATO experience

In January 2021, the ATO released its first *RTP Schedule Findings Report* outlining the aggregated disclosures made by companies for the 2018-19 income year under Category C of the schedule. As noted above, Category C disclosures relate to specific questions from the RTP schedule instructions, usually relating to high-risk issues highlighted by the ATO in its guidance products.

The ATO has indicated that approximately 1,240 companies lodged the RTP schedule for the 2018-19 income year. A majority of those companies reported at least one Category C disclosure, with the largest proportion of disclosures relating to PCGs, for which a company is required to also disclose its self-assessed risk rating against the framework provided in the PCG.

Conclusion

While acknowledging its importance to the ATO in managing tax risks, the expansion of the matters to be considered in the RTP schedule and the number of taxpayers which might need to lodge it means an increased compliance burden for corporate taxpayers, but one that must be managed. Generally speaking, taxpayers that have good tax governance processes in place will find the burden easier to manage.

All companies should carefully consider whether they have an obligation to prepare and lodge the RTP schedule. The RTP schedule forms part of the income tax return and must be lodged by the due date for the tax return. Failure to complete the schedule where it is required can lead to significant penalties.

Completing the RTP schedule, particularly for the first time, can be a daunting task. The questions cover a wide range of issues, and while many of these involve cross-border arrangements, there are also questions relating to imputation benefits, trust splitting, roll-overs, Div 7A (private company deemed dividends), unamended mistakes or omissions, the research and development tax incentive, fragmentation of trading businesses, and share buy-backs.

Prepare early and do not underestimate the amount of work that may be required to satisfactorily complete the schedule, and consider and respond to the extensive array of Category C questions. As with all other income tax return schedules, a taxpayer must take reasonable care in completing the schedule, and penalties may apply for false or misleading statements or late lodgment.

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Principal
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NSW Duties Act: charging the land

by Cullen Smythe, CTA, Commissioner of State Revenue, Revenue NSW

For decades, the NSW landholder duty provisions have imposed a liability on acquirers of interests in entities holding NSW real property. However, the ability to collect this revenue in cases where a liable party is located offshore, with no directly held Australian assets, has been limited. Through amendments passed in 2020, the acquirer of a relevant interest, together with the landholder itself, are jointly and severally liable, and landholder duty liabilities form a charge on the land. This article outlines the limitations of the international "revenue rule", and the way the 2020 amendments to the *Duties Act 1997* (NSW) address this problem. The article also provides some practical examples covering both domestic and international scenarios to illustrate how the provisions are administered by the Chief Commissioner.

Introduction

Transfers of real property have long been subject to stamp duty in NSW, with indirect transfers (through certain holding vehicles) only subject to a specific regime since 1987.[1] Given the complexity of corporate holding structures and the increasing reliance of the NSW duties regime on real property, the provisions have been undergoing a continual process of evolution to ensure that they adequately address developments in corporate structures and commercial operations. This need to adapt has only increased with the greater incidence of cross-border investment and the use of large and intricate holding structures.

However, there are a number of impediments to enforcing tax statutes offshore that have limited the ability of revenue authorities to ensure that entities are paying their fair share of tax. Accordingly, in 2020, provisions were introduced into the *Duties Act 1997* (NSW) (Duties Act) aimed at ensuring compliance with the landholder duty provisions of the Act – regardless of whether a transaction occurred domestically or offshore.

Nature of the problem and history

State taxes in the framework

In a world where corporate structures regularly include off-shore entities, the integrity of revenue systems requires that international legal arbitrage should not be freely available to avoid tax. Unfortunately, this is more of an aspiration than a reality, despite years of policy development, international tax treaties, and specific legislative provisions that aim to address particular avoidance arrangements.

It is a longstanding principle that countries will not enforce penalty or revenue obligations owed to other jurisdictions, absent a treaty or other binding obligation. This causes difficulty for Australian state revenue enforcement when the liable party to landholder duty is located offshore and may not have any assets located in an Australian jurisdiction, let alone located within a particular state.

The common law position was outlined in the House of Lords decision in *Government of India, Ministry of Finance (Revenue Division) v Taylor.*[2] That case involved the liquidation of a United Kingdom registered company that had been trading in India and owed taxes to the Indian Government.

The House of Lords held that, as a general principle, foreign states were unable to recover taxes in English courts, acknowledging that this was a clear and longstanding principle extending back to at least the 1700s.[3] In reaching its decision, the House of Lords noted that, despite claims of the appellant that the rule was being softened somewhat in a trend seeing countries moving closer to one another, there was no authority for such a proposition, and similarly there was no reason to treat member states of the British Commonwealth as being above this rule.[4]

This principal has been understood and applied consistently in Australia from early times (with Australian authorities left in no doubt as to the difficulty of recovering tax imposts in UK courts from the early years of the 20th century[5]) and, given the shrinking of the globe and increased commerce across international borders, would appear to be increasing in prominence.[6]

This "revenue rule", while generally accepted across nations,[7] does carry significant subtleties of interpretation,[8] as well as a somewhat grey area when it comes to the international administration of tax default induced bankruptcies.[9] While the impact has been mitigated somewhat through the international tax treaty regime[10] in the context of federal taxes, the limited scope of these instruments has, to a large extent, left Australian states on their own when considering the enforcement of their revenue statutes.

NSW landholder duty

The NSW landholder duty provisions are found in Ch 4 of the Duties Act. The provisions were initially introduced[1] into the *Stamp Duties Act 1920* (NSW) as an anti-avoidance measure aimed at ensuring that indirect transfers of real property through holdings in certain entities were treated in a similar manner to direct transfers of land. While the provisions have changed significantly from the time they were first introduced, the core elements remain largely the same.

The basic principles of the landholder provisions are simple: a person (or persons acting together) that makes a "relevant acquisition" in a "landholder" will attract duty at transfer duty rates on the underlying land and goods[11] deemed to have been acquired. A "landholder" is defined as a unit trust scheme, private company or listed company that has "landholdings" in NSW with an unencumbered (market) value of $2m or more.[12] The "landholdings" of an entity include real property held directly, and also held indirectly through certain downstream entities.[13] A "relevant acquisition" occurs when a person acquires an interest that amounts to a "significant interest" (alone, or when aggregated with acquisitions or holdings of associates), or when aggregated with interests already held by the person or their associates.[14] An "interest" in a landholder is a right to receive a distribution of any of the property of the landholder if all of the property of the entity was to be distributed[15] (for example, in the case of a liquidation), and a "significant interest" is defined as an interest of 50% or more in a private company or unit trust, or an interest of 90% or more for a public landholder[16] (subject to certain exclusions[17]).

Where a relevant acquisition occurs, the person (or persons) making the acquisition must prepare and lodge a statement[18] and pay the duty within three months of the liability date. Historically, where the acquirer was an offshore entity with no assets located in Australia, there was very little that could be done to enforce payment of the landholder duty liability.

> *"While offshore transactions were a motivation in passing the legislation … there is no requirement that an offshore element be present before the section comes into operation."*

The amending legislation

Section 154 of the Duties Act details who is liable to pay landholder duty. Until 2020, the person liable to pay a liability arising under the landholder duty provisions was limited to the person actually making the acquisition (or in the case where a liability arose from a number of persons acting together, those persons). However, this position was modified with the assent of the *State Revenue Legislation Further Amendment Act 2020* (NSW)[19] which replaced the previous s 154 with the current provision. The amending legislation effected three significant changes:

1. a move from a system that looked to impose duty on the acquirer of a relevant (or further) interest, to a system that makes the landholder itself jointly and severally liable for the duty with the acquirer(s);
2. the ability of the landholder to recover the amount of the duty paid from the acquirer(s) as a debt; and
3. providing that any liability to landholder duty is a charge on the land for which a caveat may be registered.

In moving the amendments, the Minister for Finance and Small Business drew attention to the anti-avoidance intent of the provisions, with a specific reference to the difficulties in addressing offshore tax avoidance.[20] It is noteworthy that the amendments to s 154 were supported by the Opposition.[21]

It is also worth noting that, while offshore transactions were a motivation in passing the legislation, the provisions are not limited in application to offshore transactions and, as a consequence, there is no requirement that an offshore element be present before the section comes into operation. A further detail worth noting is that the property the subject of the charge and any registerable caveat is not limited to particular lots or parcels of real estate — all of the landholdings of a landholder are subject to the charge created by s 154(3) and may be subject to a registered caveat.

For additional details on how the Chief Commissioner administers s 154 of the Duties Act, refer to Revenue Ruling DUT 051.

How does s 154 work?

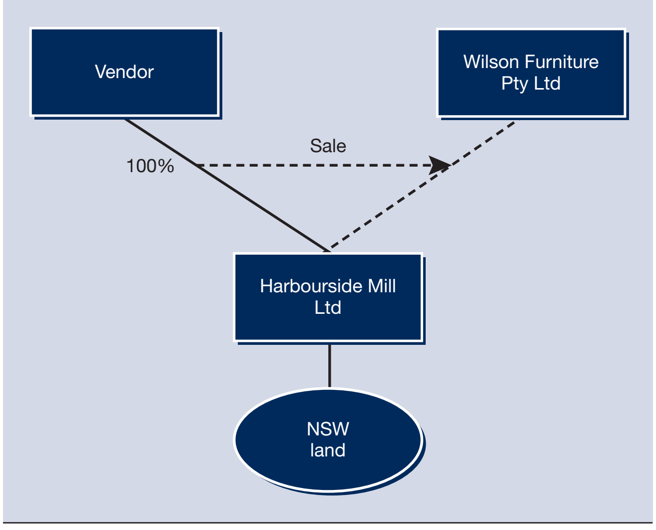
Some examples of how the Chief Commissioner may apply s 154 in various scenarios are set out below. It should be kept in mind that these examples are for illustrative purposes only, and whether or not the Chief Commissioner will register a caveat in any given situation will depend on the relevant facts and circumstances of each matter.

Example 1. Acquisition of an Australian landholding company by another Australian company

Wilson Furniture Pty Ltd, a NSW incorporated company based in Dubbo, acquires all of the shares in Harbourside Mill Ltd, a company with timber milling assets located at Coffs Harbour, NSW. Harbourside Mill Ltd is a landholder for the purposes of Ch 4 of the Duties Act.

The acquisition of shares comprises a relevant acquisition and, under s 154, both Wilson Furniture Pty Ltd and Harbourside Mill Ltd are jointly and severally liable to pay the duty. Ordinarily, Revenue NSW would pursue Wilson Furniture Pty Ltd at first instance to recover the duty payable if the

Example 1. Acquisition of an Australian landholding company by another Australian company



liability was not met on time, or if a payment arrangement was not entered into. As the person making the acquisition and all of their assets are located in NSW, a caveat is unlikely to be registered over the real property of Harbourside Mill Ltd unless there is an indication that payment of the outstanding duty may be at risk.

Example 2. Acquisition of a Singaporean company by a UK company

Healthy Fresh Inc is a US based multinational that operates a worldwide operation retailing organic produce. Its Asia-Pacific operations are held indirectly through a Singaporean subsidiary, Healthy Fresh (Sg) Pte Ltd, which owns all of the shares in its Australian subsidiary, Healthy Fresh (Aus) Pty Ltd. Healthy Fresh (Aus) Pty Ltd owns numerous leases around Australia, freehold warehouses located in Sydney and Albury, and is a landholder for the purposes of Ch 4 of the Duties Act.

New South Seas Co, BV, a Dutch corporation, is looking to diversify its international holdings, and purchases a 60% interest in Healthy Fresh (Sg) Pte Ltd. Healthy Fresh (Sg) Pte Ltd is a landholder for the purposes of Ch 4 of the Duties Act through its 100% holding of Healthy Fresh (Aus) Pty Ltd.

The 60% acquisition comprises a relevant acquisition, and both New South Seas Co, BV and Healthy Fresh (Sg) Pte Ltd are jointly and severally liable for the duty. The liability comprises a charge on the landholdings of Healthy Fresh (Sg) Pte Ltd,[22] which include the downstream holdings of Healthy Fresh (Aus) Pty Ltd.[23] As a result of the revenue rule, neither the courts of the Netherlands, nor those of Singapore will enforce the tax debt against assets in those countries. Accordingly, the Chief Commissioner may choose to lodge a caveat against the freehold warehouses in Sydney and Albury held by Healthy Fresh (Aus) Pty Ltd to secure payment of the landholder liability.

