Volume 57(2)
August 2022

The Tax Institute

Taxation in Australia

State taxes and indirect taxes
The Tax Institute

Small-scale property developments: tax issues
Rajan Verma, CTA

R&D: navigating disputes
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Invitation to write

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Insights from the Institute

Regular columns

Tax News – at a glance

by TaxCounsel Pty Ltd

July – what happened in tax?

The following points highlight important federal tax developments that occurred during July 2022. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 62 (at the item number indicated).

Cryptocurrencies

In a joint media release on 22 June 2022, the Treasurer and Assistant Treasurer announced that cryptocurrencies will continue to be excluded from foreign currency tax arrangements. **See item 1.**

Legal professional privilege

The Commissioner has issued a protocol that has been developed to assist taxpayers and their advisers when making legal professional privilege claims in response to requests for information that the ATO makes under its formal information-gathering powers. **See item 2.**

Reimbursement agreements

The Commissioner has clarified the way that the ATO will administer the reimbursement agreement provision (s 100A) in the *Income Tax Assessment Act 1936* (Cth) trust provisions in the light of the release in February 2022 of a draft ruling (TR 2022/D1) and a draft practical compliance guideline (PCG 2022/D1). **See item 3.**

Division 7A: private company beneficiaries

The Commissioner has withdrawn the ruling (TR 2010/3) and the practice statement (PS LA 2010/4) that have expressed the Commissioner's views on the Div 7A implications of a private company becoming presently entitled to income of a discretionary trust. **See item 4.**

Division 7A: benchmark interest rate

For the 2022–23 income year, the Div 7A benchmark interest rate for private companies with a regular 30 June accounting period is 4.77%. **See item 5.**

Travel and overtime meal allowances

The Commissioner has issued a determination that sets out the amounts that he considers are reasonable for the substantiation exception in Subdiv 900-B of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) for the 2022–23 income year (TD 2022/10). **See item 6.**

Effective life of depreciating assets

The Commissioner has issued a ruling that explains the methodology used by him to make a determination of the effective life of depreciating assets under s 40-100 ITAA97 (TR 2022/1). **See item 7.**

Cash flow boost not available

In a recent decision, the AAT has held that an individual who formerly carried on business in partnership with another individual but who took the business over as a sole trader was not entitled to a cash flow boost payment under the *Boosting Cash Flow for Employers (Coronavirus Economic Response Package) Act 2020* (Cth) (*Thiele and FCT* [2022] AATA 2123). **See item 8.**

Tax agents: deregistration issues

There have been two recent decisions, one of the Federal Court and the other of the AAT, on tax agent registration issues.

In the Federal Court decision, Abraham J upheld the decision of the AAT to affirm the deregistration by the Tax Practitioners Board of an individual and a company he controlled and the imposition of a two-year preclusion from reapplying for registration (*Logic Accountants & Tax Professionals Pty Ltd v Tax Practitioners Board* [2022] FCA 830). There was failure by the registered entities in relation to their personal tax affairs and also issues with work-related expense claims over a number of years. Her Honour held that none of the questions of law alleged to be involved in the AAT's decision were made out.

In the other decision, the AAT upheld a decision of the Tax Practitioners Board to terminate the agent's registration and impose a three-year preclusion from reapplying for reregistration (*Kennedy and Tax Practitioners Board (Taxation)* [2022] AATA 2316). There were issues in relation to the agent's personal tax affairs (and his failure to be open with the Board about this) and also the agent's involvement in a client's tax evasion schemes.

Settlement of marketing hub tax disputes

The ATO has confirmed that a settlement has been reached with Rio Tinto Ltd (Rio) which brings an end to all tax disputes, including longstanding disputes in relation to Rio's Singapore marketing hub.

The settlement brings Rio's total payment in relation to the disputes to almost $1b and represents one of the largest settlements in Australia's tax history. Importantly, the settlement locks in future tax outcomes, providing certainty going forward.

President's Report

by Jerome Tse, CTA

Welcome to our new Chair

President Jerome Tse introduces our new Chair, and advises caution after the cryptocurrency downturn.

Welcome to our new Chair of National Council, Clare Mazzetti.

In my February report to you, I spoke about the value that an independent Chair brings to our organisation. I'm delighted to welcome Clare Mazzetti as the Institute's inaugural Chair for a three-year term.

Clare has over 20 years of financial services and management consulting experience in roles spanning client services, advice, strategy, program management, M&A, and risk management/governance. She has held a number of Board director, Board adviser and non-executive roles for organisations that include Qudos Bank, Uniting Financial Services, Police Bank, the Australian Shareholders' Association, Agricultural Management Company, and the Australian Medical Association Foundation (QLD).

As a non-executive director, Clare assists organisations to grow and transform through good governance, key to which are managing risk, balancing short-term tactical responses, long-term strategic thinking, pragmatic commercial demands and constraints, stakeholder engagement, collaboration, and empowering people and teams.

Clare will bring perspective and skill to the governance of The Tax Institute, ensuring that our members, our member value proposition, and our members' funds continue to be protected, used and invested wisely and in accordance with our objectives. The Chair's three-year appointment (as opposed to a President's typical one-year term) brings additional stability of leadership to National Council. The role of the President continues to have the same importance as it does today, working to address the changing needs of our members year on year. I will continue to advocate for members, promote continuing education opportunities for members, and engage with members, regulators and the government on all things tax. In fact, Clare's appointment will give me (and future Presidents) more time to execute on the things that matter most to you, our members. I look forward to working closely with her in the coming months.

Tax time cryptocurrency warning

As you no doubt know, reflective of the wider global markets, the cryptocurrency market is continuing to suffer a significant downturn, signalled by such events as Bitcoin's value shrinking more than 70% in the past seven months.

It has always been true that tax practitioners are often privy to their clients' highest and lowest moments. You may have clients who are impacted, perhaps significantly, by the downturn in the cryptocurrency market. Not only does this require the usual tact when assisting clients through tricky situations, but this will also mean having a close eye on a developing regulatory environment as the ongoing debates take place. As advisers, we need to be mindful of the fundamentals, such as whether losses are deductible against income or are otherwise capital in nature, and be cautious of tripping up on key rules, such as whether a cryptocurrency arrangement is, in fact, a wash sale.

Despite the collapsing of prominent market players, regulators and governments have not taken their eye off the space. Rather, they are increasingly looking at digital assets and how they interact with other areas of our economy, and our tax and legal systems.

At the beginning of this month, and in the wake of the Central African Republic launching the Sango Project to soon join El Salvador in adopting Bitcoin as legal tender, the Albanese Government announced its intention to retrospectively legislate so that cryptocurrency assets are not to be regarded as a foreign currency for tax purposes from 1 July 2021. Although this brings some certainty (given the ATO's view on this issue in TD 2014/25 had otherwise remained unchanged since December 2014), this is but one of the broad smorgasbord of issues in applying a more "traditional" tax regime to something new. How the government treats other digital asset issues, and how and whether they apply retrospectively or not, will need constant monitoring.

As part of the Australian Government's broader regulatory approach, the Board of Taxation is undertaking a review of the appropriate policy framework for the taxation of digital assets, including cryptocurrencies. The Board is expected to publish a report by the end of 2022.

The Tax Institute, like other professional bodies, will be keen to input into the Board of Taxation's review. We are also working with these other bodies to identify and attempt to address the most pressing issues in this space for the betterment of the tax system at large.

We will continue to work in the best interests of our members to ensure you get the guidance you need to accurately represent your clients, and to ensure that, at each tax time, you are as best armed as you can be to help your clients navigate this new world.

CEO's Report

by Giles Hurst

The Tax Summit: bigger and brighter in 2022

CEO Giles Hurst on shining bright as a united community at The Tax Summit in 2022.

By now, you are probably aware that we are busily gearing up for our biggest and most anticipated event of the year: The Tax Summit. The full program is now available, and I encourage you to explore what's on offer and plan out an experience for you and your team – there is much to be discovered and enjoyed this year.

The last time we held The Tax Summit in person, we filled the ICC in Sydney with a thumping, electric atmosphere previously unmatched in the tax profession. In my March 2020 report to you, I wrote:

> "The Tax Summit 2020 … is already the single largest event that The Tax Institute has ever hosted, and the sheer scale of the content and value sets a new standard in tax for Australia."

The response to that event was phenomenal – an outpouring of excitement, support and generous praise for what our dedicated volunteers and our wider member community had achieved. It was a special moment in time for us as a profession and as an organisation. I know I for one rode the high of the event's success and the atmosphere of camaraderie and enthusiasm well into the following months, even as the COVID-19 situation quickly became a major challenge.

I'm looking forward to an even bigger event this October, when our community once again comes together for The Tax Summit in 2022. This year, we're inviting attendees to shine together as we celebrate the world returning to normal, with high hopes for the future.

Despite uncertain times, those in the tax profession have held on to their positive attitudes and enthusiasm for guiding clients through some of the trickiest times of their lives. Each and every one of our members has shone in their own way over the last year or two, whether it was as a professional leader, as a client champion, or as a parent, partner, child or friend. But, like a constellation of stars, we shine brightest when we come together as a community.

At The Tax Summit this year, we're making it a point to acknowledge and celebrate each other. The best part of holding a major in-person event like The Tax Summit is experiencing the energy of a community that embraces a wealth of perspectives and forges ahead with curious and open minds. I can't wait to see our members and guests all in one place again – it has been too long.

We will be joined by a number of keynote speakers, including: jurist, educator and former Justice of the High Court of Australia, the Hon. Michael Kirby AC CMG; renowned tax lawyer and Australian poet, Geoffrey Lehmann; Australian Small Business and Family Enterprise Ombudsman, the Hon. Bruce Billson; author and journalist, Leigh Sales AM; Commissioner of Taxation, Chris Jordan AO, CTA; Inspector-General of Taxation and Taxation Ombudsman, Karen Payne, CTA; independent member for Wentworth, the Hon. Allegra Spender, MP; team doctor and work futurist at Atlassian, Dominic Price; and economist at Barrenjoey, Jo Masters.

The Tax Institute team will also be out in full force, with Scott Treatt, CTA, Robyn Jacobson, CTA, and Julie Abdalla, FTI sitting on a panel to discuss issues facing the tax system and the tax community, what practitioners can do in the face of these challenges, and what actions The Tax Institute is taking to support you. Plus, behind the scenes, our volunteers and our team from all corners of the organisation will be working hard to make this event a worthy successor to our last in-person Tax Summit in 2020.

The technical program is wide-ranging and forward-thinking, and at an event all about celebrating our shared triumphs, there will, of course, also be plenty of opportunities to socialise. The gala dinner and the Tax Adviser of the Year Awards will be the jewel in the shining crown of our program. The theme this year is "Diamonds are Forever", so ready your tuxedos and martini glasses, and be sure to put your award nominations in. Recognising the achievements and contributions of those around us (and accepting accolades for our own) is so important, and the Tax Adviser of the Year Awards are the perfect opportunity to do so.

I hope to see you all at the ICC in October for an event to be remembered.

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Inspector-General of Taxation and Taxation Ombudsman

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Tax Counsel's Report

by Julie Abdalla, FTI

Setting tax priorities in an uncertain environment

The growing list of announced but unenacted measures requires the government to take action and develop a mechanism to ensure it does not continue to get out of hand.

It goes without saying that there are challenges within our tax and superannuation systems, and a need for comprehensive reform. Taxpayers are subject to an ever-increasing amount of complexity, costs and practical difficulties in complying with their tax obligations. Despite this, meaningful tax reform has not been on any government's agenda in years.

Over time, governments have announced a raft of measures that introduce new ideas or attempt to rectify specific problems. However, many of these measures have not been enacted, leaving taxpayers with the added challenge of uncertainty with respect to their tax affairs. The list of announced but unenacted measures (ABUMs) has steadily grown in recent times. While there exists the practical challenges of enactment (including drafting resources and face time in parliament), for many measures, it is not clear where the current government stands. This raises the important questions of how these ABUMs should be prioritised and managed going forward to prevent the list from getting too unwieldy.

Incoming Government Brief

The Tax Institute's *Incoming Government Brief* (brief) does just that. We have prioritised the ABUMs that relate to the tax and superannuation systems to assist the government in determining the most appropriate pathway when actioning them. Addressing the outstanding measures will provide certainty to taxpayers and direct the discourse to avenues for more comprehensive reform rather than band-aid measures.

The brief was delivered to over 25 members of parliament, as well as other key stakeholders in the system. It has been positively received and has generated engagement by a number of those recipients who are keen to make progress on outstanding tax issues.

How the priorities were determined

The priorities were determined after an extensive analysis of what would most benefit taxpayers and what is most crucial for the health of the system. While opinions may differ on the importance of each announcement, a critical lens must be applied to ensure that the government is able to approach the ABUMs in a strategic manner which targets the most pertinent issues. In our analysis, each ABUM was considered against a range of factors, including:

- issues that require immediate attention, given the potential impact on taxpayers or the economy;
- providing support to businesses during a period of rising costs, staff shortages and broader economic uncertainty;
- the pressures on the tax profession to support taxpayers and participate in the administration of the tax and superannuation systems;
- the impact of additional compliance obligations on taxpayers;
- whether the announcement could assist government in managing future fiscal challenges, noting the potential impact of the ATO's increasing debt book on future government revenue; and
- the ability for existing systems and processes to manage the additional obligations imposed by the proposed measure.

The analysis enabled the outstanding measures to be organised into four categories: (1) measures relating to COVID-19 and other natural disasters that require immediate attention to ensure that taxpayers and businesses receive the intended support during these difficult times; (2) outstanding measures ordered in the highest, medium and lower priority; (3) other key issues that, although not ABUMs, are creating significant challenges of which government should be aware; and (4) ABUMS that should not proceed.

In our view, ABUMs that were placed in the highest priority category should be actioned earlier because of the significant impact of one or more of the factors outlined above. For example, the two small business "boost" measures announced in the Federal Budget 2022–23 are intended to encourage businesses to invest in their staff and improve their operations. Meanwhile, the announced changes to the non-arm's length expenditure rules could mitigate unintended consequences that could impact the superannuation balances of all Australians.

That is not to say that lower priority ABUMs are not worth pursuing. However, measures that would impose additional burdens on taxpayers and tax practitioners should be carefully considered and designed after consultation with industry to ensure that they are appropriately managed.

Raising awareness for tax reform

The next Federal Budget will be delivered on 25 October 2022. Pre-budget submissions are an opportunity to advocate for improvements to the tax system, including in relation to the approach to ABUMs. We welcome your thoughts on the priorities for The Tax Institute's submission.

Tax News – the details

by TaxCounsel Pty Ltd

July – what happened in tax?

The following points highlight important federal tax developments that occurred during July 2022.

Government initiatives

1. Cryptocurrencies

In a joint media release on 22 June 2022, the Treasurer and Assistant Treasurer announced that cryptocurrencies will continue to be excluded from foreign currency tax arrangements.

The media release points out that a decision by the Government of El Salvador to allow Bitcoin as legal tender had the potential to create uncertainty about the status of crypto assets, such as Bitcoin, for tax purposes in Australia.