In order to meet the tax liability, Healthy Fresh (Aus) Pty Ltd pays the outstanding liability, and the Chief Commissioner withdraws any caveats[24] lodged to secure the debt. Healthy Fresh (Aus) Pty Ltd may now seek repayment for the landholder liability from New South Seas Co, BV.[25]

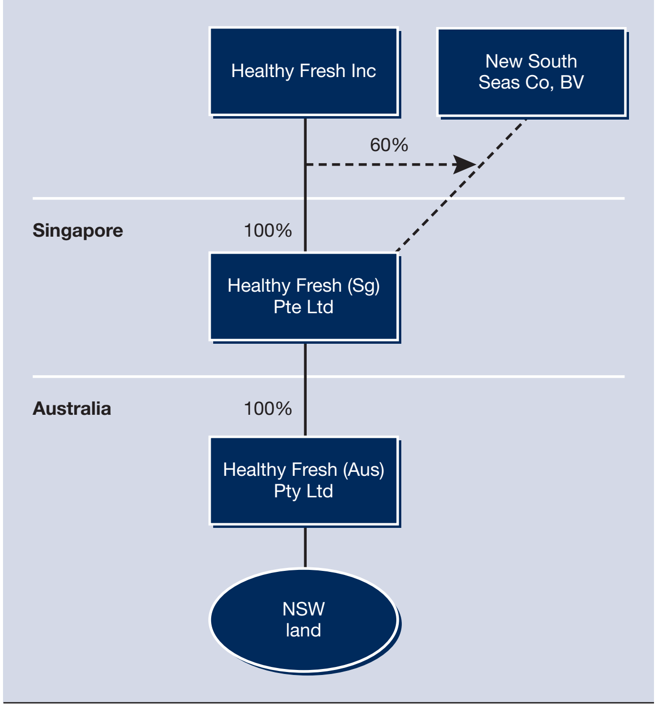
Example 3. Issue of preference shares

The Golden Infrastructure Trust is an Australian managed unit trust that acquires interests in Australian infrastructure assets through subsidiary unit trusts, and provides exposure to these assets to both domestic and foreign investors. The returns are tailored to particular investors through the issue of different classes of units with varying rights as to voting and distribution.

Eventide LLC, a Delaware incorporated limited liability company, makes a major investment into the Golden Infrastructure Trust, comprising a subscription for ordinary units and preference units and the acquisition of instruments entitled "long-term bonds". Due to the terms of the preference units and the "bonds", neither comprises debt interests for the purposes of Div 974 ITAA97. As a result, Eventide LLC has acquired an interest of 50% in the Golden Infrastructure Trust and triggered a liability to landholder duty.

Should Eventide LLC choose not to pay the landholder duty, the Chief Commissioner could choose to lodge a caveat on the NSW infrastructure assets held through the subsidiary trusts.

Example 2. Acquisition of a Singaporean company by a UK company



Example 3. Issue of preference shares

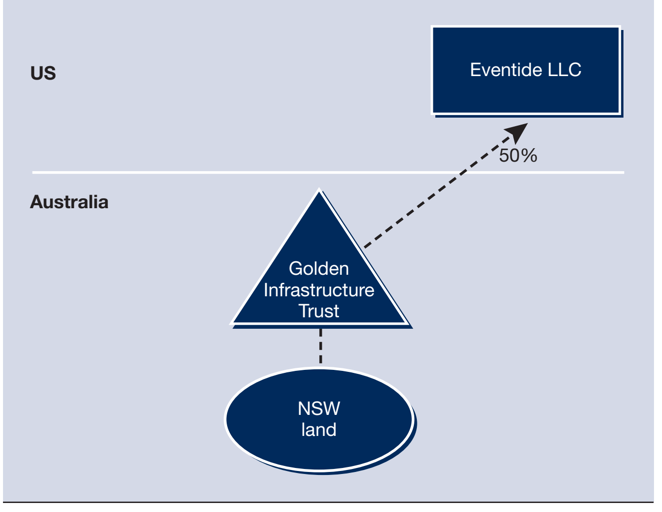


Table 1. Attribution of liability provisions

Jurisdiction	Legislation	Provision
Western Australia	*Duties Act 2008*	s 179
Northern Territory	*Stamp Duty Act 1978*	s 56S
Victoria	*Duties Act 2000*	s 85
South Australia	*Stamp Duties Act 1923*	s 102C

Other jurisdictions

Securing the payment of landholder duty liabilities is a common problem faced by all Australian jurisdictions. While a consideration of jurisdictions other than NSW is beyond the scope of this article, it is worth noting that a number of jurisdictions have adopted the attribution of liability to the landholding entity as a means to secure the payment of landholder liabilities (see Table 1).

It is important to note that, as with many other areas of state taxation law, the landholder duty provisions of each jurisdiction are tailored to the particular circumstances of each state or territory. As a result, there can be significant differences in both the form and administration of these provisions, and taxpayers and advisers alike should pay close attention to the precise wording of each provision that applies to a given transaction.

Conclusion

The amendments to s 154 of the Duties Act assists Revenue NSW in securing the payment of duty liabilities which are used to fund essential services for the state. While the ability to charge landholdings to secure payment is not limited to foreign transactions, the legislative changes do reflect a response to the increasing internationalisation of corporate structures and transactions and ensure that the legislation remains fit for purpose.

It is important to remember that Revenue NSW operates a private ruling service that can provide guidance on, and certainty on the state revenue consequences of, particular transactions.[26]

Cullen Smythe, CTA
Commissioner of State Revenue
Revenue NSW

References

1 Introduced by the *Stamp Duties (Amendment) Act 1987* (NSW), which received royal assent on 10 June 1987.

2 [1955] AC 491.

3 For example, the decision of Mansfield CJ in *Planche v Fletcher* (1779) 1 Doug 251 at 253: “One nation does not take notice of the revenue laws of another.” The case involved customs duties in the context of war between England and France.

4 [1955] AC 491 at 507-508.

5 For example, see the decision of Grantham J of the Kings Bench in *Municipal Council of Sydney v Bull* [1909] 1 KB 7, where a municipal council sought to recover contributions towards local improvements in Sydney from a property owner located in the UK. Grantham J noted (at 12): “The action is in the nature of an action for a penalty or to recover a tax … it has always been held that an action will not lie outside the confines of the last-mentioned State.”

6 Recent Australian examples include the decisions of the Victorian Supreme Court in *Re Legend International Holdings Inc (in liq)* [2018] VSC 789, and the Full Court of the Federal Court in *Huang v DCT* [2020] FCAFC 141.

7 For a discussion on the application of the revenue rule across multiple jurisdictions, see B Mallinak, “The revenue rule: a common law doctrine for the twenty-first century”, (2006) 16 *Duke Journal of Comparative & International Law* 79-124.

8 See, for example, the decision in *Alves v Hodgson* (1797) 7 TR 241 regarding stamp duties on an indenture. The court refused to acknowledge the document on the basis that, under the laws of the country of its formation, it did not take legal effect until it was stamped. Accordingly, was not a valid document in the jurisdiction of formation, with Lord Kenyon noting (at 243): “… it is said that we cannot take notice of the revenue laws of a foreign country: but I think we must resort to the laws of the country in which the note was made: and unless it be good there, it is not obligatory in a Court of Law here.” See also the House of Lords decision in *Re State of Norway’s Application (No. 2)* [1990] 1 AC 723, where the Norwegian Government sought assistance in collecting evidence that was to be used in a revenue claim against a taxpayer. Lord Goff noted (at 809) that the rule was limited to enforcement of the revenue laws of a foreign country (“an extraterritorial exercise of sovereign authority”), rather than subsidiary actions such as seeking the assistance of local courts to collect evidence.

9 See, for example, the discussion of English precedent in this area in N Feetham and G Jones, *Protected cell companies: a guide to their implementation and use*, Spiramus Press, 2008, pp 246-247. The distinction between procedural and substantive issues in a conflict of laws context is beyond the scope of this article, but is an exceptionally interesting area for further study.

10 However, assistance in collecting tax judgments is still not a general principle among treaty nations, and is often the subject of additional protocols. See Mallinak, op cit, p 94, and the UK Court of Appeal decision in *Ben Nevis (Holdings) Ltd v Commissioners for HM Revenue & Customs* [2013] EWCA Civ 578, for consideration of practical elements when applying such protocols.

11 Certain classes of goods are excluded from the duty calculation: ss 163K and 163G of the Duties Act.

12 S 146 of the Duties Act. “Land” is defined broadly to include not only fixtures and interests in land, but extends to items fixed to the land, regardless of whether they constitute fixtures at law: s 147A of the Duties Act.

13 S 158A of the Duties Act.

14 S 149 of the Duties Act.

15 S 150(1) of the Duties Act.

16 S 150(2) of the Duties Act.

17 For example, s 150(1A) of the Duties Act excludes entitlements to distributions that arise as a result of holding a “debt interest” within the meaning of Div 974 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).

18 S 152 of the Duties Act.

19 Which received royal assent on 24 June 2020.

20 See the second reading speech by the Hon. Damien Tudehope, Minister for Finance and Small Business, *Legislative Council Hansard*, 18 June 2020 at 16:14:00.

21 See the comments of the Hon. Daniel Mookhey, MLC, the second reading speech debate, *Legislative Council Hansard*, 18 June 2020 at 16:14:26.

22 S 154(3) of the Duties Act

23 Through ss147(1) and 158A(1) of the Duties Act.

24 S 154(5) of the Duties Act.

25 S 154(2)(a) of the Duties Act.

26 Revenue NSW, *Private rulings and special tax arrangements*. Website at www.revenue.nsw.gov.au/about/legislation-and-rulings/private-rulings-and-special-tax-arrangements.

Trust law: vesting and resettlement issues

by Philip Bender, ATI, Barrister, Victorian Bar

This article examines the recent case of *Re McGowan and Valentini Trusts*. In particular, the article examines the expansion of the situations in which a trust deed can be amended and a trust vesting date can legitimately be extended after vesting of a trust and without creating a new trust. The article touches on the ability of beneficiaries to join together to amend a trust deed. Also examined are the legislative requirements for a declaration of trust to be proved by some signed writing by the declarant of the trust and the means by which those requirements can be met to ensure that there is an enforceable trust.

Introduction

The recent case of *Re McGowan and Valentini Trusts*[1] explores some interesting trust law issues regarding the creation, amendment and vesting of two discretionary family trusts. The case has potential implications for the ATO's ruling on trust vesting (TR 2018/6), as well as for situations in which amendments to a trust deed may trigger a trust resettlement.

Overview of the issues in the case

An application for judicial advice was made to the Supreme Court of Victoria[2] to seek advice on five broad issues:

1. the corporate trustee of the two trusts (the corporate trustee) was not incorporated at the time both trust deeds were executed so there was an issue as to the validity of the trusts and the identity of the trustee;
2. there was a property (Victoria St) that had been purchased in the 1970s in the names of two individuals who were the heads of the family (Giuseppe and Norma Valentini). That property was never transferred into the name of the corporate trustee but had been treated as if it were held on the two trusts in equal shares. There was also no written, signed declaration of trust, which gave rise to issues as to the enforceability of any trust over the property, specifically, whether the requirements of the relevant *Statute of Frauds 1677* (UK) equivalent provision had been met;
3. there were a number of other properties (mostly pre-CGT) (other properties) for which there were no written, signed declarations of trust. This also gave rise to an issue as to whether the requirements of the relevant Statute of Frauds provision had been met;
4. one of the trusts vested in the interests of a beneficiary in 1988 and the other trust vested in the interests of a beneficiary in 1991. After vesting, however, the trusts were treated as if they had not vested for the next 30 years. There were issues around who owned the property currently being treated as being held on the two trusts and whether the trusts had, in fact, continued on in existence after vesting; and
5. in 1991, there were two deeds of variation executed in respect of each trust. Those deeds purported to significantly amend the original trust deeds pursuant to a power of amendment in those original deeds. The amendments extended the vesting dates of the trusts (despite vesting having already occurred), broadened the class of discretionary objects of the trusts, and made a raft of other changes to the administrative powers in the trust deeds. There was an issue as to whether those deeds were valid and, if so, whether the trusts continued on as the same, original trusts or whether the execution of the 1991 deeds had caused new trusts to come into existence.