The government will therefore move to clarify current arrangements in legislation that will mean crypto assets will not be regarded as a foreign currency for tax purposes. Capital gains tax will continue to apply to crypto assets that are held as investments.

This clarification will deliver a consistent tax requirement for crypto asset holders and will be backdated to 1 July 2021 for the avoidance of ambiguity following the decision by the Government of El Salvador.

The media release states that the government will continue to take a pragmatic and timely approach to its role in the rapidly-evolving digital currency landscape.

The Commissioner's perspective

2. Legal professional privilege

The Commissioner has issued a protocol that has been developed to assist taxpayers and their advisers when making legal professional privilege (LPP) claims in response to requests for information that the ATO makes under its formal information-gathering powers.

The purpose of the protocol is to recommend an approach which, in the ATO's view, will best assist the ATO when deciding whether to accept, review or challenge an LPP claim. It is voluntary to follow the approach set out in the protocol.

The protocol applies to legal practitioners and non-legal practitioners generally. It applies to all applicable LPP claims regardless of the firm or business structure within which the service or engagement is provided.

The protocol is relevant to taxpayers that are making LPP claims when responding to formal information-gathering notices issued by the ATO. This will typically be large businesses that have received a notice as part of a dispute or an audit activity. The vast bulk of the ATO's engagements in the large market is done without recourse to formal information-gathering powers. In most situations, the ATO will only issue a formal notice after attempting to obtain the information or documentation by using a cooperative approach.

Where the protocol is followed, the ATO will usually have a sufficient level of information to be able to decide what to do next. In many cases, it is likely that the ATO will accept a claim for LPP without any further enquiries. However, following the protocol does not mean that the ATO will never have concerns about LPP claims or challenge such claims, although it is less likely in these types of cases. It does mean that the ATO will be able to more readily identify what concerns it does have and to ask specific questions about those concerns.

If the protocol is not followed, there is no presumption that the LPP claims are invalid or will be challenged by the ATO. The ATO appreciates that, in some circumstances, taxpayers may decide to adopt none, or particular parts, of the protocol and not follow all of the recommendations in their entirety. In that event, the ATO requests that an explanation be provided as to where the protocol has been departed from.

Computer-assisted technology

Where computer-assisted technology is used, it is the ATO view that the taxpayer will still need to review their LPP claims, as computer-assisted processes alone are not a reasonable basis for determining if LPP applies.

The ATO does, however, see opportunities for taxpayers to include computer-assisted processes to improve efficiency, timeliness and accuracy while reducing the cost of compliance when determining whether a communication may be privileged. The ATO will seek to better understand how computer-assisted technology will assist it when determining whether to accept, review or challenge a claim for LPP.

ATO claims

It should be noted that there may be situations in which the ATO will seek to assert an LPP claim. This is illustrated by the recent decision of the AAT in *Shord and FCT*[1] which was a case involving a freedom of information request to the ATO.

3. Reimbursement agreements

The Commissioner has clarified the way that the ATO will administer the reimbursement agreement provision (s 100A) in the *Income Tax Assessment Act 1936* (Cth) (ITAA36) trust provisions in the light of the release in February 2022 of a draft ruling (TR 2022/D1) and a draft practical compliance guideline (PCG 2022/D1).

TR 2022/D1 states that, when the ruling is issued, it is proposed to apply to arrangements both before and after its issue. However, the guideline, when finalised, will

effectively only apply from 1 July 2022. This was explained in an ATO document issued in June 2022 and titled *Trust taxation – reimbursement agreement*. That document states that:

> "Entitlements from 1 July 2022
>
> Draft Practical Compliance Guideline PCG 2022/D1 *Section 100A reimbursement agreements – ATO compliance approach* sets out our proposed compliance approach in relation to beneficiary entitlements conferred on or after 1 July 2022.
>
> Entitlements before 1 July 2022
>
> For beneficiary entitlements conferred before 1 July 2022, the administrative position outlined in *Trust taxation – reimbursement agreement* (July 2014) will continue to apply."

4. Division 7A: private company beneficiaries

The Commissioner has withdrawn the ruling (TR 2010/3) and the practice statement (PS LA 2010/4) that have expressed the Commissioner's views on the Div 7A implications of a private company becoming presently entitled to income of a discretionary trust.

A draft taxation determination that was issued on 23 February 2022 (TD 2022/D1) will, when finalised, replace the withdrawn ruling and practice statement.[2]

The withdrawal notice in respect of TR 2010/3 states that the ruling is withdrawn with effect from 1 July 2022.

The withdrawal notice also states that an entity may continue to rely on the withdrawn ruling in respect of trust entitlements conferred on or before 30 June 2022. That is, the Commissioner will not devote compliance resources to arrangements conducted in accordance with TR 2010/3 in respect of trust entitlements arising on or before 30 June 2022.

5. Division 7A: benchmark interest rate

For the 2022–23 income year, the Div 7A benchmark interest rate for private companies with a regular 30 June accounting period is 4.77%.

This benchmark interest rate is relevant to:

- determine if a loan made in the 2021–22 income year is taken to be a dividend (s 109N(1)(b) ITAA36 and, as applicable, s 109D(1) or 109XB ITAA36); and
- calculate the amount of the minimum yearly repayment for the 2022–23 income year on an amalgamated loan taken to have been made prior to 1 July 2022 (s 109E(5) ITAA36).

6. Travel and overtime meal allowances

The Commissioner has issued a determination that sets out the amounts that he considers are reasonable (reasonable amounts) for the substantiation exception in Subdiv 900-B of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) for the 2022–23 income year (TD 2022/10).

TD 2022/10 relates to claims made by employees for:

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

The approach outlined in TD 2022/10 can only be used where the taxpayer receives an allowance to cover the particular expenses that they are claiming, for example, the taxpayer received an accommodation allowance and is claiming accommodation expenses.

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

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

7. Effective life of depreciating assets

The Commissioner has issued a ruling that explains the methodology used by him to make a determination of the effective life of depreciating assets under s 40-100 ITAA97 (TR 2022/1).

The effective life of a depreciating asset is used to work out the asset's decline in value (depreciation for income tax purposes).

The Commissioner makes the effective life determination having regard to the period the depreciating asset can be used for a purpose specified in s 40-100(5) (a specified purpose), one of which is use for a taxable purpose. A deduction may be available under Div 40 ITAA97 for the depreciating asset's decline in value, to the extent that the asset is used for a taxable purpose (see s 40-25 ITAA97). Tables A and B of the ruling list the effective life determinations made to date.

A taxpayer may choose to use the Commissioner's determination of the effective life of a depreciating asset or may make their own estimate (see s 40-95 ITAA97). The explanation in TR 2022/1 of the methodology used by the Commissioner to make a determination of effective life

may assist taxpayers who make their own estimate of the effective life of a depreciating asset.

TR 2022/1 replaces TR 2021/3 (*Income tax: effective life of depreciating assets* (applicable from 1 July 2021)) which was withdrawn from 1 July 2022.

8. Cash flow boost not available

In a recent decision, the AAT has held that an individual who formerly carried on business in partnership with another individual but who took the business over as a sole trader was not entitled to a cash flow boost (CFB) payment under the *Boosting Cash Flow for Employers (Coronavirus Economic Response Package) Act 2020* (Cth) (BCF Act) (*Thiele and FCT*[3]).

The applicant and his business partner conducted a business in partnership until the applicant acquired his partner's interest in the business, and conducted it as a sole trader, with effect from 1 February 2020. The Commissioner took the view that the applicant did not qualify for a cash flow boost because he was not the same "entity" as the partnership that conducted the business until 31 January 2020.

The ultimate issue for decision was whether the requirement of s 5(5)(a) BCF Act was satisfied. This would be so if:

> "an amount was included in the entity's assessable income for the 2018–19 income year in relation to it carrying on a business."

Because he did not take over the business as a sole trader until 1 February 2020, the applicant did not disclose any business income derived in that capacity in his 2018–19 personal income tax return. However, the partnership lodged a tax return for that year, disclosing a loss. The applicant's share of the loss was reflected in his tax return for 2018–19.

The AAT said that, on the plain meaning of s 5(5)(a), in the particular circumstances of the case, the argument for the applicant stumbled at the final hurdle. That was because the partnership returned a loss in 2018–19. In those circumstances, there was no amount that could be included in the applicant's assessable income from the partnership business. Where a partnership returns a loss, no amount of assessable income, even a nil amount, is included in the partner's assessable income. Rather, the statutory mechanism for effectively distributing the loss to the partners is that there is an allowable deduction to each partner for their individual interest in the partnership loss.

Accordingly, the applicant did not meet the CFB eligibility requirement in s 5(1)(f).

TaxCounsel Pty Ltd
ACN 117 651 420

References

1 [2022] AATA 1536.

2 The final determination was released on 13 July 2022 as TD 2022/11. It will be reported in the Tax News column of the next issue of the journal.

3 [2022] AATA 2123.

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Tax Tips

by TaxCounsel Pty Ltd

Discretionary trusts: non-tax litigation

Discretionary trusts often raise practical difficulties that, although not directly tax-related, are of relevance to tax practitioners.

Background

The proliferation of the use of discretionary trusts has resulted in an increasing volume of litigation with the ATO and the state revenue authorities.

The most recent significant decision in this regard is that of the High Court in *FCT v Carter*[1] which was handed down in April 2022. In that decision, the High Court unanimously reversed a decision of the Full Federal Court and held that disclaimers by default income beneficiaries of their interests under a discretionary trust deed after the end of the income year in which (unknown to them) the default provision had been activated in their favour, were ineffective for income tax purposes. The High Court held that, for the purposes of determining the present entitlements to income of the trust, it is the position immediately before the end of the particular income year that was relevant.

Discretionary trusts also frequently give rise to litigation (usually before the Supreme Courts[2]) on questions that do not directly raise revenue issues (and to which a revenue authority is not a party). The decisions in these cases can have significant relevance to the operation of a discretionary trust and are of interest to tax practitioners because of the potential ramifications of the issue.

By way of illustration, this article briefly notes several recent decisions that are of interest.

Construction of a trust deed

The most basic issue that can arise in relation to the administration of a discretionary trust is the construction of the trust instrument. This issue was recently considered by the Western Australian Supreme Court (Strk J) in *Wheatland Holdings Pty Ltd as Trustee for the Rodney Manuel Family Trust*.[3]

Her Honour accepted that Buss P in *Mercanti v Mercanti*[4] had comprehensively outlined the principles to be applied when construing a trust deed, which she summarised as follows:

1. the construction of a written agreement involves ascertaining what a reasonable person would have understood the parties to the agreement to mean. The rights and liabilities of the parties under a clause in the agreement are to be determined objectively. Consideration should ordinarily be given not only to the language of the agreement, but also to the apparent purpose and object of any transaction created by or evidenced in the agreement;
2. it is necessary, when determining the meaning of the provisions of a commercial contract, to ask what a reasonable businessperson would have understood those provisions to mean. That inquiry requires consideration of the language of the contract, the circumstances addressed by the contract, and the commercial purpose or objects to be secured by the contract;
3. a written agreement must be construed as a whole. The words of a clause in the agreement are to be given the most appropriate meaning which they can legitimately bear. A court must have regard to all of the provisions of the agreement, with a view to achieving harmony among them. In this regard, words may generally be supplied, omitted or corrected, in an instrument, where it is clearly necessary in order to avoid absurdity or inconsistency;
4. the rules that apply to the construction of contracts apply to the construction of deeds; and
5. the rules applicable to the construction of contracts apply also to trusts.

Strk J said that Buss P accepted that the words of a clause in a trust deed are to be given their ordinary and natural meaning, read in the context of the trust deed as a whole, unless the words have a special or technical meaning.

Beneficiary class: amendment

In the *Wheatland Holdings Pty Ltd* case, the issue was whether the trust deed authorised an amendment to the discretionary trust deed to add a beneficiary.

The Rodney Manuel Family Trust (the trust) was a discretionary trust established by a deed of settlement made on 15 July 1977 (the trust deed). The trust deed established Mr Rodney Manuel as appointor during his lifetime, and after his death, the trustee named in his will.

The "primary beneficiaries" under the trust deed were the children of Mr Rodney Manuel and the "income beneficiaries" were Mr Rodney Manuel, his children, his wife, his grandchildren, and the husbands and wives of his children and grandchildren.

The trustee wished to vary the trust deed so as to include in the category of "income beneficiaries" a corporate beneficiary, as the trustee understood that there were significant taxation benefits for the trust if it was able to make distributions to a corporate beneficiary. The relevant clause in the trust deed that governed the power to amend the trust deed was cl 12 which provided as follows:

> "12. The Trustee for the time being may at any time and from time to time by deeds revoke, add to or vary all or any of the trusts hereinbefore created by any variation or alteration or addition made thereto from time to time and may by the same or any other deed or deeds declare any

new or other trusts or powers concerning the Trust Fund or any part or parts thereof the trusts whereof shall have been so revoked, added to or varied but so that the law against perpetuities is not thereby infringed and so that such new or other trust powers, discretions, alterations or variations —

(i) may relate to the management or control of the Trust Fund or the investment thereof or to the Trustee's powers or discretions in these presents contained

(ii) shall not be in favour of or for the benefit of the Settlor or the Trustee or result in any benefit to the Settlor or the Trustee but shall otherwise be for the benefit of any one or more of the Primary Beneficiaries named or referred to herein

(iii) shall not affect the beneficial entitlement to any amount vested in and set aside for any Beneficiary prior to the date of the variation alteration or addition."

By an originating motion filed on 17 May 2022, the trustee sought a direction from the Western Australian Supreme Court pursuant to s 92 of the *Trustees Act 1962* (WA) ("Directions, trustee may ask Court for") that it was within the power of the trustee to amend the trust so as to include a corporate beneficiary in the category of "income beneficiaries", as that term was defined in the trust deed.

Counsel for the trustee acknowledged that there was no power in the trust deed, by operation of cl 12 or otherwise, to amend the terms and conditions of the trust deed. Counsel submitted that the power to amend was limited to the power "by deeds [to] revoke, add to or vary all or any of the trusts hereinbefore created by any variation or alteration or addition made thereto from time to time".

It was the trustee's position, however, that the proposed amendment was not an amendment to the trust's "powers and provisions" prescribed in the trust deed, but a variation to the trust itself, namely, the ability to make distributions of income to corporate beneficiaries.

It was submitted that the trustee had an express power under cl 12 to vary the trusts created, and a variation by the trustee to the trusts created to enable the addition of a corporation to the income beneficiaries so as to achieve taxation benefits would seem to be a clear exercise of such an ability to vary a trust.

As to the question of whether it is within the power of the trustee to amend the trust so as to include a corporate beneficiary in the category of "income beneficiaries" as that term is defined in the trust deed of the trust, Strk J found as follows:

"55 The Trustee's question concerns the nature, form and extent of the variation permitted under the Trust Deed. Clause 12 of the Trust Deed concerns variation and must be construed having regard to the language and apparent purpose of the clause in the context of the Trust Deed as a whole.