This article will set out the background to the case and then explore each of these issues that were considered by the court.

Importance of these issues from a trusts and a tax perspective

The above issues were extremely important from both a trusts perspective and a tax perspective. If some or all of the properties were not held on the two trusts, or the trusts were not valid at all, that could have had some important implications from a trusts and ownership perspective. It would affect who income and assets could be distributed to in the future and whether income had been properly distributed in the past. The Victoria St property was held in the legal name of Norma and, as Norma had passed away just prior to the hearing of the matter, the determination of the above issues had a potential effect on the assets of her deceased estate and their distribution (ie if she did own Victoria St outright and it was not held on trust, it would be an estate asset available for distribution).

The issues also have obvious income tax, GST (as the trusts held commercial properties), transfer duty and land tax implications. As the 1991 deeds broadened the class of discretionary objects, whether those deeds were valid could impact on whether the appropriate beneficiaries had been taxed on trust income in the past and who could be taxed on that income in the future. Further, whether assets were held on trust or by the corporate trustee in its own right could have impacted on who should have been taxed on the income and any future disposition of properties, and who should have been correctly assessed for GST and land tax.

Background

Giuseppe, now deceased, and Norma originally organised for the creation of two trusts, the Valentini Trust and the

McGowan Trust (the original trusts), predominantly in favour of their two children, Peter and Anna.

On 14 February 1977, two trust deeds (the 1977 deeds) were executed to create the original trusts, with the corporate trustee named as trustee. The 1977 deeds were executed by Giuseppe and Norma as directors of ING. ING was not incorporated until after the date of execution of both trust deeds.

In August 1976, Giuseppe and Norma entered into a contract to purchase Victoria St. Settlement of the contract of sale occurred on or about 17 November 1977, which was after the date of the 1977 deeds but before the date when the corporate trustee was incorporated. Victoria St was held jointly in Giuseppe and Norma's names until he passed away in 1989, after which it was transmitted by a survivorship application into the sole name of Norma. It was, however, always treated as being held as a property of the two trusts in equal shares.

The 1977 deeds provided for the vesting of the original trusts when Peter and Anna each turned 30. This happened in 1988 and in 1991. The trusts, though, continued to be treated as still operating.

The 1991 deeds were executed on or about 23 June 1991 (the 1991 deeds). Those deeds purported to amend the 1977 deeds to, among other things, introduce a new class of discretionary objects to the trust and extend the vesting dates of the trusts (the amended trusts). After that date, the affairs of the original trusts were conducted as if they were the amended trusts.

> *"… it is now possible … for significant amendments to be made … without creating a new trust …"*

Creation of the original trusts

An issue arose as to whether the original trusts were validly constituted, given that the corporate trustee was not incorporated when the 1977 deeds were executed. The corporate trustee was named as the trustee in the deeds, but its constituent documents were signed in August 1978 and it was recorded in ASIC records as having been incorporated in September 1978. The 1977 deeds did, however, have the common seal of the corporate trustee affixed and they were signed by Giuseppe and Norma as directors. The issue was what that meant for the validity of the trusts created by the 1977 deeds.

In order to create an express trust, there must be certainty of intention, subject matter of the trust, and beneficiaries of the trust.[3] The 1977 deeds met those requirements. There was certainty of intention because the settlor had expressly declared two trusts. The deeds also set out with certainty the identity of the beneficiaries and the trust property, namely, a settled sum of $10 on each trust. The issue was whether the validity of the creation of the trusts was affected by the named trustee, ING, not being in existence at the time of execution of the trust.

The corporate trustee submitted that equity would not allow a trust to fail for want of a trustee because that is, generally, contrary to the settlor's intention. *Raftland Pty Ltd v FCT*[4] refers to a possible exception where the settlor intended for the trust to continue only as long as the designated trustee continued in that capacity. Provisions in a trust deed which allow additional or substitute trustees to be appointed allow one to infer that the settlor did not intend the trust to fail for want of a trustee.

The court accepted that the 1977 deeds contained clauses permitting the appointment of additional or substitute trustees and so it should be inferred that the settlor's intent was that the trust should not fail for want of a trustee. Consequently, despite the corporate trustee not being incorporated at the time of execution of the 1977 deeds, the trusts created by those deeds did not fail for want of a trustee. As the court accepted that the deeds validly created the trusts, it was not necessary for the court to consider an alternative argument that the creation of the trusts should be inferred by subsequent conduct.

The next question was what happened to the trusts in the period prior to the corporate trustee's incorporation. The corporate trustee put forward a number of possible options:

- there was no trustee until the corporate trustee was incorporated;
- Giuseppe and Norma, as the persons signing the trust deeds, acted as de facto trustees until the corporate trustee was incorporated and, by the corporate trustee's conduct, accepted the role of trustee;
- there was an implicit exercise by conduct by Giuseppe and Norma, as appointors, of the powers of appointment in the trust deeds to appoint the corporate trustee as trustee after its incorporation; or
- there were acts of ratification by the corporate trustee to which certain former Companies Act provisions[5] could have applied to treat the corporate trustee as having ratified the 1977 deeds.

The court was referred to, and accepted, an existing authority in which a similar situation arose where there had been a declaration of trust prior to incorporation of the trustee. In *Rubino Investments Pty Ltd as trustee for the Rubino Family Trust v Chief Commissioner of State Revenue*,[6] the Appeal Division of the NSW Civil and Administrative Tribunal made the following comments in obiter:

> "27. It seems to me that even if the intended trustee had not been incorporated at the date of the settlement, nevertheless the party executing the trust deed on behalf of the intended trustee prior to its incorporation becomes a trustee of the settled sum upon receipt, and holds the sum on trust. The corporate trustee (here Rubino Investments) would ordinarily step into the place of the pre-incorporation trustee upon registration with ASIC and the ratification in some manner of the trust relationship.
>
> 28. In the present situation in any case the trustee had been incorporated before the transfers the subject of this dispute were executed and I infer knew the capacity in which it accepted the transfers."

The court accepted that this was the correct analysis for the original trusts. That is, Giuseppe and Norma, as the persons who signed the 1977 deeds, acted as trustees prior to the corporate trustee being incorporated. Once it was incorporated, there was ample evidence to demonstrate that it had accepted the role and was acting as trustee of the two trusts. Although there was a good outcome in the current case, this situation demonstrates the need for practitioners to take care when setting up trusts so that this type of issue does not arise in the first place.

Who owned the Victoria St property?

The ownership of Victoria St was an issue because the property was originally purchased in the names of Giuseppe and Norma. Settlement occurred in November 1977, which was after the execution of the 1977 deeds but prior to the corporate trustee's incorporation. Giuseppe and Norma initially became the joint registered proprietors of Victoria St, and Norma became the sole registered proprietor in 1991 by way of survivorship after Giuseppe's death.

The issue was whether the property became held on the original trusts in the late seventies. There was an unsigned declaration of trust over that property that, if it had been signed, was to declare that Giuseppe and Norma held Victoria St for the corporate trustee for its use and benefit.

The submission made to the court was that there was sufficient other evidence to infer an intent that Victoria St was to be held for the benefit of the corporate trustee as trustee. Giuseppe, prior to his death, had made statements that Victoria St was held for the original trusts. Norma also gave evidence that the property was intended to be trust property and she was unsure why it was not held in the corporate trustee's name. The court was satisfied based on this evidence and a range of other documentary evidence, including financial statements and tax returns, that Victoria St was held for the trusts. There was a question of whether Victoria St was held by Norma's estate on a sub-trust for the corporate trustee or was just held in a single trust as delegate of the trustee, similar to the custodian arrangement in *Commissioner of State Revenue v Lend Lease Funds Management Pty Ltd*.[7] The court found that the property was held on a separate sub-trust. Specifically, the court found that Norma's estate held Victoria St on a bare trust for ING which, in turn, held that equitable interest on trust for the beneficiaries of the original trusts. The court rejected the delegate analysis as there was insufficient evidence to support it.

Formal requirements for an enforceable declaration of trust

Under s 53(1)(b) of the *Property Law Act 1958* (Vic), a declaration of trust respecting any land or any interest in it must be "manifested and proved by some writing signed by some person who is able to declare such trust". That is necessary so that the trust is enforceable.[8] Other jurisdictions have similar legislation, which is based on the Statute of Frauds. These requirements were an issue for the two trusts because there were no written, signed declarations of trust in respect of Victoria St or the other properties.

There are a number of principles that govern the formal requirements for s 53(1)(b). The trust does not need to be created in writing, only "manifested and proved" by such.[9] It is sufficient if the writing comes into existence after the trust.[10] The beneficial owner of the relevant property is the person who is able to declare a trust.[11] What is required is a written record that sufficiently evidences the trust and its terms, that is, the declaration of trust itself does not need to be in writing.[12] This can be a combination of documents and informal writing such as correspondence, or an affidavit may also suffice, even if it comes into existence well after the declaration of trust.[13]

Importantly, though, the declaration of trust itself needs to be proved separately from meeting the requirements of s 53(1)(b). That can be done by inference and oral statements. The court was satisfied that the declarations of trust had been proved in respect of Victoria St and the other properties based on financial records and recollections of the witnesses. The court also accepted that the affidavit evidence from Norma, as owner of Victoria St and as a director of the corporate trustee, could meet the formal requirements of signed, written documents proving the declarations of trust. In addition, there was a 1989 lease of Victoria St that had the corporate trustee's seal impressed on it, and financial statements and income tax returns that had been signed by directors and that showed the properties as assets of the two trusts held in equal shares.

In summary, practitioners should take care that they meet the requirements of s 53(1)(b) or its equivalents in other states/territories when a client purchases property for a trust to avoid having to later attempt to retrospectively prove the declaration of trust, or worse, ending up with a potentially unenforceable trust and the resultant tax problems that may produce.

Vesting of the original trusts and the 1991 deeds

Vesting

One of the two trusts had vested in 1988 and the other in 1991, but the trusts continued to be administered in the same manner until mid-1991 when the 1991 deeds were executed. The first issue was what happened on vesting of the trusts. The court accepted that the trusts did not immediately cease to exist and new bare trusts did not come into existence over the trusts' assets on vesting. The assets continued to be held on the same trusts and on the same terms after vesting.[14]

Execution of the 1991 deeds

The next issue was what impact the 1991 deeds had on those continuing trusts. The 1977 deeds each contained the following power of amendment:[15]

> "8. Either the Trustee or the person or persons who for the time being have power to appoint new or additional Trustees hereof may at any time or times alter vary or rescind or add to in any way all or any of the trusts provisions and conditions herein contained and in particular and without derogating from the generality of the foregoing provisions by declaring in favour of any other issue of the said Giuseppe Valentini in addition to or in substitution for the Original Beneficiary any other trusts of the Trust Fund and the income thereof.

PROVIDED that every such alteration variation rescission or addition shall be by deed executed by the person or persons making the same and if not made by the Trustee shall be delivered to the Trustee before it shall take effect.

AND PROVIDED FURTHER that no such alteration, variation rescission or addition shall have any force or effect if it would have the result of vesting in the Settlor or the Trustee or either of them any beneficial interest in the Trust Fund or the income therefrom."

The question was whether the power of amendment could be exercised in 1991 to extend the vesting date of the trusts and to make other changes to the class of beneficiaries and administrative provisions since the trusts had both vested. On the ATO's view in TR 2018/6, such a power of amendment could not be exercised to extend the vesting date once a trust had vested.