56 The crucial words of cl 12 are '[the] Trustee … may … by deeds … vary all or any of the trusts hereinbefore created'.

57 In my opinion, the natural and ordinary meaning of these words would empower a variation of the Trust itself. The language of cl 12 does not include language that extends to a power to vary the terms and conditions of the Trust Deed …

58 Such construction is consistent with cl 2, by which the Settlor declared that the Trustee shall, and the Trustee declared that it would 'henceforth hold the Trust Fund and the income thereof upon the trusts and with and subject to the powers and provisions hereinafter expressed concerning the same'. There is a distinction drawn in cl 2 between the 'trusts' and the 'powers and provisions hereinafter expressed concerning the same'."

Accordingly, on a proper construction of the trust deed, her Honour accepted that the trustee had an express power to vary the trusts created, and accepted that a variation by the trustee to the trusts created by the trust deed to enable the addition of a corporation to the "income beneficiaries" so as to achieve taxation benefits was an exercise of such an ability to vary a trust. Further, the limits in cl 12 did not prohibit the variation proposed. Strk J therefore concluded that, in all of the circumstances presented, it was appropriate to make the direction sought.

Beneficiary class: rectification

The decision of Ball J in *Application of Paul Geoffrey Mason*[5] involved a discretionary trust (the trust) that was established by deed dated 2 July 1973 (the trust deed) and made between Mr Nicholas Mason (Nicholas) as settlor, and the plaintiff (a Mr Paul Mason) as trustee. The sole assets of the trust comprised 12 of 13 shares in Paul Mason Pty Ltd, a company through which the plaintiff had acquired real property. The remaining share was held by Nicholas on trust for the trust.

The trust deed relevantly named as beneficiaries of the trust as follows:

"(a) the spouse of the plaintiff, if any;

(b) the children, grandchildren and further issue of the plaintiff;

(c) the siblings of the plaintiff and their children provided they are nominated in writing by the plaintiff to be a beneficiary; and

(d) any person who at any time is a spouse of a beneficiary."

By a summons filed in the New South Wales Supreme Court, the plaintiff sought rectification of the trust deed to include himself as one of the beneficiaries of the trust. The plaintiff had never married and had no children. Had he married, he would have been a beneficiary because he would have been a spouse of a beneficiary. The court (Ball J) allowed the plaintiff's claim for rectification.

Ball J said that the court had power to rectify a document, including a deed establishing a trust, if that document does not correctly record the intention of the parties to it. In order to grant rectification, the court must be satisfied

by clear and convincing evidence that, at the time of its execution, the instrument did not reflect the parties' actual intention. It was also necessary that the parties' actual common intention be capable of clear expression.

The trust was established when the plaintiff was in his twenties. At the same time, each of the plaintiff's older brothers (Michael and Nicholas) established trusts in substantially similar terms. Each trust deed was prepared by the same firm of solicitors and instructions were given at the same time for the preparation of all three trust deeds. None of the trust deeds specifically named the trustee as a beneficiary. However, Michael and Nicholas, unlike the plaintiff, are and were at the time married and consequently were beneficiaries of their respective trusts by virtue of the fact that their respective spouses were beneficiaries.

The trusts were established approximately 11 years after the death of the brothers' father and were established to provide a vehicle to enable the three brothers to acquire additional properties as part of the family farming business, in which each of them was involved, with the intention that eventually they would acquire sufficient land so the business could be divided between the three of them. The original property, known as Westwood, had been bequeathed by the plaintiff's father to the plaintiff's mother and Michael.

Each trust held shares in a company. The intention was that the three companies would be the purchasers of any additional properties. The plaintiff gave evidence, which was accepted, of a meeting on 19 January 1973 at which their accountant and financial adviser at the time explained the structure in these terms:

> "14 Following the establishment of the three trusts, one property that was at the time held by the three brothers as tenants in common in equal shares was transferred to the three companies in equal shares and further properties were bought by the three companies, sometimes in conjunction with family members. In about 1990, the properties that were owned by the three companies and family members were divided into three, more or less equal shares. The one-third share referable to the plaintiff was transferred or held by him personally as to one-third and as to the balance by Paul Mason Pty Ltd."

Since the purpose of the trust was to hold land, it had not distributed any capital or income. Consequently, it was not necessary for the plaintiff or his advisers to consider who the beneficiaries of the trust were until 2017, at which time, the plaintiff started investigating the possibility of selling the properties owned by the trust he controlled to his three nephews who were the beneficiaries of the trust.

Ball J went on:

> "16 Having regard to the background and the advice given to both the plaintiff and Nicholas at the time the trust was established, it seems obvious that the plaintiff and Nicholas intended that the plaintiff would be one of the beneficiaries of the trust. The purpose of the trust was to provide a structure by which the plaintiff could acquire real property for his own benefit and for the benefit of his wife and children, if he had them, and other family members he nominated. It makes no sense that the plaintiff and Nicholas would have intended that the plaintiff would only be a beneficiary if he married and that he would become a beneficiary by virtue of his wife's status as a beneficiary. The advice that both received at the time was that the plaintiff would be a beneficiary, and they both signed the trust deed on that basis. The evidence is that neither the plaintiff nor Nicholas read the trust deed but instead proceeded on the assumption, which was consistent with the advice that they had been given, that the plaintiff would be a beneficiary. That was a natural assumption to make in the circumstances.
>
> 17 There is some suggestion in the evidence that Mr Bambach [the solicitor who drafted the deed] made a deliberate decision to exclude each of the brothers as a beneficiary of his own trust because of death duty implications. However, the relevant intentions are those of the plaintiff and Nicholas, not of their solicitor. Both deny that they were concerned about death duties or that they had given any instructions to draft the trust deed so as to minimise the possibility that death duties would be payable on the plaintiff's death."

Ball J said that there was no evidence that either the plaintiff or Nicholas was told that the plaintiff should not be included as a beneficiary because of death duty implications or that they were told that the trust deed had been drafted in that way. The advice given by their then accountant and financial adviser was that the plaintiff would be a beneficiary.

Accordingly, his Honour was satisfied that it was the plaintiff's and Nicholas' intentions that the plaintiff be a beneficiary of the trust and that the trust deed should be rectified in the way sought.

Lost trust deed

A not infrequent source of litigation arises out of the fact that the relevant trust deed cannot be found.

A recent decision in which this issue was considered in some detail is the decision of Gorton J in *Re Cleeve Group Pty Ltd.*[6] In that case, Cleeve Group Pty Ltd was registered on 19 November 1999 and, shortly thereafter, it commenced to operate as if it were the trustee of the Cleeve Group Trust. However, no executed trust deed could be found.

Cleeve Group Pty Ltd brought proceedings in the Victorian Supreme Court in which it sought judicial advice to the effect that it may operate its business on the basis that an unexecuted trust deed prepared in December 1999 by solicitors (Hall & Wilcox) was in fact executed, and that that deed continued to govern that trust. One member of the Cleeve family, Terence Cleeve, was appointed as contradictor. Terence Cleeve accepted that a trust deed was executed in 1999 and that it had been lost, but contended that the trust deed that was executed was not in the form of the trust deed prepared in December 1999 by the solicitors. Instead, Terence Cleeve asserted that it was in the form of a trust deed typed up at his request by an employee that mirrored the terms of two earlier Cleeve family trust deeds.

After considering all of the evidence, Gorton J said that he was satisfied that a deed of trust in the form of the Hall & Wilcox deed was executed at or about the time that the Cleeve Group Trust opened its back account. His Honour made an order to the effect that Cleeve Group Pty Ltd was and had been justified in managing and administering the Cleeve Group Trust according to the terms of the unexecuted trust deed prepared by Hall & Wilcox.

The issues that Cleeve Group Pty Ltd was required to establish to obtain the relief it sought were summarised by Gorton J as follows:

- first, that a trust deed was in fact executed in or around late 1999. If this could not be done, the Cleeve Group Trust would fail and there would have to be some process of ascertaining the beneficial ownership of the assets held in the name of Cleeve Group Pty Ltd; and
- second, that the executed trust deed was in the form of that propounded. This second step involved, conceptually, leading secondary evidence of the contents of the executed trust deed. In order to do this, Cleeve Group Pty Ltd would first have to establish that the executed copy of the trust deed had been lost.

Some observations

Practitioners who are called on to advise in relation to the affairs of a discretionary trust must not act on the basis of any preconceived ideas as to what the trust deed provides.

The terms in which discretionary trusts are drafted vary considerably and it must be ensured that anything done is authorised by the deed and is done in accordance with the terms of the deed. Where the deed is deficient in any respect, consideration will need to be given to the question of whether the deed can be amended and, if so, whether the power of amendment in fact permits the particular amendment. Any revenue consequences of a proposed amendment will, of course, need to be considered.

The last case discussed above emphasises the need for appropriate record-keeping. The trust deed is the most fundamental document that must be kept but there is a range of other documents that need to be kept, including any amendments to the deed, resolutions of the trustee, and financial records.

TaxCounsel Pty Ltd

References

1 [2022] HCA 10.

2 The decision of the Supreme Court of a state or territory is of persuasive (not binding) relevance for the Supreme Court of another state or territory.

3 [2022] WASC 211.

4 [2016] WASCA 206.

5 [2022] NSWSC 808.

6 [2022] VSC 342.

Higher Education

Balancing study, work and family during a pandemic

The dux of CTA3 Advisory for Study Period 3 2021 talks about the challenges of completing the Graduate Diploma of Applied Tax Law during the pandemic.

Clare Pendlebury
Supervisor, CIB Accountants and Advisers, New South Wales

Please provide a brief background of your career in tax.

I started work in 2001 through the cadetship program at Pitcher Partners, Sydney, working in Business Services, except for one season working in Audit. After a secondment to New York in early 2008, I moved to CIB Accountants and Advisers. I have worked in Business Advisory since the beginning of my time at CIB and, from 2010 onwards, have chosen to work part-time and focus on family life. Twelve years and three children later, including a move to Dubbo in regional NSW, my job is now fully remote so I can maintain a good balance between home and work responsibilities.

Why did you choose to study the Graduate Diploma of Applied Tax Law?

I've always had a desire to continue further study after my early years of parenting. In 2019, our youngest child was in her final year of preschool and my life was becoming more balanced. I was thirsty for another challenge and looking to increase my skills and qualification base. When looking at course options, the Graduate Diploma of Applied Tax Law was the best combination of technical coverage, study commitment and program fee cost.

What skill or knowledge areas have you gained by undertaking the program?

One skill I have gained in completing the Graduate Diploma of Applied Tax Law is being able to research a tax issue thoroughly using legislation, ATO guidance and other materials. The course forces you to take the next critical step, which is applying your tax research to a case study that mirrors a real-world tax issue. The most valuable subjects were CTA2A and CTA2B as these cover all of the major areas of tax law which I deal with in my business advisory role. While I had a good working knowledge of these areas prior to enrolling, it was helpful to study the tax concepts in more detail and look at the application of the law from many different angles.

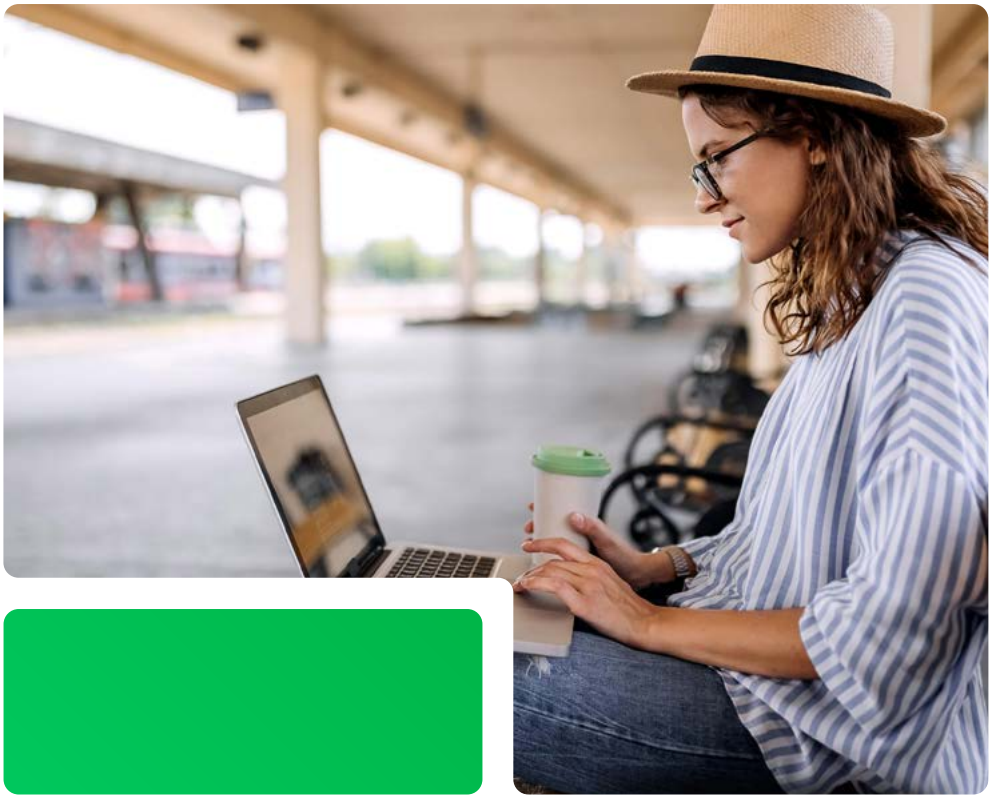
CTA3 Advisory has improved my letter-writing skills and ability to present tax advice in a succinct and readable manner. It is important for tax advisers to have a detailed knowledge of their subject-matter, but they must also be able to communicate that knowledge to clients in a clear and comprehensible way.

How did you juggle study, work and other commitments?

The normal time management plans of balancing study, work and family commitments were turned upside down by extended COVID-19 lockdowns in the second half of 2021. I was spread thin between remote working, home-schooling three primary school-aged children, and a husband who was extremely busy as an essential worker. I could only complete CTA3 Advisory because my mother came to live with us for five weeks and helped with home-schooling the children. This allowed me to work during the day, study at night, and then spend time with the family each afternoon. My main advice is to have a supportive family and ensure that you are ready and focused to maximise the time you have allocated to study. Additionally, maintain some work–life balance through regular activities to help you switch off. For me, it was going for an early morning run, gardening or playing board games with the family.

What advice do you have for other tax professionals considering the Graduate Diploma of Applied Tax Law Program?

Even after working in tax for 20 years, there is always more to learn and time to broaden your knowledge. The Graduate Diploma of Applied Tax Law is a great course for individuals starting their tax career and wanting to gain an excellent grounding in a wide range of tax areas. It's also a valuable program for experienced professionals who may have had time away from tax and wish to re-acquaint themselves with up-to-date tax knowledge.



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22-0020EDU_03/22

State taxes and indirect taxes

by The Tax Institute

This chapter of the *Case for Change* considers the Australian indirect tax landscape, the pervasive issues in those taxes, including the state and federal dichotomy, and potential options for reform. This chapter also considers a number of direct state taxes. The types of taxes covered by this category include some of the most efficient and some of the most inefficient taxes, taxes drawing on both the simplest and most complex concepts, taxes that are all-pervasive and taxes that few need comply with, taxes that are loathed and (if not loved) taxes that are supported. However, perhaps the most difficult area of this category is the way in which taxes and responsibilities are shared between different layers of government in our federal system and the difficulties and behaviours that the current imbalance encourages. While there may be no simple panacea, this area of tax perhaps offers the greatest opportunity for reform and for significant societal as well as economic benefit. This chapter identifies many of those opportunities and offers options for further consideration.