There is a question then as to what powers can be exercised by a trustee after a trust has already vested. In *Hancock v Rinehart*,[16] the following comments were made regarding the functions of the trustee after vesting of a trust:

> "The advantages and disadvantages of the competing proposals must be seen in the context of the functions that the trustee will be required to discharge. Because the Trust has now vested, those functions no longer include all the broad discretionary powers that the trust deed conferred in the trustee. In particular, the trustee no longer has any discretion to distribute the income or capital of the Trust other than equally between the beneficiaries. Other than receiving and distributing income and (if and when called for) capital, equally between the four beneficiaries, the functions of the trustee are likely to be limited to reviewing the books and records in relation to the past administration of the Trust, taking any action in that respect that may be in the interests of the Trust, and enforcing the rights of the Trust as a shareholder in HPPL. Thus the remaining functions of the trustee are neither extensive, nor onerous; they do not involve such a discretionary component as would enable the trustee to favour one beneficiary over the others; but they do involve at least monitoring, and potentially asserting, the interests of the Trust against the outgoing trustee Mrs Rinehart, and her company HPPL."

Those comments suggest that a trustee's function is quite limited and is unlikely to extend to being able to exercise a power of amendment, at least not to extend the vesting date of a trust. The following comments in *Clay v James*[17] possibly suggest a wider function of a trustee after vesting:

> "**1.7 Whether the power conferred by clause 7(a) on the Appointor to remove Trustees and appoint new Trustees ceased at the end of the Trust Period**
>
> 22 This question obtains its significance in virtue of the fact that each of the trustees, that is, the present trustees, was appointed after the expiration of the trust period on 10 June 1974. Mr James was appointed on 28 February 1976, Mr Karlson on 1 March 1984 and Ms Walker on 24 January 1987. Each of the appointments was made by one of the original trustees, Mr Speed, in whom there was vested by cl 7(a) of the settlement the power of removal and appointment.
>
> 23 I can see no reason in principle and I have been referred to no authority which is to the effect that the power of appointment and removal of trustees terminates on a vesting of the trust. It is a question of intention to be ascertained upon a proper construction of the trust deed. There is nothing in the deed itself which limits the duration of the power of appointment and removal and there would seem to me to be no reason to attribute to the parties to the deed an intention to limit the duration of the power to any period less than the period during which trustees still have duties to perform.
>
> 24 I can see no reason why the appointor under a settlement should not have the power to, for example, appoint new trustees after a vesting for the purposes of winding up the trust. It is not to the point that this is not what Mr Speed purported to do in the exercise of his power to appoint the present trustees. That the only duties which trustees had to perform after a vesting date were the duties involving in winding up the trust does not provide a basis for a contention that the power of appointment itself did not survive the vesting date. The trust deed did not stand cancelled or become void on that date."

The corporate trustee pushed for a wider view of a trustee's powers after vesting in *Re McGowan and Valentini Trusts*. The submissions put to the court included a submission that the power of amendment in the 1977 deeds was not, by its terms, limited in time and so should not have such a limitation placed on it by prohibiting it to be exercised after vesting. However, it was accepted by the corporate trustee that there was an inconsistency between this argument and the trusts having vested because the amendments would prevent the beneficiaries with interests on vesting from taking those interests and the trusts would revert to discretionary trusts with a wider class of discretionary objects. The corporate trustee sought to overcome this difficulty by relying on the principle in *Saunders v Vautier*.[18] That principle ordinarily means that, if all beneficiaries with full capacity who have an absolute entitlement to a trust fund consent, they can bring the trust to an end and call for distribution of its assets to them. There is some authority that suggests that the principle can extend to such beneficiaries also consenting together to amend a trust deed.[19] The corporate trustee relied on that principle to argue that, as Anna and Peter (the beneficiaries with interests on vesting) had consented to the 1991 deeds, the power of amendment had been validly exercised by those deeds.

The court accepted these arguments and found that the power of amendment could be exercised after vesting, for the benefit of and with the consent of Anna and Peter, to validly extend the vesting dates of the trusts and amend the class of discretionary beneficiaries and make other changes to the administrative provisions of the trusts. The 1991 deeds were therefore valid.

Continuation of the trusts

The final issue in the case was whether, having validly amended the trusts by the 1991 deeds, the same trusts continued in existence after those deeds were executed or whether new trusts were created. In other words, the question was whether the 1991 deeds had resettled the trusts from a trusts law perspective.

The corporate trustee's position was that, if the power of amendment could be validly exercised, its exercise by the 1991 deeds must have resulted in a mere continuation of the original trusts. First, that position was based on *FCT v Commercial Nominees of Australia Ltd*[20] and *FCT v Clark*[21] which, together, appear to accept that amendments to a trust deed validly made pursuant to a power of amendment should not result in a new trust being created where there is a sufficient degree of continuity of trust property, beneficiaries, and the terms of the trust.

Second, the corporate trustee relied on English authorities[22] that suggested that, where a trust deed was amended pursuant to the consent principle in *Saunders v Vautier*, a new trust was not necessarily created on amendment.

Finally, the corporate trustee contended that there was no change in the "substratum" of the trusts. The "substratum" of a trust is essentially the purpose of the original trust. The original trusts in this case were set up to benefit particular family members. The amendments to the original trusts in the 1991 deeds were still aimed at benefiting members of the same family, although with a wider class of family members. Consequently, there was no destruction of the substratum of the trusts.

The court accepted these arguments and found that, in substance, the variations that were made by the 1991 deeds, including the extension of the vesting dates, did not bring the original trusts to an end. Those original trusts continued. The court found that the 1991 deeds were executed pursuant to specified powers of amendment so the varied terms of the trusts were traceable to the settlor's intentions as expressed in the 1977 deeds.

These findings demonstrate that it is now possible, following *Clark's* case, for significant amendments to be made to a trust deed under a power of amendment without creating a new trust and triggering adverse tax outcomes. That gives practitioners much greater flexibility when the need arises to make alterations to a trust deed.

Conclusion

The Commissioner's view in TR 2018/6 is that a trust cannot have its vesting date extended after it has already vested. *Re McGowan & Valentini Trusts* demonstrates that that position is not always correct. Where there is a wide power of amendment and consent by the beneficiaries in whose favour the trust vests, it may still be possible to extend the vesting date after vesting, as well as make other amendments to a trust deed. This assumes that the trust property has not yet been distributed to beneficiaries.

The case also highlights the greater flexibility that practitioners now have after *Clark's* case to amend trust deeds under a power of amendment without creating new trusts. That will not always be the case, but it does at least demonstrate that, in many situations, there would need to be very significant changes made to a trust before a new trust would arise and adverse tax consequences would happen.

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Disclaimer

The author is a barrister and was Counsel acting in *Re McGowan & Valentini Trusts* [2021] VSC 154. The views expressed in this article are solely his own.

References

1 [2021] VSC 154.

2 Pursuant to r 54.02 of the *Supreme Court (General Civil Procedure) Rules 2015* (Vic).

3 *Kauter v Hilton* (1953) 90 CLR 86 at 97; *Korda v Australian Executor Trustees (SA) Ltd* [2015] HCA 6 at [7].

4 [2006] FCA 109 at [66].

5 *Companies Act 1981* (Cth) and *Companies (Application of Laws) Act 1981* (Vic).

6 [2018] NSWCATAD 133.

7 [2011] VSCA 182.

8 *Versaci v Rechichi* [2019] VSC 747 at [67].

9 *Byrnes v Kendle* [2011] HCA 26 at [48].

10 *Kafataris v DCT* [2015] FCA 874 at [30]; *Perpetual Executors and Trustees Association of Australia Ltd v Wright* [1917] HCA 27; *Extra Nominees Pty Ltd v Comptroller of Stamps (Vic)* (1990) 21 ATR 3664.

11 *Tierney v Wood* (1854) 52 ER 377 at 379-380; *ISPT Nominees Pty Ltd v Chief Commissioner of State Revenue* [2003] NSWSC 697 at [299].

12 *Gentsis v Forty-first Advocate Management Pty Ltd* [2004] VSC 398 at [89].

13 *Secretary, Department of Social Security v James* (1990) 95 ALR 615 at 622; *Draper v Official Trustee in Bankruptcy* [2006] FCAFC 157 at [39] and [159].

14 Based on *Clay v James* [2001] WASC 18.

15 [2021] VSC 154 at [110].

16 [2015] NSWSC 646 at [128].

17 [2001] WASC 18.

18 [1841] EngR 629.

19 *Re Dion Investments Pty Ltd* [2014] NSWCA 367 at [46].

20 [1999] FCA 1455.

21 [2011] FCAFC 5.

22 Including *Re Holmden's Settlement Trusts* [1968] AC 685; *Goulding v James* [1997] 2 All ER 239; *Re Holt's Settlement Trusts* [1969] 1 Ch 100; and *Wyndham v Egremont* [2009] EWHC 2076 (Ch).

Navigating transactions involving "pre-CGT" assets

by Elizabeth McNamara, Director, and Michael Dean, FTI, Partner, PwC

It is widely known (at least within the community of tax advisers) that capital gains arising from transactions involving pre-CGT assets are generally disregarded. However, there are two key provisions (Div 149 of the *Income Tax Assessment Act 1997* (Cth) and CGT event K6) which, via their application, could result in a tax liability arising to the taxpayer. Given the complexity of these provisions and the potential for transactions to escape the tax net, transactions involving pre-CGT assets remain a key focus area of the ATO. Taxpayers who are better prepared for transactions are far more likely to be able to proceed with confidence.

Introduction

Australian business founders and owners who commenced business in the 1970s and early 1980s are now approaching their retirement years, with many looking to exit via initial public offering or trade sale, or transition ownership to the next generation via succession or estate planning. Despite the capital gains tax (CGT) regime being introduced some 36 years ago, many successful founders and owners believe they have maintained pre-CGT status over shares or other assets, and therefore do not anticipate income tax payable on exit. However, typically, it is not that simple.

While a capital gain arising from a transaction involving a CGT asset acquired prior to 20 September 1985 is generally disregarded, there are two key provisions which, via their application, could result in a tax liability arising to the taxpayer. Given the complexity of these provisions and the potential for transactions to escape the tax net, transactions involving pre-CGT assets remain a key focus area of the ATO. Taxpayers who are better prepared for transactions are far more likely to be able to proceed with confidence.

This article considers the application of Div 149 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) and CGT event K6 to transactions involving pre-CGT assets.

Division 149

An asset which was acquired by a taxpayer prior to 20 September 1985 is a pre-CGT asset unless Div 149 ITAA97 (or one of the predecessor provisions) is triggered.[1]

When does Div 149 apply?

An asset stops being a pre-CGT asset and Div 149 is triggered at the first time (on or after 20 September 1985) the majority underlying interests in the asset are not held by the ultimate owners who held the majority underlying interests in the asset immediately prior to 20 September 1985.[2]

Accordingly, Div 149 impacts the pre-CGT status of assets held within structures (eg assets owned by companies and trusts) and has no application to pre-CGT assets held directly by individuals (eg shares in ultimate holding companies).

"Majority underlying interests" in a CGT asset is defined[3] to be:

- more than 50% of the beneficial interests that ultimate owners have (directly or indirectly) in the asset; and
- more than 50% of the beneficial interests that ultimate owners have (directly or indirectly) in any ordinary income that may be derived from the asset.

"Ultimate owners" are generally individuals but can also include not-for-profit companies (but not trusts or other structures) and certain government entities.[4]

For private companies and unit trusts (which are considered non-public entities for the purposes of Div 149),[5] this means that Div 149 is generally triggered at the first time (on or after 20 September 1985) the individuals who held the beneficial rights to income and capital of the company or trust immediately prior to 20 September 1985 cease to hold *more than* 50% of those interests.

Practical examples where Div 149 would not be triggered

IT 2530 confirms that a change in the proportions in which natural persons hold interests in an asset would not have a bearing on the application of s 160ZZS of the *Income Tax Assessment Act 1936* (Cth) (one of the predecessors of Div 149).

The example expressed in IT 2530 illustrates this point:

> "10. Immediately before 20 September 1985 underlying interests in an asset of a company were owned by four natural persons in the following proportions –
>
> A – 90%
>
> B – 5%
>
> C – 3%
>
> D – 2%.
>
> Following a change in the shareholding of the company after 20 September 1985, the underlying interests in the asset were owned by natural persons in the following proportions –
>
> A – 1%
>
> B – 2%
>
> C – 48%
>
> D – 0%
>
> E – 49%.
>
> The natural persons who owned underlying interests both immediately before 20 September 1985 and after the change in ownership were A, B and C. Immediately before 20 September 1985 A, B and C between them owned more than one half of the underlying interests (i.e., 98%). After the change A, B and C between them still owned more than one

> half of the underlying interests (i.e., 51%). Accordingly, more than one half of the underlying interests in the company's asset continued to be held by the same persons ..."

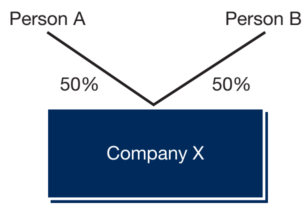
Notwithstanding that the above example was written with reference to s 160ZZS ITAA36, ss 149-30 and 149-35 ITAA97 express the same ideas as the former s 160ZZS, and therefore IT 2530 remains relevant.[6]

The application of Div 149 can be contrasted with the loss testing rules in Div 165 ITAA97 where the same share same interest rule[7] would apply to deny the availability of losses in the above scenario.

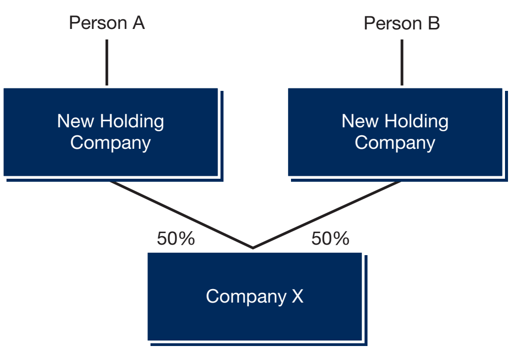
As the majority underlying interests look through structures to the ultimate individuals, transactions occurring in the ownership levels between the pre-CGT asset and the ultimate owners should also not trigger Div 149.

Example. Transferring shares to a holding company

On 19 September 1985, Person A holds 50% of the shares in Company X and Person B holds the other 50% of the shares in Company X.



On 30 June 2020, Person A transfers their shares in Company X to a new holding company which is wholly owned by Person A, and Person B transfers their shares in Company X to a new holding company which is wholly owned by Person B. Despite there being a complete change in the shareholding of Company X, tracing through to the ultimate owners of Company X gives the same ultimate individuals and therefore Div 149 would not be triggered.



In the above example, however, if Person A sold their interest in Company X to Person B, Div 149 would be triggered as only 50% of the underlying interest is maintained and not more than 50%. If, instead, Person A retained an interest in Company X, say, 0.1%, Div 149 would not be triggered. This factor should be considered when advising on shareholder transactions.

Relevantly, Div 149 does not impact the shares held by the individual ultimate shareholder, that is, in the above example, if Person A sold their interest in Company X, there would be no impact to the pre-CGT status of Person B's pre-CGT equity.

The examples above are simple for illustrative purposes. However, the analysis becomes more complicated where different classes of shares are issued or redeemed, and the potential change in ultimate owners that could arise from any change in share structure should be considered prior to implementation.

Exceptions to the "more than 50%" rule

There are a few limited circumstances in which Div 149 will allow for the pre-CGT status of assets to be maintained despite a change in 50% or more of the ultimate ownership, that is, on death and following the breakdown of a marriage or relationship if the roll-over provisions in Subdiv 126-A ITAA97 are applied.

In these circumstances, the ultimate owner who acquired the interest in the underlying assets because of the death of a person or a Subdiv 126-A roll-over is treated as "standing in the shoes" of the former owner.[8]

Example. Exception to the "more than 50%" rule due to death

Vivian held 60% of the shares in a company on 19 September 1985. On 1 April 2021, following her death, her shares passed to her daughter, Jane.

Under the CGT provisions, for the purposes of determining any future capital gain or loss on the disposal of the shares, Jane will be taken to have acquired the shares on 1 April 2021 for their market value at that date.[9] However, in relation to the pre-CGT assets held by the company, Div 149 applies as if Jane had owned the shares in the company at the time Vivian had owned the shares. That is, Div 149 is not triggered because of shares passing on the death of a former holder.

Tracing through discretionary trusts

Under ordinary legal concepts, where there is a discretionary trust, no beneficiary is entitled to income or capital of the trust until the trustee exercises its discretion to distribute income or to make an appointment of capital. Because the beneficiary of a discretionary trust does not hold an interest in any asset of the trust or in the ordinary income derived from the asset until the trustee's discretion is exercised, it would not be possible for a discretionary trust to satisfy the continuing majority underlying interests test in s 149-30(1) ITAA97.

However, the Commissioner, in IT 2340, applies a "look-through" approach to discretionary trusts, taking into consideration the way in which discretionary powers of the trustee are in fact exercised. The Commissioner's views are expressed as follows:

> "5. In relation to what are generally referred to as discretionary trusts, i.e., family trusts, the trustees of which have discretionary powers as to the distribution of trust income or property to beneficiaries, in considering the question of whether majority underlying interests have been maintained in the assets of the trust it will be relevant to take into account the way in which the discretionary powers of the trustees are in fact exercised.
>
> 6. Where a trustee continues to administer a trust for the benefit of members of a particular family, for example, it will not bring section 160ZZS into application merely because distributions to family members who are beneficiaries are made in such amounts and to such

> of those beneficiaries as the trustee determines in the exercise of his discretion.
>
> 7. In such a case the Commissioner would, in terms of sub-section 160ZZS(1), find it reasonable to assume that for all practical purposes the majority underlying interests in the trust assets have not changed. That is consistent with the role of the section to close potential avenues for avoidance of tax in cases where there is a substantial change in underlying ownership of assets and the legislative guidance contained in Subdivision G of Division 3 of Part III of the Act. On that basis, trust assets acquired by the trustee before 20 September 1985 would remain outside the scope of the capital gains and losses provisions of the Act.
>
> 8. On the other hand where, by the exercise of a trustee's discretionary powers to appoint beneficiaries or by amendment of the trust deed, there is in practical effect a change of 50% or more in the underlying interests in the trust assets – such as where the members of a new family are substituted as recipients of distributions from the trust in place of persons who were formerly the object of such distributions – the section would have its intended application as described."

The Commissioner has considered the application of Div 149 in the context of ownership interests held through discretionary trusts in several private binding rulings.

It is generally accepted that, in circumstances where a pre-CGT asset has been held by a discretionary trust since before 20 September 1985 and there have been no amendments to the trust deed since that time, Div 149 should not be triggered.[10]

More complicated examples, such as where individuals transfer shares to their family trusts,[11] where there are amendments to the trust deed to expand or contract beneficiaries,[12] or where individuals transfer shares to family trusts controlled by other family members, should all be considered on their specific facts and circumstances.

While existing private binding rulings give an indication of the Commissioner's position, a private binding ruling is only binding on the ATO as it applies to the entity that requested the ruling and does not bind the ATO in relation to other taxpayers. Given the complexity of the interaction between the operation of discretionary trusts and the application of Div 149, taxpayers should consider engaging with the ATO by way of early engagement or private binding ruling.

Division 149 and dividend access shares

The Commissioner has taken a similar position to that in IT 2340 in relation to dividend access shares. Share structures with discretionary elements that were in existence prior to 20 September 1985, and with no change to shareholdings, should not trigger Div 149 merely due to the application of that discretion.[13] However, the issue of new shares that have discretionary rights to dividends after 20 September 1985 is likely to trigger Div 149.[14]

Implications of assets ceasing to be pre-CGT assets

When Div 149 is triggered, the CGT asset will cease to be a pre-CGT asset on that date. The market value of the asset on that date will form part of the first element of the asset's CGT cost base,[15] and the company or trust holding the former pre-CGT assets will be taken to have acquired those assets on the date Div 149 was triggered.[16] Therefore, any capital gain arising on a disposal of a former pre-CGT asset will be subject to Australian income tax.

Examples where Div 149 can be unintentionally triggered

Transactions involving a 50% change in shareholding can trigger Div 149 (see example above). However, ensuring that a shareholder maintains a small percentage shareholding (eg 0.1%) may protect the pre-CGT status of underlying assets for the remaining shareholders.

In a succession scenario, where a shareholder would like to pass ownership of the family business to their children, a transfer of shares during life would trigger Div 149, whereas a transfer to their children as part of their estate on death would not.

Following on with the succession scenario, if the founding shareholders transferred the shares held individually to their respective family discretionary trusts, they may not trigger Div 149. The ATO has issued some positive private binding rulings[17] with similar circumstances. However, for reliance, a taxpayer should seek their own ruling prior to executing any transfers.

As with all tax planning, it is essential that taxpayers consider how the anti-avoidance provisions may apply to their specific facts and circumstances, and, where appropriate, they should engage with the ATO at an early stage.

> *"Given the complexity ... taxpayers should consider engaging with the ATO by way of early engagement or private binding ruling."*

CGT event K6

While Div 149 addresses whether a pre-CGT asset held within a structure remains a pre-CGT asset, CGT event K6 looks at whether a tax liability could arise to the owner of a pre-CGT interest in an entity where certain CGT events occur in relation to those interests.

When CGT event K6 applies

CGT event K6 applies as an anti-avoidance provision to counter the avoidance of CGT liabilities that would otherwise arise where a holder of pre-CGT interests in a company or trust holding post-CGT assets of significant value could choose to sell the pre-CGT shares or units instead of the underlying post-CGT assets.

CGT event K6 applies when:[18]

- a taxpayer owns shares in a company or an interest in a trust which was acquired before 20 September 1985;
- CGT event A1, C2, E1, E2, E3, E5, E6, E7, E8, J1 or K3 happens in relation to the shares or interest;
- there is no roll-over for the other CGT event; and
- just before the other CGT event happened:

- the market value of property of the company or trust (that is not its trading stock) that was acquired on or after 20 September 1985; or
- the market value of interests that the company or trust owned through interposed companies or trusts in property (except trading stock) that was acquired on or after 20 September 1985,

is at least 75% of the net value of the company or trust. This is commonly referred to as the 75% test.

The time of CGT event K6 is when the other relevant CGT event occurs.[19]

When CGT event K6 occurs, the capital gain is equal to that part of the capital proceeds that is reasonably attributable to the amount by which the market value of the post-CGT property (other than trading stock) is more than the cost base of that property.[20] You cannot make a capital loss.

The net value of a company or trust is the amount by which the sum of the market values of the assets of the entity exceeds the sum of its liabilities.[21] When considering the net value of an entity, an additional anti-avoidance provision applies to disregard: the discharge or release of any liabilities; or the acquisition of any asset if the discharge or release, or the acquisition, was done for a purpose that included ensuring that the 75% test would not be satisfied.[22]

The 75% test

It is relevant to note that the 75% test includes an "or" test that, first, considers only the property of the entity in question (s 104-230(2)(a) ITAA1997) and, second, considers interests owned by that entity through interposed companies or trusts (s 104-230(2)(b) ITAA97).

Both tests may give the same result (eg in single-tiered structures), but often result in varying outcomes when dealing with multi-tiered groups (discussed further below).

To avoid the application of CGT event K6, an entity would need to fall under the 75% threshold applying both tests.

While, at face value, the 75% test appears straightforward, there are a few nuances worth highlighting. The first is that the ratio is comparing the (gross) market value of post-CGT property with the *net value* of the company (ie including liabilities), so it is possible to exceed the 75% threshold in a company or trust holding minimal post-CGT property if the entity is highly leveraged.

Example. Single-tiered structure (s 104-230(2)(a))

Property of Company A	Market value
Cash	$1m
Land (pre-CGT)	$18m
Deferred tax asset	$17m
Borrowing	$16m

The first question to consider in this example is: what is "property"? The ATO provides guidance in TR 2004/18, stating that the term "property" has its ordinary legal meaning and does not mean "asset" or "CGT asset".