Federalism and vertical fiscal imbalance

One of the challenges faced by governments in all federations is that, over time, the financial costs of providing services tend to shift between the different levels of government. Unless financial adjustments are made, the constitutional responsibilities of one level of government can become misaligned with the capacity of that government to raise revenues needed to meet its obligations.

Federalism in Australia has given rise to a dual system of taxation (setting aside the matter of local government taxes, duties and other charges). The Australian tax system comprises a complex matrix of state[1] and federal taxes, both direct and indirect.

The Commonwealth is limited by the Constitution in its ability to make laws in direct relation to taxation. Section 51(ii) of the Constitution provides that the Commonwealth has the power to make laws with respect to taxation, although essentially only in a manner that does not discriminate between the states or parts of them.

The Commonwealth has a practically greater power than the states to impose taxes and raise revenue. However, the states are responsible for a greater proportion of public expenditure. A restricted ability to impose efficient taxes puts the states in the unenviable position of relying on inefficient taxes, such as stamp duty and payroll tax, in order to raise sufficient revenue. This dependency disincentivises the states from reducing or repealing such taxes, compounding the vertical fiscal imbalance (VFI) which arises between these levels of government.

A VFI creates inefficiencies, undermines accountability between different levels of government, reduces fiscal transparency and can result in the misallocation of resources. It gives rise to inefficiencies, including through bureaucratic overlap and the cost of administering grants between governments. It undermines government's accountability to the public by severing the nexus between a government's decisions on the degree of services provided and the revenue raised to fund them. It reduces transparency regarding who is responsible for which government services, which, tying in with the issue of accountability, can give rise to unaccountability for funding and operational shortfalls. Inadequate funding of services and uncertainty as to responsibility can lead to a misallocation of resources. Overall, the impact is a slowed responsiveness of governments to the needs of the public. Importantly, this issue has been raised in a number of forums and other bodies have shared these observations, both in relation to the impact of VFI more broadly, and specifically regarding the imbalance between the taxing and spending powers of the Commonwealth and the states.[2]

The reform of fiscal federalism is a particularly complex area of governance, with virtually no 'perfect' solutions. In our view, the position put by the Business Council of Australia summarises the situation well:[3]

> "Ideally, each Government should raise the funds necessary to fulfil its responsibilities. It is questionable, however, whether Australia's revenue raising system could be so radically adjusted given how far the pendulum has swung in favour of the Commonwealth. Without adjustments, however, it is likely that the States will become increasingly the service deliverers of the Commonwealth's policy agenda."

As outlined above, the states have a limited capacity to raise revenue and the taxes within their remit are largely inefficient. It is acknowledged that some states have access to mining royalties which can provide significant revenue streams. However, even in those cases, the raising of royalties effectively reduces their access to Commonwealth grants.

VFI has existed in some form since the beginning of Federation. This is to be expected in any federation as it recognises the inability of certain states to raise the revenue required to fund essential services that other states may be able to more readily fund for various reasons, including the availability and location of natural resources. This underpins the need for special grants which, when properly administered, ensure that public services

such as health care and education are equally available throughout the country. However, there are certain significant issues which arise from the current extent of VFI in Australia's tax system. One such issue relates to the cost of raising revenue. On the one hand, the states do not face all of the real costs (including political) of raising the revenue which they spend as part of it is passed on by the Commonwealth. On the other hand, the states are burdened with more expenditure than they have the means to cover independently. In any case, this VFI leads to less efficient service delivery.

Changes in responsibility for the collection of certain taxes have often been linked to intergovernmental financial relations. These changes have occurred as a result of High Court decisions, state and Commonwealth political decisions, intergovernmental agreements,[4] and broader challenges that may arise socially or politically, such as pressures to fund public expenditure. One thing is clear though — the extent of VFI continues to grow and is becoming increasingly unsustainable. At a high level, the solution must be either for the Commonwealth to assume greater responsibility for the collection of taxes and pass this on to the states so that they may relieve themselves of inefficient revenue sources, or for increased taxing powers to be devolved to, or activated by, the states. While each option gives rise to unique complexities, it is noted that the latter would provide greater certainty of funding to the states without requiring ongoing negotiations with the Commonwealth and the use of complex formulae to determine funding by grants. We consider that this is a fundamental area in which sweeping reform is required, and where the Commonwealth and the states must work together to develop a viable long-term solution.

That arrangements need to be addressed is brought into stark relief by the fact that changes by one state to its own taxation arrangements can, via the arrangements between the states and the Commonwealth relating to the sharing of GST, cause another state's share of GST to be affected.[5] The Commonwealth Grants Commission has noted that:[6]

> "If a state increases its tax rate, it will increase the national average rate, increasing the assessed revenue raising capacity of States with a relatively large share of the tax base and reducing their assessed GST requirements."

This, among other acknowledged issues with the current approach to GST sharing, is an impediment to real reform.

Payroll tax

Overview

Payroll tax is broadly a tax on wages, in cash or in kind, provided by employers to their employees. It was introduced by the Commonwealth in 1941 in order to help fund welfare payments, such as the national child endowment scheme.[7] It initially applied as a 2.5% levy on payrolls. For approximately three decades, the administration of payroll tax was controlled by the federal government as part of its remit over the income tax base. However, in 1971, as a result of lobbying for access to a growth tax, it was handed over to the states. This occurred in acknowledgment that payroll tax would be essentially the sole growth tax available at the state level.[8]

While initially uniform across the states, over time, there have been unilateral changes by the states, including increases to the rate, as well as modifications to the applicable thresholds and other rules.

Over a decade ago, an attempt was made to harmonise payroll tax across the country. Notably, in 2007, the Commissioners across all states committed to harmonising the administration of payroll tax. Since then, amendments have been made to harmonise the various payroll tax regimes across a number of areas, including the availability of certain allowances, the treatment of certain benefits for payroll tax purposes, employee share schemes and grouping.

Since 2009, the states have implemented largely uniform legislation. In 2010, the Commissioners of all states signed a *Protocol for Payroll Tax Harmonisation between Jurisdictions*.[9] These harmonisation initiatives have been successful in part, though further work is required to achieve genuine harmonisation.

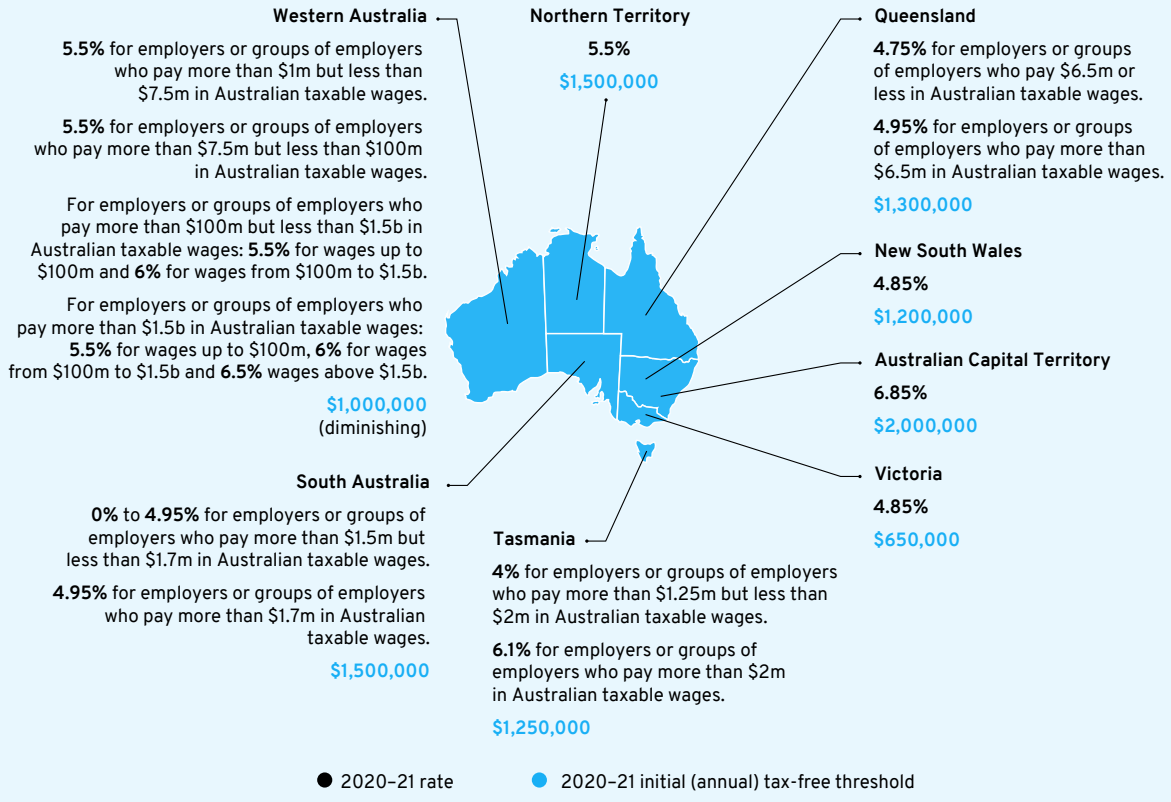
There are certain significant aspects of payroll tax which remain inconsistent from state to state. Despite the harmonisation attempts noted above, each state administers its own nuanced regime with different criteria for determining an employer's liability, including different tax-exempt wage thresholds, allowable deductions and rates of tax. Aside from certain allowable deductions, the key areas of significant dispersion are the rates and thresholds applied. In terms of administration, while most states have previously agreed to use jointly issued revenue rulings, this is not yet uniform across the country. In addition, the significant compliance burden imposed on employers must be addressed.

Tax competition between the states, as well as lobbying by employers and employer groups, have resulted in the payroll tax base being reduced to less than half of the comprehensive labour income tax base. Today, payroll tax is levied at rates ranging from 4.75% to 6.85%. Despite increases to thresholds and reductions to the rate, payroll tax still raises the most revenue for the states and has become the most important state tax in terms of revenue collection, accounting for between 24% to 36% of each state's total revenue.

Figure 1 provides a summary of the payroll tax rates and thresholds across the states but does not take into account potential variances, such as discounts for regional employers in certain states.

Payroll tax contributes more revenue than any other state tax. In 2018–19, it raised approximately 30% ($9.4b) of New South Wales total tax revenue, 37% ($7.0b) of Victorian tax revenue, and 25% ($4.16b) of Queensland tax revenue.[10] The OECD reported that, as a direct form of taxation, Australia relies more on payroll tax than other OECD countries in the Asian and Pacific economies.[11]

Figure 1. Payroll tax rates and thresholds



Payroll tax has a relatively stable base and, as outlined above, it is intended to be a growth tax that provides steadily increasing revenues which are intended to support state budgets throughout economic cycles and to weather unplanned circumstances, such as disaster relief.

Payroll tax (re)design – anomalies and the need for harmonisation

Issue – inconsistent regimes particularly in relation to rates and thresholds

As mentioned above, there are anomalies across the different state payroll tax regimes, most conspicuously in relation to the applicable rates and thresholds. In addition to varying legislative frameworks, the various revenue offices provide different levels of guidance and assurance, all of which can be subject to interpretation.

In some cases, concessions and exemptions are available in one state but not another.[12] Likewise a particular benefit may be subject to payroll tax in one jurisdiction but not another. This means that an employer operating in one jurisdiction may be (dis)advantaged compared to another employer in similar circumstances but operating in a different jurisdiction. It also means that an employer that operates across several jurisdictions is required to keep up with the nuances in each regime.

Options for harmonisation

If it is to be retained by the states, the overarching answer to the majority of issues arising in relation to the payroll tax system is harmonisation. While some level of competition between the states may be healthy, we do not consider that payroll tax (or any tax in a national context) is the appropriate avenue for this.

Consistency across the various payroll tax regimes would level the playing field for Australian businesses and would reduce compliance costs for those employers operating across multiple jurisdictions. This would eliminate one disincentive from expanding a business from a domestic state market to a multi-state or national operation. This promotes productivity, workforce participation and economic growth generally, and is therefore better for the Australian economy as a whole.

We consider consistency across payroll tax regimes would be best achieved through centralised administration by a single body, most likely the ATO. Similar to how the GST is administered by the ATO and GST revenue is collected at the federal level and passed on to the states, it is envisaged that this kind of arrangement could be implemented in relation to payroll tax.

Alternatively, we would recommend that the states come together and use best endeavours to reach agreement on a genuinely harmonised payroll tax regime, specifically including rates and thresholds. Further, built into any such agreement must be a commitment not to subsequently vary aspects of the system, including interpretative approaches, without prior consultation and agreement of the states. This could parallel the arrangements in place in relation to variations to the GST rate and base.

Issue – the meaning and use of the term 'employee'

There is a lack of harmonisation of the definition of 'employee' across the various payroll tax regimes. The result is that employers are burdened with the 'employee versus contractor' dichotomy in yet another aspect of the tax system. To overcome this, employers must generally seek assistance from a tax adviser, noting that this option may lack certainty due to the broad interpretation of payroll tax law and inconsistencies from state to state. Without certainty, employers are exposed not only to potentially significant payroll tax liabilities, but also to penalties and interest.

Option – introducing an all-encompassing concept of a 'worker'

As outlined earlier in the *Case for Change* paper, the rapidly changing nature of employment and the labour market has seen the emergence of new work relationships such as the sharing or gig economy. In the context of tax compliance, non-traditional ways of working have introduced a new level of complexity to be carefully considered alongside the traditional dichotomy between an employee and a contractor.

The OECD recently reported that, across OECD countries, there is a growing number of workers earning income outside of the traditional employee–employer relationship.[13] This trend is driven by various factors, for example, demographic changes, labour market regulation and the relevant tax system.

The Tax Institute supports reform that ensures that tax policy keeps pace with changes in the labour market. We recommend the adoption of a broad and inclusive concept of a 'worker' to encompass the various classifications (i.e. employee, contractor and non-traditional work relationships resulting from the growing gig economy). Such a term should be defined in legislation and should apply consistently across all Australian taxes and the superannuation system.

This would simplify the suite of employment taxes, both at a state level and a federal level. Importantly, it would cut red tape associated with the classification of an individual as an employee or contractor (which can be subject to inconsistent interpretation across the various taxes and, in the context of the states, the various regimes). It can also reduce potential opportunities for arbitrage by businesses in their selection of the type of labour contract offered to an individual, or for individuals in their decision to operate as an employee, or an incorporated or unincorporated contractor.[14]

While introducing the concept of a worker is preferable, at a minimum, a harmonised definition of 'employee' should apply not only for the purposes of all payroll tax regimes across the country, but indeed, for all remuneration-based taxes.

Importantly, a harmonised definition (whether implementing the concept of a worker or retaining references to employees as distinct from contractors) should be legislated. This would provide greater certainty and consistency than the current approach which relies on the common law definition.

Disincentives to economic growth

Issues

Payroll tax is an additional cost to businesses which play a critical role in supporting the Australian economy by expanding the Australian workforce.

The liability to payroll tax is based on wages paid and is unconnected to profit. This may disincentivise wage growth above the applicable tax-free threshold (considered below). This disincentive is compounded at times where market activity declines. Most recently witnessed throughout the COVID-19 pandemic and the economic recession, businesses that retain workers during difficult times, for the most part, have maintained their payroll tax liabilities despite potentially significant declines in profits. This imposes added pressure on those businesses. From a payroll tax perspective, businesses that retrench staff during such times are left in a better position. This is inconsistent with the government's objective of creating jobs and encouraging economic prosperity.

Besides ad hoc exemptions, such as the reduced rate of payroll tax for regional employers in bushfire-affected areas in Victoria, payroll tax regimes across the country generally exclude the impact of economic and natural disasters.

Assuming harmonisation is achieved, questions arise as to the appropriate threshold and rate of payroll tax. A higher rate of payroll tax, while beneficial to the states as a source of revenue, could indirectly result in reduced effective wages for employees, leading to a fall in employment in small and large businesses alike (either because of the cost to business or because of the withdrawal of labour from the market). This must be balanced against the impact of a lower rate which could potentially reduce overall revenue for the states. The same can be said of the threshold.

Options – payroll tax rates and thresholds

Further research and modelling is required to determine the redistribution effects of a higher payroll tax rate reform and whether a reduction in other taxes or an increase in government expenditure, including in the form of transfer payments, could appropriately offset the lower take-home wage for employees.

The alternative is an overall revenue-neutral reform package. This would be achieved through a broader payroll tax base (achieved through lower or nil tax-free thresholds, and reduced concessions and exemptions) and a lower overall rate (for example, potentially between 2.5% to 3.5%). Implementation at the national level with collection via PAYG would have the added benefit of reduced administration and compliance costs (simplicity). In light of the minimal distributional effects, a flow-on outcome would be a reduction in opportunities for distortion.

The Tax Institute is of the view that simplifying and standardising payroll tax regimes through a consistent lower rate and the removal of thresholds is the preferrable

option. Compliance costs are significantly reduced where readily available Single Touch Payroll (STP) data is used, and rebates may potentially be used to further offset costs for certain businesses.

Options – alternatives to payroll tax

The system must be modernised to become more agile for the benefit of taxpayers and the state governments alike. As acknowledged above, payroll tax is currently fundamental to state governments as a significant source of revenue. It plays a critical role in supporting the state budgets and in weathering economic adversity. However, reform is critical to ensure that it allows businesses not only to survive in times of hardship, but also to expand.

Business turnover tax. One alternative to payroll tax is a business turnover tax. A business turnover tax is a relatively simple, presumptive tax that applies to the turnover of a business. Importantly, it does not distinguish between employing and non-employing businesses.

Such a tax imports a significantly lower level of complexity as it operates simply as a designated rate of tax applied annually to the turnover of a business. Unlike an income tax, deductions would not be taken into account, further simplifying its application by eliminating the requirement to determine whether expenses are tax-deductible and how they may be claimed. Given that deductions are not taken into account, the rate of tax would be expected to be lower than standard rates. In view of the relative simplicity in the tax base and its application on an annual basis, a business turnover tax would also involve a much less onerous record-keeping and compliance burden as compared to payroll tax.

State income tax. Another alternative is state income tax. While there are a myriad of ways in which a state income tax could operate, such a tax should alleviate existing VFI to some extent.

There are a number of ways to overcome potential double taxation or the risk of creating multiple tax regimes. At the outset, the basis for determining liability could remain under existing income tax laws, primarily the *Income Tax Assessment Act 1997* (Cth) and the *Income Tax Assessment Act 1936* (Cth). This would avoid the inefficiency of creating new state-based income tax regimes and would ensure a level playing field whereby the same regime continues to apply to all taxpayers.

To prevent double taxation, the federal income tax could be reduced to the extent that a state income tax is imposed. For example, where 30% federal income tax were otherwise payable, if 10% state income tax is imposed, the federal income tax rate would reduce to 20%. It is acknowledged that this would create two layers of income tax, though this could be overcome by requiring lodgment of a single tax return, with the tax payable divided among the Commonwealth and the relevant state in the applicable proportions.

It should also be noted that, while there is a degree of harmonisation between the payroll tax (and, indeed, stamp duty, land tax and other) regimes operated by the states, they are still separate regimes governed by state law, such that replacing them with state-based income tax should not be as significant a change as it may appear on its face.

There are a number of options that could be considered, incorporating one or both of a business turnover tax and a state income tax. These alternatives and some combinations are outlined in Table 1.

Whether such a tax should apply to individuals only or equally to businesses requires consideration of whether a business turnover tax is feasible. Either a business turnover tax or a state income tax may be viable in isolation, but they may also work in tandem, as suggested in Table 1, provided that they are carefully considered to prevent double taxation at the state level and also in the context of existing federal taxes.

There are a number of other factors which require careful consideration, such as the potential disadvantage to smaller states and the compensation mechanism that may be required. We consider that there is value in undertaking further work and assessing these alternatives in greater detail.

Regardless of the option chosen, but particularly if payroll tax is retained, the merits of tax concessions for small to medium-sized enterprises (SMEs), start-up businesses and those businesses affected by unforeseen and extenuating circumstances (such as bushfires, floods or COVID-19) should be considered. While it is acknowledged that many SMEs are exempt from payroll tax by operation of a tax-free threshold, this is generally not the case in Victoria due to the significantly lower than average threshold and, in any case, a tax-free threshold can in most jurisdictions be affected by the operation of the grouping rules (discussed below).

Disproportionate compliance and administrative costs

Issue

In addition to an annual return and other ongoing record-keeping requirements, payroll tax returns must be lodged monthly. This compliance burden increases exponentially where an employer operates across more than one jurisdiction. The cost to businesses of managing their payroll tax obligations in each state is significant and can deter businesses from expanding across multiple jurisdictions.

Table 1. State income tax combinations and options

	Individual	Business
1.	State income tax	State income tax (akin to federal company tax)
2.	State income tax	Business turnover tax
3.	State income tax	
4.		Business turnover tax

This is exacerbated by the variability of thresholds and rates which, as considered above, also disincentivise business expansion and wage growth, even in a single jurisdiction.

Options

The solution to this issue could be found in the administration of payroll tax. Allowing businesses to lodge a single annual return, or, alternatively, for payroll tax to simply be reported on a business activity statement (BAS), would be a significant reduction in the compliance burden on businesses, particularly in the latter case, given that most businesses incurring a payroll tax liability are already required to lodge a BAS.

Further, as outlined above, payroll tax is not an appropriate avenue for competition between the states. Particularly in the current economic climate, the focus of the state and federal governments should be the creation of jobs and economic growth across the entire nation.

By either removing or standardising the tax-free thresholds, and by implementing a single rate, businesses will not be (dis)advantaged for operating in one jurisdiction over another and payroll tax will cease to be a consideration in determining where to employ staff and whether to expand a business.

Complexities relating to grouping

Issues

From a business group perspective, payroll tax is an inefficient and cumbersome tax.

The grouping provisions in the various payroll tax regimes are expansive and broad-reaching. Aside from very limited exceptions, the main exclusion rests on the discretion of the relevant Commissioner. Despite harmonisation in this area, the approach taken can vary from state to state. This can give rise to inconsistencies in the application of payroll tax and particularly in the availability of any relevant tax-free threshold.

Further, the compliance costs for a group liable to payroll tax are high. Unless the group is a single lodger group, all members of the group are generally required to lodge returns for essentially the same information (albeit that the threshold may only be claimed by the designated group employer). This burden is compounded where the group operates over multiple jurisdictions.

Options

The business turnover tax discussed above is a holistic option for reform which could address issues arising with regard to grouping for payroll tax purposes, and indeed other aspects of the system. Similarly, a system with no exemptions would obviate the need for grouping as all employing entities would be included in the regime. (This could be coupled with a reduced rate.) Alternatively, there should be a focus on redrafting the legislation in this area and cutting red tape in terms of the compliance obligations imposed on a group.

Taxes on land and transfers of real property

Overview

The Tax Institute supports reforms which make the tax system more efficient, fairer and sustainable. In addition to these principles, in the context of land and property, The Tax Institute supports reforms which make housing more affordable for all Australians.

As outlined earlier in the *Case for Change* paper,[15] efficiency relates to the extent to which a cost (such as a tax) distorts behaviour, rather than the cost itself. Land can be a highly efficient tax base, capable of delivering sustainable revenue. It is efficient largely because it is immobile and cannot move to escape tax in the same way as other tax bases, such as labour or capital. While the cost of the tax may influence the price of the land, it generally does not affect how or the extent to which it is used (subject to the availability of exemptions, considered below).

When considering mobility, it follows that greater economic growth could be achieved more readily where more revenue is raised from immobile sources, such as land, than from mobile tax bases which have the potential to escape the Australian tax net, for example, by being contracted or offshored. The tangible, immovable nature of land makes it difficult to evade or manipulate the associated taxes by residents and, indeed, non-residents alike.

The efficiency of taxes on land, like any other tax, is, of course, inversely proportional to the level of exemptions and concessional treatment available in respect of certain types of taxpayers or uses of land (for example, residential, commercial, charitable, or primary production). In assessing existing taxes and potential alternatives, governments must be mindful of the potential for exemptions to distort behaviour and, specifically in the context of land, to change how it is used. This part of the chapter primarily considers stamp duties on transfers of land and real property, land tax and the potential for new property taxes.

Stamp duties

Stamp duty is a state-based charge, levied on the transfer of certain assets, in this context, real property and land.[16] It is generally payable by the purchaser of the asset and is determined by reference to the higher of the purchase price and the market value of the asset. Rates and thresholds vary from state to state, though, as a general premise, stamp duty rates increase progressively depending on the asset value.

Table 2 sets out a high-level summary of the maximum duty rates and foreign purchaser surcharges in each state as at February 2021.

Stamp duties are archaic. They are founded on reasons which are simply not relevant or justifiable in today's day and age.[17] Worse still, they distort behaviour. Stamp duties discourage transfers of land and other assets more broadly. In the residential space, this inhibits people from upsizing or downsizing depending on their familial circumstances.

Table 2. Maximum duty rates and foreign purchaser surcharges

Jurisdiction	Maximum duty rate	Foreign purchaser surcharges
New South Wales	5.5%	7% premium rate applies to transfers of residential property where the value exceeds $3,101,000.[18] 8% surcharge applies to foreign purchasers of residential property.
Victoria	5.5%	8% surcharge applies to foreign purchasers of residential property.
Queensland	5.75%	7% surcharge applies to foreign purchasers of residential property.
Western Australia	5.15%	7% surcharge applies to foreign purchasers of residential property.
South Australia	5.5%	7% surcharge applies to foreign purchasers of residential property.
Tasmania	4.5%	8% surcharge applies to foreign purchasers of residential property. 1.5% surcharge applies to foreign purchasers of primary production land.
Northern Territory	5.95%	
ACT	4.54%[19] 5%[20]	

It impedes workforce mobility and the ability of people to relocate freely for other purposes. It is one of the major obstacles for first home buyers to enter the property market.

Stamp duties are not commensurate to other economic conditions. Studies have shown that, since the 1980s, stamp duty costs have increased approximately three times faster than house prices.[21] Bracket creep is a serious problem in this context, with certain states having little or no rate adjustments since the 1980s.[22]

For each of the states, stamp duty is a significant source of revenue. Although the base (essentially land) is immobile and therefore has the potential to be fundamentally efficient, because they are tied to transactions, stamp duties are highly volatile, and the revenues generated are highly dependent on a number of external factors, such as market forces and the extent to which properties are transacted. For example, where there is a surge in property prices, as we periodically experience in many parts of the country, revenues generated from stamp duty will prima facie increase. However, where there is a lack of turnover in the property market, stamp duty revenues suffer. The effect is that, while the states can enjoy high revenues in times of peak market activity, those which are particularly reliant on stamp duty as a major source of revenue are especially exposed during periods of economic downturn and slowed market activity. That is, stamp duty is unreliable as a consistent revenue stream.

Land taxes

Land tax is an annualised state tax based on the unimproved value of land as determined by the relevant state Valuer-General where such value exceeds the applicable tax-free threshold.

Table 3 sets out a high-level summary of the general land tax rates in each state as at February 2021.

Land taxes are much less volatile than stamp duties, although they are still bound, to an extent, to market movements in respect of the value of the land itself. In acquiring land that is liable to land tax, purchasers may

Table 3. Land tax rates

Jurisdiction	Maximum general land tax rate	Surcharges and other additional rates
New South Wales	2%	2% surcharge for residential land owned by foreign persons.
Victoria	2.25%	2% absentee owner surcharge (all taxable land). 1% vacant residential land for certain parts of Melbourne.
Queensland	2.75%	2% surcharge for absentee individuals, foreign corporations and trustees of foreign trusts (all taxable land).
Western Australia	2.67%	0.14% metropolitan regional improvement.
South Australia	2.4%	2.4% trust surcharge.
Tasmania	1.5%	
Northern Territory	N/A – property activation levy imposed on unimproved capital value of vacant land and certain non-residential properties in Darwin.	
ACT	1.12% plus $1,326 fixed charge.	0.75% surcharge for residential land

factor in the cost of the tax in their pricing. That is, land value reflects the future, after-tax earnings on land, the outcome being that by equalising the after-tax return on land with the return on other investments, land tax does not distort investment decisions.[23]

An important policy consideration is that, as noted above, land tax applies to the unimproved value of land. The liability does not take into account the value of buildings or other capital improvements. This means that land tax does not hinder investment or productivity. It does not deter the use of land for particular purposes (subject to the availability of exemptions), nor does it influence a decision to improve the land, other than from perhaps a cash flow perspective.

As noted above, land taxes have the potential to be highly efficient. Land has a broad base, available in a fixed supply. The only real substitute for one parcel of land is another parcel of land. However, existing regimes generally have a narrow base, excluding land used for certain purposes (for example, owner-occupied residential housing). This creates the potential for landowners to determine whether to use land in a taxable or exempt manner. This, in turn, affects the efficiency of the tax as it removes the fixed element of the supply of taxable land. It also impacts where the burden of the tax ultimately falls, given that it may be passed on to the users of land (that is, tenants or business owners of the land as part of their cost of production).

In each state operating a land tax, there are a number of exemptions in place which can reduce a taxpayer's liability to land tax, potentially to nil. These include (subject to certain criteria) a person's principal place of residence, primary production land, boarding houses, low-cost accommodation, and residential and caravan parks. There are also concessions and exemptions for not-for-profit organisations, retirement villages, aged care establishments, nursing homes and childcare centres.

Options

Property tax

The overarching issue with both stamp duties and land taxes is inefficiency. Stamp duties are unfair in that the burden is borne disproportionately by those who transact in real estate. Land taxes are currently inefficient due to the broad exemptions which remove a significant proportion of land from the tax base.

There are a number of key factors when considering reform in this area. One is establishing a comprehensive base with minimal exceptions. Another is determining the appropriate rate (or rates) at which the tax will be imposed (and the extent to which any thresholds will operate in tandem). Whether or not reform in this area should be revenue-neutral, and how the desired outcome can be achieved, whether in the short, medium or long term. Another important consideration is the potential overlap between a property tax and local government charges, such as council rates and levies. While the real risk here is different levels of government competing for the same base and potential double taxation, the opportunity is the streamlining of regimes which can lead to greater cohesion between different levels of government, thereby further enhancing efficiency. A reform package which takes into account these factors would lend itself to greater efficiency, stability and a fairer outcome for residents.