TR 2004/18 goes on to state:

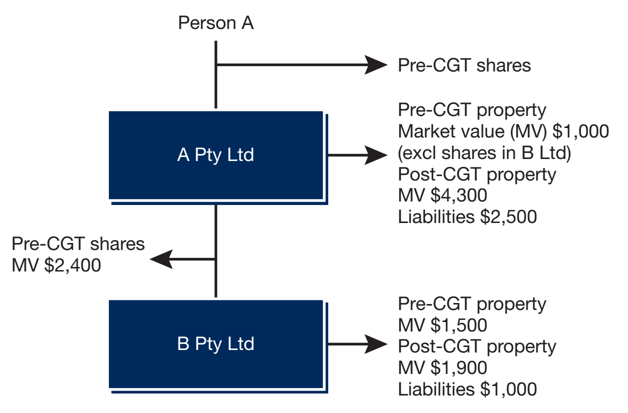
> "51. The term 'property' is not defined for the purposes of CGT event K6 although trading stock is specifically excluded. Property in section 104-230 has its ordinary legal meaning (see *ICI Australia Ltd v. Commissioner of Taxation*;[23] *Hepples v. Commissioner of Taxation*;[24] *R v. Toohey; Ex parte Meneling Station Pty Ltd*;[25] *Naval, Military and Airforce Club of South Australia Inc v. Commissioner of Taxation*[26]).
>
> 52. The *Macquarie Dictionary* (3rd revised edn) defines 'property' to mean 'that which one owns; the possession or possessions of a particular owner'. The term 'property' in its context in section 104-230 is property owned by either the company referred to in paragraph 104-230(2)(a) or by lower tier companies.
>
> 53. It extends to any kind of property. It covers most CGT assets, including pre-CGT assets, but does not include a CGT asset that is not property. It can include such things as land and buildings, shares in a company, units in a unit trust, options, debts owed to the company, interests in assets and goodwill. Motor vehicles, in relation to which capital gains or capital losses are disregarded for CGT purposes, also constitute 'property'."

When determining the net value of the company, the ATO provides in TR 2004/18 that the term "assets" in the context of the expression "net value" in s 104-230(2) ITAA97 means the property and other economic resources owned by the company that can be turned to account, and that a "liability" has its ordinary meaning and extends to a legally enforceable debt but not to a contingent liability or to a future obligation or expectancy.

Applying this to the above example, cash and land (assuming it is not trading stock) would both be "property", whereas a deferred tax asset is not "property". The market value of post-CGT property would be $1m and the net value of the company would be $3m ($19m – $16m), resulting in a post-CGT property net value ratio equal to 33.3%. In this instance, the 75% test would not be satisfied.

The second nuance is that the second part of the 75% test looks at the market value of post-CGT property owned through interposed entities compared to the net value of the company. That is, the numerator does not include post-CGT property held by the head company of a multi-tiered structure, and only includes post-CGT property owned *through* interposed entities. However, the test still compares the value of post-CGT property owned through interposed entities to the net value of the company as a whole.

Example. Multi-tiered structure (s 104-230(2)(a) and (b))



In this example, the first test looks only at the post-CGT property of A Pty Ltd ($4,300) as a proportion of the net value of A Pty Ltd (($5,300 – $2,500 + $2,400) = $5,200), which would satisfy the 75% test ($4,300/$5,200 = 82.69%).

When applying the second test, the post-CGT property owned by interposed company B Pty Ltd ($1,900) as a proportion of the net value of the company ($5,200) gives 36.54%, which does not satisfy the 75% test.

As one test is satisfied, CGT event K6 is triggered, and Person A must take into account the property referred to in s 104-230(2)(a) ITAA97 when determining the capital gain apportionment under s 104-230(6). If both tests were satisfied, the taxpayer would be required to calculate the capital gain apportionment, taking into account the property referred to in each of s 104-230 (2)(a) and (b) (separately) and then disregard the lower gain.

Because the two tests compare different groups of property as a proportion of the (single) net value, a different mix of assets between A Pty Ltd and B Pty Ltd could result in neither (or both) tests being satisfied (noting that the anti-avoidance rules in s 104-230(8) may disregard any transfers done to ensure that the 75% test is not satisfied).

Additional guidance in relation to certain types of property

Trading stock

The 75% test specifically excludes trading stock from the calculation of the post-CGT property held. However, the definition of "net value" includes the market value of the property owned by the company less its liabilities. Accordingly, the value of trading stock is included in the calculation of the net value of the company.

This is confirmed by the Commissioner in PBR 1051635988256 (dated 18 February 2020):

> "For both limbs of the 75% test, the 'net value' of the test company is the amount by which the sum of the market values of its assets exceeds the sum of its liabilities (subsection 995-1(1) of the ITAA 1997). In the context of 'net value', the word 'assets' means property and other economic resources of the company that the entity is capable of turning to account, even if they are not property (paragraph 20 of TR 2004/18).
>
> Accordingly, for the purposes of calculating an entity's net value, 'assets' would include trading stock, off-balance sheet assets (e.g. depreciated plant and internally generated goodwill) and pre-CGT assets. In other words, it would cover all the entity's CGT assets, off-balance sheet assets and identifiable assets in terms of accounting standards. However, it does not include 'tax benefits' and non-proprietary assets."

Consequently, care should be taken when considering whether company assets are held for purposes of manufacture, sale or exchange in the ordinary course of a business and therefore should be excluded from the calculation of post-CGT property.

Property that was pre-CGT but for Div 149

As addressed earlier in this article, when Div 149 is triggered, the entity's pre-CGT assets will cease to be pre-CGT assets on that date. The market value of an asset on that date will form part of the first element of the asset's CGT cost base and the company or trust holding the former pre-CGT assets will be taken to have acquired those assets on the date Div 149 was triggered.

While a literal interpretation of the CGT legislation would suggest assets that are post-CGT assets due to the operation of Div 149 would be included as post-CGT property in a CGT event K6 calculation, the Commissioner allows assets that are deemed to be acquired post-CGT in accordance with Div 149 to be excluded from the calculation of post-CGT property.[27]

Goodwill

It is common to see in transactions involving operating entities where a material source of the value is attributable to goodwill. It is therefore necessary, for the purposes of CGT event K6, to determine whether the goodwill of a business is a pre-CGT or post-CGT asset. This invariably requires careful consideration of what the business of the entity was prior to 20 September 1985 and comparing it to the business that the entity carries on at the date of the transactions.

The Commissioner acknowledges that the goodwill of a business that commenced prior to 20 September 1985 can remain a single pre-CGT asset *provided* the same business continues to be carried on even though the sources of goodwill may change or there are fluctuations in goodwill during the life of the business.[28] However, it is possible that a business can change so much that it can no longer be said to be the same business, and where this occurs, the original (pre-CGT) goodwill ceases to exist and a new CGT asset (the goodwill of the new business) is acquired.[29]

When comparing the business that is being carried on at the time CGT event K6 is triggered to the business carried on prior to 20 September 1985, the Commissioner notes in TR 1999/16 that the business does not have to be identical, and if the essential nature or character is not changed, the business remains the same. That is, the test is not the same as the "same business test" described in paras 12 and 13 of TR 1999/9 relating to satisfaction of the tax loss provisions in Div 165.[30]

Practically, however, this can be difficult to demonstrate due to the historic nature of the analysis required. The authors' experience is that many taxpayers no longer hold records evidencing the business of the company prior to 1985, and recollections of founders, along with original advisers and accountants, are not always clear.

In one experience, a taxpayer in the retail industry still held their original cash book, annual accounts, copies of print ads placed in newspapers, and copies of original clothing designs from the early 1980s, clearly demonstrating what the business was in the years leading up to 20 September 1985. The authors' experience is that this level of record-keeping is rare and working with a taxpayer to demonstrate what their business was in those early years can turn into a time-consuming forensic exercise, and therefore is best started well before an exit is on the horizon.

Calculation of the capital gain where the 75% test is passed

Where CGT event K6 applies, a taxpayer will make a capital gain equal to that part of the capital proceeds from the share or interest that is reasonably attributable to the amount by which the market value of the property referred to in s 104-230(2) is more than the sum of the cost bases of that property.[31]

This means that, if the 75% test is passed under both s 104-230(2)(a) and (2)(b), the taxpayer will be required to prepare two CGT calculations, separately taking into account the post-CGT property used in each calculation. It is the Commissioner's view that the lesser capital gain should be disregarded.[32]

If only one of the 75% tests is satisfied, the property referred to in that section in which the test is satisfied is used to calculate the capital gain.

What constitutes a *reasonable attribution of capital proceeds* for the purposes of calculating the capital gain will depend on the facts of each case. However, the Commissioner provides in TR 2004/18 a two-step approach[33] (outlined below), which the ATO considers to be reasonable in a single-tiered structure, although the Commissioner notes that the ATO would not accept a capital gain under the two-step approach if the result is manifestly and materially unreasonable.

Step 1. Determine how much of the capital proceeds actually relates to the post-CGT property: This step requires assumptions to be made about:

– the extent to which the post-CGT property and the remaining property of the company, such as its pre-CGT property and trading stock, are reflected in the capital proceeds; and

– how the liabilities in existence relate to the post-CGT property and the remaining property of the company.

Applying a proportionate basis would see the capital proceeds being apportioned as follows:

$$\text{Step 1 amount} = \text{Capital proceeds} \times \frac{\text{Market value of post CGT property}}{\text{Market value of all property}}$$

The post-CGT property included in the numerator is the property taken into account under s 104-230(2)(a), and the property included in the denominator is all property owned by the company.

Step 2. Determine how much of the step 1 amount relates to the amount by which the market value of the post-CGT property exceeds the cost base of that property:

$$\text{Step 1 amount} \times \frac{\text{Market value excess}}{\text{Market value of post-CGT property}}$$

The market value excess is the amount by which the market value of the property (in s 104-230(2)(a) for the single-tiered example) is more than the sum of the cost bases of that property.

The market value of the post-CGT property is the sum of the market value of the property taken into account under s 104-230(2)(a).

The above steps can also be useful in determining a reasonable attribution of capital proceeds in multi-tiered structures. However, modification may be required following an analysis of the relevant facts to ensure that the outcome is reasonable.

The above steps assume that the company liabilities relate to the pre-CGT property and post-CGT property on a proportionate basis. Where a taxpayer is able to demonstrate that specific liabilities relate to solely to a relevant asset, they are able to modify the formula accordingly.[34]

In the context of a sale transaction, it is common for the purchaser to require the target company to be sold without related-party liabilities. Accordingly, it is common for taxpayers to clear (repay, forgive or otherwise extinguish) related-party liabilities prior to sale. Due to the nature of the CGT event K6 calculations, the release of intra-group assets and liabilities can impact the resultant calculations, and advisers should bear in mind that the anti-avoidance provision in s 104-230(8) is not a "dominant" or "sole purpose" test. Therefore, discharge of liabilities that have a commercial purpose can still be ignored if a purpose also includes ensuring that the 75% test is not passed.

Interaction with other provisions

Tax consolidation

Division 149

When determining the allocable cost amount for a joining entity, the step 1 amount is the cost of the membership interests in the joining entity held by members of the joined group,[35] which is generally its cost base unless the market value of the membership interest is less than the cost base.

Where Div 149 is triggered, the first element of the tax cost base of the asset becomes its market value as at that date,[36] and it would be reasonable to expect that, where a membership interest ceases to be a pre-CGT asset due to Div 149 in a group that subsequently consolidates, the market value at that date would form the step 1 amount.

However, Div 705 ITAA97 includes an adjustment to the tax cost setting amount where there is a loss of pre-CGT status of the membership interests in the joining entity.[37] The impact of s 705-57 ITAA97 is that the tax cost setting amount of certain revenue assets (eg trading stock, depreciables) is effectively capped at their terminating values and the excess tax cost setting amount is converted to a capital loss.[38]

CGT event K6

Within a tax consolidated group, a pre-CGT asset can be transferred from one subsidiary member of the group to another and remain a pre-CGT asset of the head company. However, it is important to note that the single entity rule[39] and entry history rule[40] only apply for head company or entity core purposes (broadly, when working out the head company or subsidiary's liability for income tax for an income year).

CGT event K6 is a shareholder liability and ignoring the single entity rule would result in pre-CGT assets (in the eyes of the head company) that have been legally transferred between group members no longer being pre-CGT property for the purposes of the CGT event K6 calculation. That is, despite the head company applying the single entity rule and ignoring the transfer, from a shareholder perspective when applying CGT event K6, the legal holder of the asset did not acquire that asset prior to 20 September 1985.

Furthermore, where the 75% test has been passed, a taxpayer is required to determine the market value excess with reference to the tax cost base of post-CGT property. The authors' most recent practical experience is that the ATO may accept the tax cost base of the assets in accordance with the tax consolidation rules (eg ignoring transfers within the consolidated group and set in accordance with the allocable cost allocation calculations) being used for these calculations. However, the legislation appears deficient in this regard.