There are various options for reform in this area, but those which The Tax Institute recommends fall broadly in the scope of property taxes. One somewhat tested option would be to follow recent examples, such as the ACT which, in 2012, commenced a 20-year gradual shift away from stamp duties, or the recent proposals currently being considered by the NSW Government to replace stamp duties and, where applicable, land tax with a broad-based, annualised property tax.

The Tax Institute has considered a number of potential issues and key aspects of a potential shift away from stamp duties (and land tax) towards a property tax regime.

Housing affordability. A common concern in this context relates to the potential increase in housing prices in the short to medium term in respect of those properties brought into the new regime. The increase is expected to potentially reflect the stamp duty liability that otherwise would have arisen. Such an increase could exacerbate challenges facing buyers in an environment of escalating house prices.

Where financial lenders take into account the ongoing cost of the proposed property tax in determining a borrower's capacity to service a loan, it is expected to reduce a person's servicing capacity (due to the reduced after-tax income position resulting from the annual property tax cost) compared to their servicing capacity in the case of a property liable to stamp duty. Subject to whether a person has a high cash deposit/low servicing ability or a low deposit/high servicing ability, the overall effect of this should be that a stamp duty purchaser and a property tax purchaser should be able to borrow equivalent amounts, with neither category of purchaser worse off in that regard.

The Tax Institute considers that it will be important for governments to undertake comprehensive analyses of the impact of the proposed property tax on property prices, and to communicate those findings and the way in which that impact may be ameliorated by standard banking assessment rules.

A choice to opt-in. One challenge in the use of property taxes as compared to stamp duties is the ongoing nature of the liability. Stamp duty is an upfront, finite, one-off cost. Property tax (which is essentially a form of land tax), on the other hand, is an ongoing, annualised liability which can continue indefinitely. While the rate of tax can be generally lower (than stamp duties, and indeed existing land taxes) in raising the same revenue, it can mean that, depending on a landowner's holding period, the total tax cost of holding a particular parcel of land can be higher or lower.

Providing taxpayers with optionality between paying stamp duty on the one hand and annualised land tax on the other, at least at the time of introduction of a property tax, is a politically convenient way to transition to property tax.

This will allow taxpayers to determine which option will be most suitable for their circumstances, depending on a range of factors, including their intentions with respect to the holding period of the relevant property and their financial position.

It is recognised that a right of election may, at least temporarily, result in a more complex two-tiered tax system that will require greater effort to administer. Optionality may also create distortions in the market as some buyers may price assets based on paying stamp duty and others may price assets based on paying property tax. However, if the alternative is an immediate transition to a property tax that leaves sectors of the community without the means to pay (or a transition which applies to all landowners over a set period of time), then, despite its complexity, a two-tier system remains a preferable outcome.

Where the choice to opt-in is only triggered on a transaction in real property, noting the small proportion of properties that transact in a given year relative to the total number of properties in any given state, a two-tiered system is unlikely to be a significant outcome, particularly in the early stages of reform.

Thresholds. While governments need to ensure that their existing revenue base is protected to some extent during a transitional phase, the use of thresholds should be simply that – transitional measures. The use of thresholds introduces a complex third layer to the potentially two-tiered system noted above. Complexity arises in relation to the movement of property values suburb by suburb as they transition and shift between eligibility and ineligibility as market prices fluctuate. Thresholds may also create a distortionary impact on those properties otherwise nearing the said threshold. This may arise, for example, in the context of lending approvals in respect of properties at the margins of the relevant threshold.

Revenue neutrality. Each state will need to consider whether it would have an objective of revenue neutrality or otherwise. From the perspective of taxpayers, a right of election will provide protection for current purchasers, especially those who intend a long-term hold of land, from an unforeseen increase in the tax that they ultimately pay. However, where that choice is irrevocable, the freedom to choose the regime that best suits a particular taxpayer's circumstances will gradually decrease as more properties are opted-in to the property tax system.

If a government's ultimate objective is to bring all properties into a property tax regime, and for the system to be revenue-neutral as compared to the status quo, thorough consideration and justification of the relevant rates will be required to ensure that the tax paid and collected under the new system is, indeed, revenue-neutral. This might necessarily mean that rates will be adjusted from time to time, which would lead to further uncertainty for taxpayers at the time of acquiring the land. It must be said, though, that a revenue-positive outcome is not necessarily undesirable, provided that it is part of holistic reform which sees reductions in revenues from other sources.

Concessions and exemptions. A significant issue for consideration in the development of a property tax will be whether the regime should contain any concessions or exemptions akin to those contained within the existing land tax and stamp duty systems. In this regard, consideration should be given to specific industries or entity types, certain types of transfers including those resulting from bequests or other intergenerational transfers, and transfers occurring in corporate reorganisations.

The Tax Institute recognises that the circumstances of farmers and primary production businesses are unique and their ability to pay an annualised tax may vary from year to year depending on external factors. Consideration should be given to the enactment of nuanced averaging measures to support those farmers who choose to opt-in to any property tax regime.

Charities generally enjoy certain longstanding broad exemptions from land tax and somewhat narrower exemptions from stamp duty. From a policy perspective, it would not be desirable to impose a new tax cost on charities. A particular issue arises out of the distinction between exemptions available under the duties law and in respect of land tax. While wide exemptions from land tax generally apply, duty exemptions for charities are usually more limited. In addition, if the transition mechanism is 'opt-in', consider whether it would be desirable for a charitable organisation to 'opt-out' for the time it holds the land and is used for charitable purposes.

An important question, therefore, is whether a property tax scheme would follow that of the existing land tax regime allowing for a broad exemption for charities, or whether it would be more restrictive following the model for stamp duty (or a combination of both). The Tax Institute recommends that, where a government considers a property tax reform, it engages with key charitable stakeholders, particularly those whose charitable purposes fall outside the scope of the stamp duty exemption and would be most adversely affected were any property tax exemption to follow the stamp duty model rather than the land tax regime.

Local governments. Increases in land values result in increases in rates payable to local governments. As noted above, this may result in state governments and local governments competing over the same tax base. In addition, one of the key issues here is that certain sectors of society receive relief from rates under longstanding arrangements for those in need (for example, pensioners). The Tax Institute is of the view that the underlying policy for such relief should apply equally to any proposed property tax.

Revenue administration. Apart from the social equity and economic issues arising, in the context of hardship, important considerations arise in the area of revenue administration. Stamp duty is easy to collect and must be funded upfront by a taxpayer seeking to buy a dutiable asset. Revenue collection is, therefore, generally straightforward, given that the tax 'follows the money'. This is not necessarily the case with a land or property tax, especially where the taxpayer is unable to pay.

To provide assurance to prospective purchasers considering opting-in to the new regime, The Tax Institute recommends that the way in which any such scheme will be administered should be set out in detail at the outset. This should include, in particular, the way in which the relevant revenue authority will exercise any discretions to provide relief to taxpayers. In the event that deferred financing is used (eg a reverse mortgage whereby the state takes a charge over the land for unpaid property taxes) which is repayable on death, consider whether such an approach would effectively be taken to be a death tax in disguise.

State-based approach. As for other state-based taxes, a cohesive approach across the states is desirable, though in the case of land and real property, it is less critical. For mobile tax bases such as capital and most labour, there is less justification for competition or inconsistency between the states. However, noting the immobility of land, there is greater freedom for states to dictate their own rates and conditions (including exemptions).

That said, and acknowledging that recent years have seen a greater divergence among the states, harmonisation of regimes across states has the benefit of ensuring fairness and consistency for Australians regardless of the state in which they choose to live and/or invest. This could be achieved by intergovernmental agreements between the states or also including the Commonwealth. Regardless of the approach taken, it is important for the federal government to provide support to the states which do choose to embark on the path of reform. Revenue stability will be key to empowering the states to embark on a path of enacting more sustainable revenue sources. This will be beneficial for the Australian people, the states, the Commonwealth and the economy more broadly.

Resource rent taxes

Overview

The Henry review recommended a broad-based resource rent tax as an effective way to ensure an appropriate return to Australians for the exploitation of Australia's natural resources.[24] In particular, the Henry review recommended that the then existing resource-charging arrangements should be replaced by a single resource rent tax administered at the federal level.[25] Among other reasons, this was on the basis that existing arrangements, in particular royalties, provided an insufficient return to the community given that they were unaffected by changes in profits, and the overall distortive effect on investment and production decisions also contributing to the reduction of the return to the community.[26] It was noted that Australia has the world's largest economically demonstrated resource reserves of brown coal, lead, mineral sands (rutile and zircon), nickel, silver, uranium and zinc, and the second largest reserves of bauxite, copper, gold and iron ore (contained iron).[27]

Despite the recommendations made in the Henry review, Australia's existing regimes for the taxation of the exploitation of its natural resources are unsatisfactory. Currently, Australia has only one resource rent tax, being the petroleum resource rent tax (PRRT), considered below. The short-lived mineral resource rent tax (MRRT) was introduced on 1 July 2012 in order to tax the gains on certain profits from resources such as iron ore, coal, oil and gas. The Rudd–Gillard Government had initially announced the idea of a broad resource tax on 2 May 2010, in the form of the resource super profits tax (RSPT). The RSPT was based on recommendations from the Henry review. However, it was subsequently determined that the RSPT would be replaced by the MRRT, which diverged substantially from the Henry review recommendations.[28]

The *Minerals Resource Rent Tax Act 2012* (Cth) was passed on 19 March 2012. Amendments resulted in it commencing on 1 July 2012.[29] The MRRT was a similar style of rent tax to the already existing PRRT but it applied at an effective rate of 22.5%, being a reduced rate derived from the nominal rate of 30% reduced by the extraction factor of 7.5%.[30] It applied to iron ore and coal mining projects with an annual profit above the $75m threshold, and had no refund of excess deductions. As enacted, the MRRT was distinct from that which had been recommended by the Henry review.

For a number of reasons, mining companies opposed the MRRT. Its abolition was promised as part of the Abbott Government's pre-election campaign, and in September 2014, it was repealed by the *Minerals Resource Rent Tax Repeal and Other Measures Act 2014* (Cth).

With the PRRT operating alongside certain state-based arrangements, this is an important area which requires greater consideration. The Tax Institute's overarching recommendation is for the government to reconsider the taxation of economic rents derived from Australia's natural resources. A surcharge or levy, akin to the major bank levy, should be considered. This would be, perhaps, the simplest way to tax economic rents in this industry, ensuring efficiency, a low compliance burden and an appropriate return to the community.

Petroleum resource rent tax

As mentioned above, unique taxes and royalties apply in the mining and natural resources sector. At a very high level, they are broadly charges imposed on a fixed rate per unit that is produced, as well as profit-based royalties. Royalties place a cost on the use and sale of a commodity present on the land, similar to the way in which a road usage or congestion charge would be imposed to reflect costs to a community. In contrast, the PRRT captures the profits made from unique deposits.

Until 1975, the main return to Australian society from the extraction of offshore petroleum resources was through petroleum royalties. A crude oil levy was imposed in 1975 by the Commonwealth under the *Excise Tariff Act 1921* (Cth). The levy was introduced in response to dramatic increases in global oil prices in the early 1970s. It was initially imposed at a flat rate per barrel, although variable rates, depending on the date of discovery of petroleum deposits, were introduced when price controls on domestic crude oil production were removed in 1978. This was intended to encourage the production of resources in new and remote

areas. However, in recognition that the net return would, in some cases, be insufficient to justify investment in certain fields, the variable rates were subsequently replaced by a sliding scale levy in 1983, with a top marginal rate of 87% depending on the quantum produced from a petroleum field. The sliding scale was thereafter restructured, with three scales representing different discovery periods, and both its scope and rates gradually reduced. Today, it only applies to offshore petroleum title areas that are out of the scope of the PRRT, although, in certain cases, exemptions from the levy apply. As the name would suggest, it applies to crude oil only and not to natural gas.[31]

On 18 April 1984, the federal government announced that offshore petroleum projects developed after that date would be subject to a new resource rent tax and exempt from royalties and the crude oil levy. Three years later, the *Petroleum Resource Rent Tax Assessment Act 1987* (Cth) (PRRTAA) and related legislation were enacted. Although the Act was not passed by parliament until 1987, it applied retrospectively to exploration permits awarded on or after 1 July 1984 and recognised expenditure incurred on or after 1 July 1979.

One of the objectives of the PRRT was to reduce distortions to offshore petroleum exploration and development while generating an equitable return to society. However, mineral rights have always been a contentious issue between the Commonwealth and state governments, and the PRRT has been no exception.

The PRRT applies at a rate of 40% to the taxable profits of oil and gas projects located in Commonwealth waters, and on the North West Shelf project which is a shared jurisdiction between Western Australia and the Commonwealth. It no longer applies to onshore oil and gas projects such as those located in Gladstone, Queensland, which are instead covered exclusively by a state-based royalty regime. It has applied to offshore petroleum projects other than the North West Shelf project and the Joint Petroleum Development Area since its introduction. The Bass Strait project has been subject to PRRT since 1990 and, since 2012, the PRRT regime was applied to the North West Shelf project. In 2012, onshore petroleum projects were brought within the PRRT regime, although they were removed from its scope from 1 July 2019. As a result, provisions that related to initial amounts of starting base expenditure and the consolidation single entity rule were repealed. Separately, from that date, new uplift rates have applied to certain categories of carried-forward expenditure.

The PRRT regime has been subjected to significant and detailed reviews, including an independent review by Mr Michael Callaghan AM PSM who issued his final report to the then Treasurer, the Hon. Scott Morrison MP on 13 April 2017[32] (the Callaghan review). The government responded to the Callaghan review on 2 November 2018.[33] As part of the government's response, a separate inquiry into the effectiveness of the residual pricing method (RPM) contained within the *Petroleum Resource Rent Tax Assessment Regulation 2015* (Cth) (PRRT Regulations) was commenced by the Australian Treasury.

Among other things, the Callaghan review included recommendations on administration on the grounds that the administration of the PRRT significantly differs from other tax regimes. Notable recommendations related to the choice of functional currency for PRRT purposes, the filing of returns for exploration permits, and matters such as the availability of substituted accounting periods. These matters and others are considered below. The issues raised in this chapter of the *Case for Change* are not exhaustive and we reiterate our recommendation that the government consider other significant issues within the PRRT regime, particularly those raised in the Callaghan review.

Issues and options

The operation and efficiency of the PRRT regime are important to the health of the overall tax system, particularly to give confidence to the Australian community that they are receiving an appropriate share of any profits that attach to a petroleum project on the basis that the petroleum itself is an asset of the Australian people.

Overall, The Tax Institute recommends that the changes proposed in the government's response to the Callaghan review be progressed. The options outlined below will significantly improve the administration of the PRRT regime and provide certainty to PRRT taxpayers and potential investors.

> "The state and indirect tax regimes are inconsistent, inefficient, incoherent, administratively costly, with a high compliance burden."