Although there are provisions that seek to address situations where a subsidiary member of a tax consolidated group with a pre-CGT proportion is sold,[41] it is less clear whether CGT event K6 could apply where the pre-CGT factor rules apply to the subsidiary member.[42]

Roll-overs

This article does not detail the requirements of Subdiv 122-A, Subdiv 124-M or Div 615 ITAA97 roll-overs. However, it is important to note that, where the original shares subject to a Div 615 or Subdiv 122-A roll-over are pre-CGT assets, the shares in the new company may retain their pre-CGT status.[43] This is relevant when reviewing corporate records to ascertain whether shares in a company could be pre-CGT shares, as a company incorporated in 2021, for example, could still have pre-CGT shares on issue if the shares were issued as part of a Subdiv 122-A roll-over of a pre-CGT asset.[44]

Beware of Subdiv 124-M

Critically, a roll-over of pre-CGT shares under the provisions in Subdiv 124-M ITAA97 would not maintain pre-CGT status and the newly issued shares would be post-CGT assets.[45] It is important, therefore, to understand the details of any historical restructures prior to advising on a current transaction.

Where a capital gain arises as a result of CGT event K6, if the taxpayer had acquired the share or unit after 20 September 1985 and could have chosen a roll-over for the other CGT event under Subdiv 124-M, the capital gain is disregarded.[46] This is automatic and not a choice.

Ordinarily, if a taxpayer exchanges an interest that was acquired before 20 September 1985 for an interest in a replacement entity under an arrangement, the first element of the cost base and reduced cost base of the interest in the replacement entity is its market value just after it was acquired. However, where s 104-230(10) applies, the cost base and reduced cost base of the interest in the replacement entity is reduced by the amount of the CGT event K6 capital gain that is disregarded.[47]

Residency

CGT event I1 occurs when an individual or a company ceases to be an Australian resident.[48] CGT event I2 applies when a trust stops being a resident trust for CGT purposes.[49]

The relevant taxpayer is required to work out whether they have made a capital gain or capital loss for each CGT asset owned (except for taxable Australian property) just before ceasing to be a resident. However, a capital gain or loss made in relation to pre-CGT assets is disregarded.[50]

CGT event I1 and I2 are not CGT events that trigger the application of CGT event K6. Therefore, individuals, companies or trusts that cease to be Australian residents and hold pre-CGT interests in a company or trust that are not taxable Australian property will have a capital gain on departure disregarded, even if the majority of the underlying assets of the company or trust are post-CGT.

Residency remains a key focus area for the ATO, and taxpayers looking to migrate overseas and cease Australian tax residency should ensure that they are properly advised. Further, it is essential that taxpayers consider how the anti-avoidance provisions may apply to their specific facts and circumstances and, where appropriate, engage with the ATO at an early stage.

Death and CGT event K6

Division 128 ITAA97 sets out what happens when an individual dies and a CGT asset that they owned just before dying devolves to their legal personal representative or passes to a beneficiary of their estate.

Generally, Div 128 applies to disregard a capital gain or capital loss from a CGT event involving the passing of an asset to a beneficiary of a deceased estate.[51] However, importantly, this is not the case where the asset passes to a beneficiary who is an exempt entity, a trustee of a complying superannuation, or a foreign resident. In this situation, CGT event K3 is triggered. While a capital gain arising under CGT event K3 in relation to a pre-CGT asset is disregarded,[52] CGT event K3 is a trigger for CGT event K6.

Therefore, while a capital gain arising on pre-CGT shares passing to a resident beneficiary on the death of the former holder would be disregarded if those same shares instead passed to a foreign resident, CGT event K6 may be triggered via CGT event K3 and a capital gain may arise to the estate.[53]

Conclusion

Advising on transactions involving "pre-CGT" assets is often complex and typically requires in-depth analysis. Taxpayers often maintain that their shares or other assets are "pre-CGT" and should not result in any income tax payable on disposal. However, this is clearly not always the case.

The authors recommend that tax advisers engage with their clients prior to exit events, with a view towards reviewing and documenting the tax attributes of assets held within their clients' group. Taxpayers who are better prepared for transactions, and proactively engage with the ATO, are far more likely to be able to proceed with confidence.

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27 Paras 64 and 67 TR 2004/18.
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31 S 104-230(6) ITAA97.
32 Para 23 TR 2004/18.
33 Paras 27-33 TR 2004/18.
34 See example 6 in TR 2004/18.
35 S 705-65 ITAA97.
36 S 149-35(2) ITAA97.
37 S 705-57 ITAA97.
38 S 104-500 ITAA97.
39 S 701-1 ITAA97.
40 S 701-5 ITAA97.
41 Ss 711-65 and 711-75 ITAA97.
42 Pre-CGT factors were calculated for an entity (in which pre-CGT membership interests were held) that joined a consolidated group before 10 February 2010 and the head company did not make a choice to apply the new pre-CGT proportion rules to that entity.
43 Ss 122-40(3), 122-55, 122-60 and 124-90(4) ITAA97.
44 The following article comprehensively considers the CGT roll-over provisions and is worth reading: L Tapiolas, "Taking the CGT path less travelled", paper presented at The Tax Institute's 34th National Convention, March 2019.
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46 S 104-230(10) ITAA97.
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A Matter of Trusts

by Philippa Briglia, Sladen Legal

Fixed trusts and NALI

In addition to the "general" non-arm's length income provisions, special rules apply to distributions from a trust to a complying superannuation fund.

The non-arm's length income (NALI) provisions contained in s 295-550 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) can apply to income of a superannuation fund through either direct or indirect investments. An important type of NALI to be aware of when structuring superannuation fund investments is where the fund invests in a unit trust which does not meet the definition of a "fixed trust" for NALI purposes.

Legislative background

Under the ITAA97, a distribution from a trust is NALI of a complying superannuation fund if:

- the superannuation fund does not have a fixed entitlement to income from the trust (s 295-550(4)); or
- the superannuation fund has a fixed entitlement to income from the trust, which is derived under a scheme where the parties were not dealing with each at arm's length and either or both of the following applies:
  - the income is greater than might have been expected had the parties been dealing with each other at arm's length in relation to the scheme; and/or
  - from 1 July 2018, the loss, outgoing or expenditure (either revenue or capital in nature) incurred in acquiring the entitlement, or in gaining or producing that income, are less than (including a nil amount) those which might have been expected had the parties been dealing with each other at arm's length in relation to the scheme (s 295-550(5)).

It is clear from the above provisions that any distribution that a superannuation fund receives from a standard discretionary trust will be NALI, as a discretionary beneficiary by definition does not have a fixed entitlement.

What is not as clear is what will constitute a "fixed entitlement" for the purposes of s 295-550 as extracted above. "Fixed entitlement", as it appears in s 295-550, is not an asterisked term, indicating that it is not specifically defined under the ITAA97 for the purposes of that subsection. In the decision of *The Trustee for MH Ghali Superannuation Fund v FCT*[1] (discussed further below), the Administrative Appeals Tribunal considered that "fixed entitlement" in the precursor to the current NALI provisions takes the meaning provided in s 272-5 in Sch 2F to the *Income Tax Assessment Act 1936* (Cth) (ITAA36), which provides as follows:

> "(1) If, under a trust instrument, a beneficiary has a vested and indefeasible interest in a share of income of the trust that the trust derives from time to time, or of the capital of the trust, a beneficiary has a ***fixed entitlement*** to that share of the income or capital."

That is, the definition of "fixed entitlement" under s 272-5 of Sch 2F ITAA36 is very restrictive. This is to be contrasted with the ATO view, as discussed below.

ATO view in TR 2006/7

The ATO in TR 2006/7 considered the question of what constitutes a fixed entitlement in respect of the "special income" provisions of former s 273 ITAA36. The special income provisions were the precursor to the current form of NALI provisions in s 295-550.

In TR 2006/7, the key determinant as to whether the income is derived as a result of a fixed entitlement is whether the income was derived by way of the trustee or any other person exercising a discretion. In TR 2006/7, the ATO notes that, in its view:

- if a complying superannuation fund derives income from a trust by way of the trustee or any other person exercising a discretion, the income distributed will be special income (ie NALI); and
- a trust distribution to a complying superannuation fund, where the superannuation fund's entitlement to the distribution does not depend on the exercise of the trustee's or any other person's discretion, will not be special income (ie NALI).

In the explanatory reasons accompanying TR 2006/7, the ATO explains that:

> "*Trust distributions – 'fixed entitlement'*
>
> 208. Having regard to the statutory context, it is considered that the composite expression 'income derived … by virtue of a fixed entitlement to the income' is designed to test whether an amount of trust income that had been included in the assessable income of a superannuation entity under subsection 97(1) was included because the *entity had an interest in the income of the trust that was, at the very least, vested in interest, if not in possession***,** immediately before the amount was derived by the trustee.
>
> 209. To have an interest in the income of a trust estate*, a person must have a right with respect to the income of the trust that is susceptible to measurement*; a right merely to be considered as a potential recipient of income is not sufficient. An interest in the income of a trust estate *will be vested in interest if it is bound to take effect in possession at some time and is not contingent upon any event occurring* that may or may not take place. In contrast to a vested interest, a contingent interest will be one which gives no right at all unless or until some future event happens such as the exercise of a discretion by the trustee or some other person." (emphasis added)

This is a very different determination of fixed entitlement as to that adopted in other provisions of the tax law. In particular, as noted above, the interpretation of fixed entitlement in Sch 2F ITAA36 is very restrictive. The interpretation on the meaning of "fixed entitlement" as set out in TR 2006/7 is therefore more practical and pragmatic and far less restrictive than that adopted in other provisions of the tax law.

The ATO has confirmed that it is continuing to adhere to the interpretation in TR 2006/7 after the rewrite of the relevant provisions and the introduction of the concept of NALI replacing special income. This was confirmed in the minutes of an NTLG Superannuation Subcommittee meeting held in March 2010, where the ATO:

– reiterated that TR 2006/7 outlines that, even though a trust may not be a fixed trust for other income tax purposes, it may be a fixed trust for the purposes of the NALI rules; and
– confirmed that TR 2006/7 still provides the ATO view on what constitutes arm's length income even though it refers to the provisions in the ITAA36 which were relevant before 1 July 2007.

The Trustee for MH Ghali Superannuation Fund

There has been some doubt as to the interpretation of the "fixed entitlement" requirement as a result of the decision of the AAT in *The Trustee for MH Ghali Superannuation Fund v FCT* (*Ghali*).[1] In that decision, Senior Member Egon Fice considered that it was incorrect to say that there is no definition of "fixed entitlement".

He found that the meaning of the expression was provided for in the tax law in the trust loss rules in Sch 2F ITAA36. He stated:

> "27. Although Mr Tisher submitted that the expression *fixed entitlement* is not defined in ITAA 36, with respect, that is incorrect. ***The meaning of that expression was set out in Schedule 2F at Subdivision 272-A of ITAA 36 in the 2005 and 2006 income years and it remains in the current Act.*** Section 272-5 sets out the meaning of the expression *fixed entitlement* to a share of income or capital of a trust …
>
> 28. The question therefore in this case is whether the Unit Trust Deed grants a beneficiary of that trust ***a vested and indefeasible interest in a share of the income or capital of the trust.*** If it does, a unit holder has a fixed entitlement to a share of income or capital of the trust." (emphasis added)

Ghali decision impact statement

The ATO does not accept that the decision in *Ghali* stands as authority that the definition of "fixed entitlement" for the purposes of the NALI rules is as provided in Sch 2F ITAA36. In the decision impact statement on *Ghali*, the ATO states that neither of the parties appearing before the AAT advanced the view that the Sch 2F definition was applicable, and neither of the parties had the benefit of making submissions in respect of this issue.

As such, the ATO believes that its position in adopting a more purposive approach to the meaning of fixed entitlement as outlined in TR 2006/7 continues to be appropriate. The relevant extract from the decision impact statement is as follows:

> "*The meaning of 'fixed entitlement' in s 273*
>
> …
>
> The Tribunal concluded that 'fixed entitlement' in s 273 took its meaning from the definition in Schedule 2F to the 1936 Act.
>
> However, because *neither party advanced the view that the Schedule 2F definition was applicable, the Tribunal did not have the benefit of submissions about the elements of the definition of fixed entitlement in Schedule 2F.*
>
> Section 272-140 says that 'in this Schedule [2F]' fixed entitlement has the meaning given by Subdivision 272-A. Fixed entitlement is not defined in s 6 of the 1936 Act, and there is nothing in s 273 that suggests that the Schedule 2F definition applies. On that basis, the Commissioner respectfully maintains the view that the definition does not apply for the purposes of s 273. The Commissioner considers that this is a more favourable approach for superannuation funds, because the fixed entitlement test as set out in TR 2006/7 might be expected to be satisfied in more circumstances than the Schedule 2F test.
>
> …
>
> The Commissioner proposes to adhere to his existing view that the Schedule 2F definition is inapplicable for the purposes of s 273. Although not considered by the Tribunal, we note that *the Commissioner's view is that the Schedule 2F definition also does not apply for the purposes of s 295-550: see TR 2006/7 and the minutes to NTLG Superannuation Subcommittee meeting of March 2010.*" (emphasis added)

Current position

As a result of the decision impact statement, when determining whether a superannuation fund holds a fixed entitlement to the income of a trust for NALI purposes, the applicable test (under the ATO's view) is whether the superannuation fund's entitlement to the distribution depends on the exercise of the trustee's or any other person's discretion.

If the superannuation fund's entitlement to the distribution does *not* depend on the exercise of the trustee's or any other person's discretion, the superannuation fund will invariably have a fixed entitlement to the income of the trust for the purposes of s 295-550(4) ITAA97.

To determine whether such a discretion exists, the trust deed for the trust should be carefully reviewed to ensure that the unitholder's entitlement to the income of the trust is indeed "fixed", ie that it does not depend on the exercise of the trustee's or any other person's discretion. Some older unit trust deeds commonly have a wide range of unit classes, some of which have "fixed rights" and some of which have rights which depend on the exercise of a discretion. Even where no "discretionary" units have been issued (and therefore the discretionary powers attached to them are essentially rendered inoperative), it is still not ideal for the unit trust trustee to have the ability to issue "discretionary style" units under the trust deed where a superannuation fund is a unitholder.

In addition, some superannuation funds inadvertently hold units in "hybrid" unit trusts under which the trustee has discretion to distribute income, capital or capital gains to a discretionary class. Such a hybrid unit trust is unlikely to create a fixed entitlement to income, even where such a discretion has never been exercised. In such circumstances, the parties to the unit trust could consider whether the deed could be rectified or amended to create a fixed entitlement.

Conclusion

From a NALI fixed entitlement perspective, the safest course is for a superannuation fund unitholder to only hold units in "normal" fixed unit trusts. That is, the trust deed for the unit trust should provide that all unitholders will have a fixed entitlement to the income and capital of the unit trust in accordance with their proportionate unit holdings.

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Reference

1 [2012] AATA 527.

Superannuation

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SMSF wills versus BDBNs

SMSF wills are subject to significant legal risk, and therefore BDBNs are generally preferred. Of course, all BDBN strategies require a strong foundation in the governing rules of the SMSF.

Overview

SMSF wills have become a topical issue in recent times as some claim they have certain advantages over binding death benefit nominations (BDBNs). This article briefly examines SMSF wills and compares them to BDBNs.

In broad terms, it is the authors' view that SMSF wills are subject to significant legal risk, and therefore, BDBNs are generally preferred.

What is an SMSF will?

There is considerable variability to the strategies that are given the label "SMSF will" and the methods of how they are intended to operate. Accordingly, what one supplier refers to as an "SMSF will" can vary significantly compared to another supplier's usage of that term. For example, there can be important differences in relation to the following aspects, among other things:

- the formality requirements of how an SMSF will must be documented and executed (including witnessing requirements) and whether trustee notification is required;
- the extent to which a member's wishes are effectively embedded in hard-wired language in the SMSF deed;
- the priority rules that apply to conflicts between SMSF wills, BDBNs and pension nominations; and
- the rules regarding revocation of an SMSF will compared to the revocation of a BDBN or a reversionary pension nomination.

Some suppliers describe an SMSF will, in general terms, as the directions made by a member to deal with their death benefit and regulating who gets to act for and on behalf of a deceased member. However, the effectiveness of each SMSF will strategy depends on the particular documentation and whether the strategy is legally effective.

Some SMSF wills require recording the member's instructions via a deed of variation to the SMSF deed, or otherwise via separate documents that seek to limit the future exercise of trustee discretion. Moreover, some SMSF wills allow for instructions to be given by an alternative decision-maker in relation to the payment of a death benefit. In addition, some SMSF deeds include hard-wired language, sometimes termed "death benefit rules" or other "special rules", that deal with the payment of death benefits. (For ease of expression and for the purposes of making the comparison with BDBNs, this article does not distinguish between SMSF wills and "death benefit rules".)

Typically, SMSF deeds that include SMSF will powers provide that an SMSF will takes priority over other forms of directions to the trustee, such as a BDBN.

As you will appreciate from the above observations, the term "SMSF will" does not have a fixed normative meaning. The term is a description for various SMSF succession planning strategies, typically based on the terminology used in the SMSF deed and related documents. While a BDBN also does not have a fixed normative meaning, SMSF members generally understand what a BDBN is.

So what is best: an SMSF will or a BDBN?

Some claim that a major advantage of SMSF wills is that they do not suffer from the uncertainties associated with the BDBN rules in the *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA93) and the *Superannuation Industry (Supervision) Regulations 1994* (Cth) (SISR94), particularly reg 6.17A SISR94. While SMSF wills are often drafted so that they are not subject to reg 6.17A, this is also the case with appropriately drafted BDBNs.

SMSF wills emerged as an alternative option to BDBNs due to perceived limitations relating to BDBNs. In particular, some considered that BDBNs may be limited to the three-year sunset period in reg 6.17A(7). Additionally, there was some concern that BDBNs could only be used to specify "who" but not "how" to pay a death benefit. Thus, SMSF wills and related strategies appeared to initially have some attraction over BDBNs.

However, since mid-1999 when BDBNs first became popular, there has been considerable litigation that has established what a BDBN can and cannot do. The key cases include *Donovan v Donovan*,[1] *Munro v Munro*,[2] *Cantor Management Services Pty Ltd v Booth*,[3] *Perry v Nicholson*,[4] *Re Narumon Pty Ltd*,[5] and *Hill v Zuda Pty Ltd*.[6] (Also, the ATO's view in SMSFD 2008/3 is instructive.)

As result of these cases, and other authorities, it is clear that SMSF BDBNs are not subject to reg 6.17A SISR94 or s 59 SISA93. Similarly, there is no longer any doubt that BDBNs can direct a fund trustee regarding how a death benefit must be paid, eg as a death benefit pension. Thus, a BDBN based on an SMSF deed that is appropriately drafted can be non-lapsing. Indeed, in the recent decision of *Hill v Zuda*, the Western Australian Court of Appeal confirmed that this is the settled legal position in all Australian jurisdictions.

It is also important to note that this position is consistent with the long-held ATO view set out in para 1 of SMSFD 2008/3:

> "Section 59 of the [SISA93] and regulation 6.17A of the [SISR94] do not apply to … (SMSFs). This means that the governing rules of an SMSF may permit members to make death benefit nominations that are binding on the trustee, whether or not in circumstances that accord with the rules in regulation 6.17A of the [SISR94]."

There may be some who say that the number of disputed cases involving BDBNs suggests that SMSF wills should be used in favour of BDBNs. However, it is the authors' view that the BDBN cases are all positive in providing guidance, clarity and comfort regarding how to implement BDBN strategies successfully. Indeed, with the benefit of this rich case law, which clearly articulates the "dos and don'ts" of BDBNs, clients can have confidence that BDBNs provide a straightforward and legally effective method for SMSF members to give instructions on how their superannuation benefits are to be dealt with on their death.

Accordingly, while the authors acknowledge the instances where BDBNs have been litigated and where the courts have identified various issues associated with BDBNs, an impressive body of knowledge and legal practice has emerged from these cases. On the other hand, there does not appear to have been any cases involving SMSF wills. This means that there is no case law authority (that the authors are aware of) to provide guidance or clarity on what SMSF wills are or whether they are effective. The authors are also not aware of any published ATO or regulatory view on point.

Which method should you adopt?

Advisers should seek to follow established legal methods, supported by relevant case law and, where applicable, published views from the ATO as the SMSF regulator (such as in SMSFD 2008/3 noted above).

In the authors' opinion, a BDBN is generally a more straightforward and more cost-effective method compared to an SMSF will.

Indeed, many SMSF deeds include BDBN forms for each member to complete. Some BDBN forms can be completed to achieve many popular directions, including a cascading nomination (eg one or more dependants and/or the legal personal representative can be selected if the member's spouse predeceases the member).

Some BDBN forms also include an option to easily achieve an automatically reversionary pension leveraging off the power in the SMSF deed. For example, a client may have three account-based pensions in place and want to make these automatically reversionary to their surviving spouse. Some SMSF deeds give priority to the BDBN over the pension documents to the extent that there is any inconsistency. (It is recommended that pension documents be checked anyway to ensure that there are no inconsistencies.)

Further, for more complex directions, a tailored service is recommended where the adviser providing the tax and superannuation advice and the lawyer preparing the legal documents gain an understanding of the client's circumstances and goals and provide feedback on the key options and strategies to implement those goals in a legally effective manner.

SMSF succession planning

Strategies such as BDBNs and SMSF wills should never be implemented in isolation. Advisers need to carefully choose which supplier they use for their documents, including SMSF deeds and constitutions. Advisers should be mindful that, if they choose a supplier, that choice implies that the adviser is recommending the documents are fit for the client's purpose and will be effective. Thus, the choice of document supplier should not be based on cost alone, and advisers are encouraged to review the documents and have them checked by a qualified lawyer if the supplier is not legally qualified.

Naturally, in addition to ensuring that the documents are appropriate and legally effective, clients should develop and implement an SMSF succession plan that provides for the control of the fund to pass to trusted persons as intended, eg in relation to loss of capacity or death. Clients' SMSF succession planning needs to be consistent with their wills and enduring powers of attorney.

Given that the key foundation to many SMSF strategies, including a valid BDBN, is having a sound SMSF deed history, unless the prior SMSF documents have been properly varied, executed and retained, the deed may be subject to challenge and any succession planning and other strategies based on that deed may be subject to risk and challenge. Thus, where there are multiples deeds that relate to the same SMSF over many years, it is important to check to see if there are any items requiring rectification in the prior document trail.

Conclusion

The authors generally recommend a BDBN in preference to an SMSF will due to, among other reasons, the greater simplicity of, and confidence in, BDBN strategies based on an established body of law.

Of course, all BDBN strategies require a strong foundation in the governing rules of the SMSF. Accordingly, a fund's document trail must be carefully reviewed prior to any BDBN strategy being implemented to ensure that there are no weaknesses that will compromise the strategy, and an appropriately drafted SMSF deed must be in place.

Finally, succession to the control of an SMSF is also vital, as highlighted in *Wooster v Morris*[7] where the BDBN was ignored by the deceased member's second spouse. Accordingly, a BDBN strategy should be implemented as part of an overall SMSF succession plan that integrates with the client's estate plans. This is best done in conjunction with an experienced lawyer who is qualified to prepare legal documents and covered by appropriate insurance.

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Events Calendar

November/December 2021

STATE/EVENT	DATE	CPD
Online		
29th Noosa Tax Intensive	18/11/21	13
2021 National GST Conference	2/12/21	13
New South Wales		
2021 National GST Conference	2/12/21	13
Queensland		
29th Noosa Tax Intensive	18/11/21	13

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Cumulative Index

The following cumulative index is for volume 56, issues (1) to (5). Listed below are the pages for each issue:

Vol 56(1): pages 1 to 84
Vol 56(2): pages 85 to 142
Vol 56(3): pages 143 to 212
Vol 56(4): pages 213 to 278
Vol 56(5): pages 279 to 340

Legislation

Rulings and other materials

Cases

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