The Tax Institute recommends that there should be consideration of whether the PRRT regime remains fit-for-purpose and the extent to which it may be simplified. We consider that a number of administrative and technical changes should be legislated. Undertaking these amendments will maintain the integrity of the regime, while improving the administrative experience for all users, including taxpayers and the ATO.

Importantly, the amendments outlined below should be legislated. Such changes are relatively simple solutions which will have a significant impact on reducing the compliance burden associated with the PRRT.

Distribution of an appropriate share of profits from petroleum projects

The Callaghan review noted concerns raised by community groups that the PRRT was not providing an equitable return to the Australian community on the development of petroleum resources. The report stated:[34]

> "In particular, concern was expressed that PRRT revenue is declining at a time when a number of large LNG

projects have or will soon come into production that will result in Australia becoming a leading exporter of LNG. Concerns were also expressed that some large LNG projects may not pay PRRT for decades to come, or may never pay PRRT at all."

Functional currency

Issue

There is no ability to choose a functional currency other than that of the ultimate parent entity. If the functional currency of the ultimate parent is not USD, which tends to be the prevailing oil and gas industry currency, significant challenges arise in complying with the regime, particularly given the interactions with the RPM measures in the PRRT Regulations.

There are information limitations placed on taxpayers where participants in a joint venture, in particular the operator of a project, have a PRRT functional currency which differs from other joint venture participants, given that often they do not maintain multiple currency ledgers. We note that this issue is not limited to multiple entry consolidated groups. This has led to taxpayers being required to enter into individual agreements with the ATO to ensure that compliance resources are not directed to matters of currency conversion. It also results in inefficient systems usage and significant manual processes to manage currency as the taxpayer's systems often cannot maintain the information directly.

Option

Reform in this area should allow the flexibility for a PRRT taxpayer to select the currency in which to report. Alternatively, a simple fix in the majority of cases may be to allow the election of USD as well as AUD as the appropriate functional currencies for the PRRT regime. Given that USD is the ordinary reporting currency for the majority of the oil and gas industry, this option is likely to have the desired practical outcome.

While we acknowledge that the ATO has been able to enter into agreements not to direct compliance resources to currency-related matters within the PRRT on the basis that it is considered low risk, this is far from appropriate for a regime with such large spending occurring.

Substituted accounting periods

Issue

Taxpayers who pay PRRT are unable to apply for a substituted accounting period. This forces all such taxpayers to use a 30 June year end. This is the case despite the prevalence of a 31 December balance date in the oil and gas industry. This gives rise to duplication and often necessitates manual intervention to calculate the financial information necessary to prepare a full-year return.

Option

The ability for a taxpayer to select a substituted accounting period consistent with its own statutory reporting period is one of the most fundamental choices within the income tax regime. It enables taxpayers to reduce compliance burdens and align record-keeping and report production within systems. A substituted accounting period has no real impact on the tax collected but merely the administration for the relevant PRRT taxpayer. That it is not currently contemplated by the PRRT regime is an anomaly that should be corrected by a legislative amendment.

It is therefore recommended that the ability to elect a substituted accounting period be legislated.

Filing of returns

Issue

There is generally a significant lag between incurring expenditure and development. This can sometimes be as long as multiple decades (for instance, in relation to the Gorgon project, there was more than 40 years between discovery and production).

There is currently no obligation to lodge PRRT returns for exploration permit spends.

An obligation to lodge a PRRT return arises only when assessable receipts are first recorded by a project. This triggers the review period covering time limits for the Commissioner to issue an amended assessment. However, it leads to a scenario where often all of the prior years need to be considered shortly after the lodgment of the first PRRT return, including the prior exploration expenditure history, which could have spanned several decades by that stage.

It is far from ideal that reviews/audits of expenditure can be undertaken several decades into the future. Documents must be stored for the future, which is entirely inconsistent with corporate record retention, and transfer pricing which has a seven-year limit. A large portion of such records, particularly historical documents, are held in hardcopy.

From a government perspective, PRRT returns hold only limited usable information, in particular on the size of expenditure pools, including those which may be transferrable between projects under the PRRT regime. This has led to a significant modelling issue for the Commonwealth Treasury and difficulties arise in attempting to advise the government on anticipated revenue collections over various timeframes.

Option

We consider that it should also be legislated that returns be required to be lodged with the ATO from when a project incurs expenditure, not from when it derives assessable petroleum receipts. This is consistent with the income tax return requirements for carrying on an enterprise. It is also valuable as a data source for the Commonwealth Treasury in modelling and forecasting expenditure information much earlier than it currently obtains it.

While this does give rise to a new administrative obligation on PRRT taxpayers, this should be balanced by a four-year amendment period from the lodgment of a return. It will also provide a longer-term trade-off in the context of security over the historical positions and avoid unduly expensive document retention costs.

Tolling arrangements under the existing PRRT Regulations

Following the boom in greenfield liquefied natural gas (LNG) development in Australia, the Australian LNG industry is entering a phase of seeking to maximise the use of existing infrastructure by processing new sources of petroleum through that existing infrastructure.

As existing resources and fields mature, processing capacity will continue to open up in existing LNG plants throughout Australia, providing opportunities to use this capacity to monetise new undeveloped resources.

In many cases, the processing of undeveloped offshore resources through existing infrastructure involves the payment of a processing fee or 'toll' from the new resource owner to the facility owner. That is, the owner of the new resource, rather than building a new processing facility, negotiates and enters into an agreement with the owner of existing processing infrastructure to process its gas in consideration for a fee.

Such arrangements could become increasingly common in the industry in the future. It is therefore important to ensure that the PRRT Regulations continue to be fit-for-purpose and compatible with the type of commercial arrangements underpinning future Australian LNG developments, including LNG tolling and other processing arrangements.

While there may be a wide variety of these arrangements, this section of the chapter of the *Case for Change* primarily contemplates arrangements for the processing of third party gas through an existing facility, and the payment of a tolling fee. It also assumes that project combination is not available.

It is clear that the processing of third party gas was contemplated in the original design of the PRRT Regulations. As such, the regulations contain provisions relating to 'multiple use' of infrastructure which operate to ensure that costs are only included in the RPM to the extent that they relate to processing the sales gas of that particular petroleum project. The 2005 explanatory statement[35] also contains some useful commentary as to how the PRRT Regulations should apply to the processing of external petroleum.

Issues

The Tax Institute is of the view that there remains scope to provide far greater clarity and more specific guidance to taxpayers on the specific application of the PRRT Regulations to tolling arrangements which may become prevalent in Australia in the future.

The drafting of the PRRT Regulations would benefit from greater clarity in relation to their application to tolling arrangements, including, for example, reg 6 (When an integrated GTL [gas-to-liquids] operation[36] exists) and reg 11 (Participants in an integrated operation).

The current laws and regulations operate clearly and appropriately for existing facility owners. To the extent that the upstream portion of a facility is used to process external petroleum, assessable tolling receipts will be generated by the facility owner. The relevant expenditure incurred in generating those tolling receipts will be deductible.

In relation to the facility owner's own RPM calculation, the existing PRRT Regulations ensure that costs are excluded to the extent that they relate to processing third party petroleum.

However, there is less clarity for new resource owners. From the perspective of new resource owners, the PRRT Regulations would benefit from clarification in a number of areas to provide greater certainty to taxpayers.

The new resource owner is required to calculate PRRT as a separate PRRT project. In doing this, the starting point is to identify the relevant integrated GTL operation under reg 6 PRRT Regulations, subreg (1) of which provides:

> "(1) An ***integrated GTL operation*** exists if there is an operation (the ***overall operation***) in which:
>
> (a) petroleum is, or will be, recovered from a petroleum project; and
>
> (b) sales gas is, or will be, produced from some or all of the petroleum; and
>
> (c) some or all of the sales gas is, or will be, processed into a liquefied product."

Interpreting this definition is critical to identifying the relevant project natural gas, project sales gas and project product of the integrated GTL operation for the purposes of applying the PRRT Regulations.

From the new resource owner's perspective, it is critical that the above definition is interpreted to mean that the relevant 'sales gas' for its integrated GTL project is only the product it has title over and is being produced from its production licence (rather than all product processed through the shared facility). In other words, the new resource owner's project should be considered a separate PRRT project from that of the infrastructure owners.

This appears to be the correct interpretation having regard to the intent of the PRRT Regulations and produces logical and reasonable tax outcomes, namely, that the new resource owner relies on the upstream and downstream portions of the toll in calculating their RPM price, and calculates their RPM based on their own cost structure. Further, the only tax information required from the facility owner is an upstream/downstream split of the toll and the volumes of gas processed from each source. This information is unlikely to be commercially sensitive and commercial boundaries between the new resource owner and the facility owner are maintained.

An alternative reading of reg 6 (that there is only one integrated GTL project) would include the facility owner as a 'participant' in the new resource owner's PRRT project under reg 11. This would therefore require the facility owner's underlying costs to be included in the new resource owner's RPM, which would give rise to a number of issues. In particular, the new resource owner would be required to calculate their RPM based on the detailed underlying

capital and operating cost data of the facility owner. This data is generally commercially sensitive and, in some cases, may not be made available by the facility owner. Further, the requirement to provide detailed, confidential cost data could, in many cases, prejudice the prior negotiation of a processing fee/toll.

Options

A focus of any tax reform in this area should be ensuring that the PRRT Regulations are fit-for-purpose and clear to taxpayers for years to come. Care should be taken to ensure that the PRRT Regulations apply clearly and appropriately to all types of arrangement, including arrangements with common owners, or where there is no toll.

Consideration of these matters formed part of Treasury's review[37] prior to that review being deprioritised at the onset of the COVID-19 pandemic. Achieving greater clarity remains important to providing certainty to taxpayers to support future investment decisions.

The drafting of the PRRT Regulations would benefit from greater clarity in relation to their application to tolling arrangements, and indeed other brownfield development concepts more broadly, which are likely to become more prominent in Australia through the coming years and decades.

The identification of phases could be simplified for tolling arrangements. Regulation 9 PRRT Regulations identifies the phase points of an integrated operation. Simplifying a tolling facility to a single upstream phase and single downstream phase would reduce the amount of technical data required to be shared between the facility owner and new resource owner. Further, it would better align with the commercial nature of a tolling arrangement, where a service-type fee would typically be paid in respect of processing the new resource owner's product.

Greater clarity in these areas will ensure certainty of outcomes for taxpayers, underpinning further investment decisions in Australia. This clarity is critical in securing future investment in the Australian LNG industry in the face of scarce capital markets. It will also ensure that confidentiality and commerciality can be maintained within the industry without being compromised by onerous information-sharing requirements between projects and taxpayers.

Reversion of production licence

The PRRT regime contains rules to ensure that, as a project progresses from an exploration permit to retention lease to production licence, the relevant expenditure remains attached to the project as the type of interest held progresses. However, the PRRT regime does not contemplate the rare circumstances in which a production licence may revert to a retention lease.

The absence of provisions addressing these circumstances creates uncertainty and a risk of unintended outcomes. The disallowance of deductions for historical exploration expenditure in relation to that project is an example of such an unintended outcome.

There are a number of different types of petroleum titles which a PRRT taxpayer may hold. The most common of these being exploration permits, retention leases and production licences.

As a project or prospect progresses through its life cycle, the type of interest held typically changes as exploration and feasibility work progresses. For example, a retention lease or production licence may be granted over an area previously covered by an exploration permit.

This relationship between licences, permits and leases is acknowledged and built into the PRRT laws through s 4 PRRTAA. This provision sets out the circumstances in which various interests will be considered 'related' to each other and 'derived' from one another.

Section 5 PRRTAA builds on this by defining what is meant by 'exploration for petroleum in, or recovery of petroleum from, the eligible exploration or recovery area in relation to a petroleum project'. This phrase is critical to determining what constitutes deductible exploration expenditure in relation to the project under s 37 PRRTAA.

There have been cases in the industry where, subsequent to a production licence being applied for and granted, a decision is taken not to proceed with the development. In these cases, the taxpayer may apply for the production licence to revert to another type of interest reflecting the stage of maturity to which the project has regressed (typically, a retention lease).

Issue

Section 4 PRRTAA currently only contemplates a project moving forward towards production. It does not contemplate the reversion scenario outlined above. The intention of the PRRT regime suggests that the historical deductible expenditure should continue to remain with the reverted interest.

This deficiency in the PRRT regime was acknowledged in the Callaghan review but has not been remedied. The absence of specific rules addressing reversion creates fiscal uncertainty and a risk of the unintended outcome that the historical spend of that project is no longer deductible.

This uncertainty may significantly impact the economics of projects and therefore the ability to make investment decisions to invest scarce capital to bring new gas to market.

Options

One option for reform is to specifically include reversion scenarios in the operation of ss 4 and 5 PRRTAA. This would ensure that the types of changes in title interest in s 4 are comprehensive and broad.

Alternatively, a new provision could be included specifically addressing a reversion scenario. It is envisaged that such a provision would specifically provide that a reverted interest would either be treated as a continuation of the prior production licence where it relates to the same geographical area or would otherwise link the interests, such as through the project combination provisions in s 20 PRRTAA.

Other indirect taxes

Overview

There are a number of other indirect taxes at play, both at a state and a federal level. As outlined above, a significant proportion of these taxes contribute very little to overall revenue. Many of these taxes are complex to interpret and apply, and give rise to disproportionate administrative and compliance costs, both for the respective governments and for taxpayers.

Some examples are considered in this section. We consider that this is an area where the governments at both the state and federal level should dedicate time and resources to reassessing the value of such taxes and the various options for reform, whether they may be abolition, simplification, streamlining or otherwise. In circumstances where we have suggested options other than abolition, we consider that further analysis and modelling are required to support any given option.

Luxury car tax

Issues

The luxury car tax (LCT) is a tax imposed on vehicles, the GST-included value of which exceeds that of certain LCT thresholds (see Table 4). The LCT is payable by individuals and businesses that sell or import the vehicles. The LCT tax amount is calculated and dependent on whether or not the vehicle has already had the LCT paid on it and whether it is being sold or imported. Each method has a different calculation dependent on particular factors in relation to the vehicle and, as such, can have different exemptions or deductions, as well as other rates applied onto it.

The LCT was introduced to Australia on 1 July 2000 among broader tax reform measures, including the GST, to somewhat replace some of the regulations of the previous.

Table 4. LCT thresholds

	LCT thresholds	
Financial year	**Fuel-efficient vehicles**	**Other vehicles**
2020–21	$77,565	$68,740
2019–20	$75,526	$67,525
2018–19	$75,526	$66,331
2017–18	$75,526	$65,094
2016–17	$75,526	$64,132
2015–16	$75,375	$63,184
2014–15	$75,375	$61,884
2013–14	$75,375	$60,316
2012–13	$75,375	$59,133
2011–12	$75,375	$57,466
2010–11	$75,375	$57,466
2009–10	$75,000	$57,180

Source: ATO website at www.ato.gov.au/rates/luxury-car-tax-rate-and-thresholds/.

The wholesale sales tax (WST) had been introduced to Australia in 1930 in order to overcome the economic problems of that time, including the Great Depression and reducing customs revenue. The LCT was considered necessary because replacing the WST with a 10% GST meant that vehicles would be taxed at a 10% rather than the previous 22% and 45%.

The LCT was also driven by a policy objective of protecting the Australian car manufacturing industry. The government deemed it inappropriate for the price of luxury vehicles to fall as a result of this change. As such, the LCT was introduced along with the GST, and the WST was abolished. The LCT was initially imposed at a rate of 25% on vehicles above a certain threshold. In 2008, the rate was increased from 25% to 33%, which remains the current rate. The 2021–22 threshold for fuel-efficient vehicles was $79,659, and for other vehicles, it was $69,152. This threshold was increased for the 2022–23 financial year, with values increasing to $84,916 and $71,849, respectively (refer Table 4).[38] The relevant financial year threshold depends on the year that the car was imported, acquired or sold.

There are few exemptions to the LCT. The purchase of certain vehicles is not subject to LCT, including motor homes, campervans, emergency vehicles and commercial vehicles designed mainly for carrying passengers. Vehicles that are imported by endorsed public institutions for the sole purpose of public display are not subject to the LCT. In addition, capped refunds of LCT paid are available to primary producers and tourism operators when eligible vehicles are purchased.[39]

Options

In general, luxury taxes have a narrow base which makes them fundamentally inefficient. They are also ineffective and arbitrary in redistributing wealth.

The LCT served a purpose confined to its history when it was implemented. It is currently the only luxury goods tax imposed in Australia. Other luxury goods that were taxed at a higher rate under the WST were not replaced by special taxes or rates other than the standard GST. The LCT no longer serves its original purpose. It no longer has a protectionist purpose, given the state of the Australian car manufacturing industry, and it no longer acts as a tariff on imported cars.

The LCT may be considered justifiable on the grounds that it is relatively easy to collect and equitable in that it taxes those who are able to afford it. However, it defies horizontal equity in that people in the same economic situation pay different amounts of tax depending on their choice of vehicle. This is increasingly problematic in the current landscape, and will become more problematic in the future with the increase of electric vehicles on the market. Electric vehicles are generally more expensive than comparable fuel-powered vehicles. This means that they are more likely to attract LCT. This exponentially increases the upfront cost of buying an electric vehicle compared to fuel-powered vehicles. Implementing or maintaining measures which

disincentivise environmentally sustainable practices, such as the use of electric vehicles, seems an anachronism in the present day.

The LCT also goes against vertical equity as people may become liable for the LCT due to the kind of vehicle required. For example, a small sports car may attract the same LCT as a minivan required by an average family as a means of transport.

The Tax Institute supports the abolition of the LCT and recommends that other vehicle taxes should be replaced by more efficient user road charges (considered below). At the time of writing, Australia currently does not have a cohesive climate change policy, nor related policy in relation to environmental sustainability. There are a number of existing systems in place around the world from which Australia may gather learnings and inspiration. For example, Norway operates a motor vehicle purchase tax system which imposes a progressive rates tax on three criteria, being weight, engine capacity and the CO2 emissions of a vehicle. A similar model could be replicated in Australia with the added benefit of addressing the environmental impact, although further consideration of the potential alternatives is required.

Motor vehicle taxes

Issues

During the 1920s, all states adopted a tax on motor vehicles, originally deemed a luxury levy. Over time, due to motor vehicles becoming more commonplace, the tax became a significant source of revenue as a mass consumption levy. At its peak, the motor vehicle tax accounted for almost 20% of state taxation revenue.[40]

Today, the states impose a number of different motor vehicle-related charges, including transfer fees, motor vehicle tax, stamp duty on vehicle transfer, and driver's licence fees. These state-based taxes apply in addition to GST and the fuel excise, which are levied by the Commonwealth.

New technologies and lifestyle changes are affecting travel and the demand on infrastructure. Cars are becoming more fuel efficient, electric vehicles are becoming more popular, and the use of ride- and car-sharing services is increasing. The COVID-19 pandemic and the resulting various periods of lockdown have presented governments and Australians with the opportunity to reassess their attitudes to working remotely or on-site, public transport, travel and their associated behaviours.[41] These changes, while positive in many ways, have resulted in a decline in traditional government revenues funded out of motor vehicle registration duty.

Duty on certificates of registration of motor vehicles applies to both new vehicles on initial registration and transfers of ownership of motor vehicles.[42] Duties apply at differential rates depending on what kind of vehicle is being registered. They are fixed charges that do not vary with the amount of time spent on the road or the wear and tear inflicted on the road networks.

The Commonwealth Government's fuel excise scheme effectively operates as a road tax. Drivers of older or larger vehicles with higher fuel consumption pay more per kilometre to use the same stretch of road as drivers of newer, smaller and more fuel-efficient vehicles. Further, electric vehicle drivers use the same road at very little cost. Fuel excise revenue has experienced structural decline as vehicles have become more fuel efficient. This trend is expected to continue as electric and other low-emission vehicles become more common.

Together, the portion of revenue generated by these taxes exceeds that of the aggregate spent by the three levels of government, federal, state and a portion of local, on the investment and maintenance of roads. However, while these charges are effective in taxing the use of motor vehicles, other areas of road use are poorly regulated, such as congestion, pollution and road damage.

It should also be noted that motor vehicle taxes are regressive taxes and can be particularly onerous for low-income households.

Options

Undoubtedly, there may be tension between current regimes that effectively result in lower ongoing taxes on electric cars and higher taxes on traditional petrol or diesel cars. The Tax Institute supports achieving a balance that allows for a sustainable tax system for motor vehicles. However, to the extent that consumers move towards low-emission and electric vehicles, as outlined above, these trends should not be discouraged as a result of taxation policies. The Tax Institute also recommends that the states and Commonwealth consider how these issues are addressed in other cities across the world. Particularly in the context of congestion charging, there are a number of cities which operate a system of congestion charging, including London, Stockholm, Milan, New York, Singapore and parts of the US.

Rationalisation of taxes on motor vehicles. The Tax Institute considers that there is merit in considering a state-based road user charge for the use of vehicles on roads and other associated services.[43] Another potential reform could be the implementation of a state tax on vehicles which would combine stamp duty along with registration fees and charges into a single annual fee that would apply equally to all motor vehicles.

Congestion charges. During peak hours, congestion on major roads is a market failure that is often not accounted for. Congestion costs could be calculated taking into account the location and time of day. Technologies such as e-tags, hubometers and geographic information systems would be some modern technologies that are available for use at relatively low costs.

A simple change to address congestion could be to vary the toll rate for congested toll roads, depending on the time of day. This reform could be even further improved by implementing a toll rate that is regularly revised through the constant use of new information, and this information

could potentially be readily available to motor users through the use of apps or a similar technology.

Any fee implemented would need to take into account the marginal social cost. Modern technology allows for a low marginal cost over a period of time where such a fee is set at a rate that is marginal to the external cost of congestion. However, the use of such technology brings with it other risks and factors for consideration outside of the realm of the tax system, including privacy.

Pollution charges. It is difficult to measure the effects of pollution by a single vehicle as it can have localised effects, such as fog or particles, as well as global effects, such as contributing to the problem of greenhouse gases. As such, a tax that is instead imposed on the principal input that results in the pollution, such as petroleum products, may be an option. It is envisaged that the rate of the tax would be reflective of the marginal external cost of pollution.

It is noted that, through the Clean Energy Future package of 2012 to 2014, the Gillard Government introduced a carbon tax. Setting aside the exemptions which had applied, and the political tensions which ultimately led to its repeal, the carbon tax is an example of holistic reform with effect beyond the tax system alone. Some form of carbon pricing regime and a coherent policy addressing climate change are critical to ensure not only the sustainability of Australia's tax system, but also our environment.

Excise and customs duties

Excise duty, under Australian law, is applied to the manufacturing of domestic petroleum fuels, alcoholic beverages (excluding wine), tobacco products, crude oil and certain biofuels. Equivalent duties such as customs duties and tariffs are imposed on imported products with the objective of protecting domestically produced goods and services.

As a revenue source, excises (and their equivalents) have remained relatively steady, but there has been a decline over time in their significance in direct relation to the proportionate amount of overall tax revenue. For example, in 1909, they accounted for an entire three-quarters of total tax revenue, but in 2003–04, they only accounted for 8.5% of total tax revenue.[44] Over this period, customs duties have seen a greater decline than excise duties, which is reflective of the fact that domestic goods are being produced in larger quantities and the decline in taxes applied to imports. Australian tariffs have also seen an increased reduction in order to increase economic efficiency in certain import industries that were deemed uncompetitive, and to meet free trade agreements and World Trade Organization obligations.[45]

Alcohol duties and wine equalisation tax

Issues

While some excises are relatively efficient, others, such as the taxation of alcohol, are highly complex. Alcohols, such as beers and spirits, are taxed on the basis of their alcohol content, also known as volumetric taxation. Different rates are applied depending on the type of alcohol that is being taxed, the content and concentration of the alcohol, and whether it is packaged or draught (such as for beer).

Unlike other alcohol, wine is taxed on the basis of its value under the wine equalisation tax (WET). The WET was introduced as part of the 2000 tax reforms, again in response to the objective of replacing the WST. It was implemented to ensure that the retail price and revenue from the wine tax would remain stable after the removal of the WST.

The WET is applied to the sale of all domestic and imported wine within Australia, at a rate of 29%. It does not apply to exported wine. In addition to the WET, the GST is also applied to the sales and importation of wine into Australia.

Like other alcohol taxes, the WET is complicated to calculate. This is because the law requires taxpayers to take into account, among other things, the type of wine product, the point of sale, and the application of any exemptions. The WET applies specifically to certain sales of portable alcohol called wine that contain an ethyl alcohol content higher than 1.5%, at a rate of 29%.

All other alcoholic beverages that contain a higher than 1.5% by volume content of ethyl alcohol are not taxed by reference to the WET but are instead taxed under the excise duty or customs duty (noted above). This two-tier system of indirectly taxing alcohol elevates the consumer price of purchasing and consuming alcohol beyond what it would be under the GST alone. It has an important public policy objective of taking into account the cost of alcohol consumption and offsetting the direct and indirect public cost of alcohol abuse while generating revenue.

The WET includes numerous different technical definitions that differentiate wine from other alcoholic beverages. For example, the definition of 'wine' includes grape wine, a grape wine product, a fruit or vegetable wine, cider or perry, mead and sake, unless they contain 1.15% per volume of ethyl alcohol (in which case, they are subject either to excise duty if manufactured in Australia, or customs duty if imported). Each of these beverages also has a number of regulations to which it is subject.

The WET is a regressive tax. As income rises, the percentage of a consumer's income that is taxed as WET for a bottle of wine decreases, an effect that is compounded by the applicable GST. The effects of the ad valorem aspects of the GST and the WET may be somewhat mitigated by lower-income consumers purchasing lower costing wine, but this does not resolve the vertical inequality.

Options

There are a number of potential options in this area. As outlined above, The Tax Institute strongly recommends the government reassess the policy behind the vast number of inefficient taxes which do not comprise a significant proportion of revenue. Where possible, these taxes should be abolished. Where any such taxes are deemed necessary, for example, to drive behavioural change, we recommend that there be adequate consideration given to ways in which

such taxes may be redesigned or simplified to improve consistency, reduce compliance costs and, where relevant, to encourage economic growth.

At least in the context of alcohol, although potentially even more broadly, a single rate may be an option to reduce complexity. However, if a standard rate is supplemented by an array of exemptions or exceptions, this may give rise to a different kind of complexity which would defeat the purpose of achieving simplicity. This may be addressed by having fewer exemptions or by implementing a dual-rate system. In the case of wine, a volumetric tax, similar to the tax applied to other alcohols, may be a potential option as it would result in the tax amount remaining the same regardless of the price of the product.

We also note that, in the context of alcohol, reduced rates which are more closely in line with international competitors may encourage growth in this industry, and would support small-to-medium Australian brewers, distillers, winemakers and others in this industry. This must of course be balanced with the behavioural and health considerations in relation to alcohol consumption.

Insurance levies

Issues

Insurance levies are taxes on a narrow base of products and vary from state to state, some of which operate more than one kind of insurance tax. Some examples are stamp duty on general and life insurance, private health insurance levies and emergency service levies. Depending on the state, general insurance duties can range from 6% to 11% of the premium payable. There are exemptions in each state, which include exemptions for annuities, hospital and medical benefits, as well as workers compensation.

Insurance levies are undeniably inefficient. They drive up premiums and discourage consumers from obtaining sufficient insurance cover. Where taxes make insurance less affordable, as with any other goods or services, it is low-income households that are most adversely affected and, in these cases, most likely to be under-insured or uninsured. This exacerbates exposure to loss in adverse circumstances.

Insurance levies are also inequitable as there is generally no connection between the purchase (or the purchasers) of insurance and the distribution of benefits from government expenditure.

Options

The Tax Institute considers that there is no sound basis for applying a special levy to insurance rather than, or in addition to, the GST as it applies to other goods and services. This view was outlined in the Thodey report commissioned by the NSW Government and has been recommended in other reviews of this area of the Australian tax system.[46]

The option here is, in our view, straightforward. Insurance levies should be abolished. Insurance products should simply be subject to GST in the same way as other goods and services. Revenue otherwise generated from insurance levies should be sought from other taxes as part of a holistic package of reforms.

Options for reform

- Consider a broad-based property tax model as part of a reform package as this would spread the burden of tax collection across a broader base (and not merely as a result of transfers of land).
- Gradually abolish stamp duties.
- Allow for protective provisions for those who have paid transfer duties either via:
  - an 'opt-in' approach (such as the approach contemplated by the NSW Government[47]); or
  - commencement of taxation of relevant transactions from a retrospective date.
- Ensure rates are balanced as a sustainable revenue source for the governments and affordable for landowners, taking into account particular sectors which may be more adversely affected by an annualised cost than others (for example, low-income earners and pensioners).
- Maintain certain exemptions and concessions, and provide deferred payment and hardship arrangements where necessary.
- Move towards a tax system that more efficiently taxes wealth, with higher rates for more expensive properties.
- Governments should unite and apply a coordinated approach to ensuring a stable source of revenue for the states.
- Centralise the collection and administration of payroll tax, akin to the arrangement in respect of GST.
- Abolish payroll tax and replace with a business turnover tax and/or state-based income tax.
- If payroll tax is to be retained:
  - harmonise and lower rates, and eliminate thresholds across the states;
  - revisit complex aspects of the legislation, such as in respect of grouping; and
  - reduce the compliance burden, such as by reporting via BAS/STP data.
- Legislate a broader concept of a 'worker' for all employment tax purposes.
- Review and reassess the value of the vast majority of taxes which immaterially contribute to overall revenue:
  - abolish inefficient taxes; and
  - simplify and streamline other taxes which, although generating little revenue, may serve a public policy purpose.

Conclusion

The state and indirect tax regimes in Australia are inconsistent, often inefficient, incoherent, administratively costly, and attract a high compliance burden. They often fail to achieve any social or economic objectives outside simply raising revenue and do little to improve productivity (and often work against productivity).

The need for reform is patent; the ability to have proper reform can only be achieved with the involvement of all levels of government. While challenging, this is not beyond the capability and competence of governments supported by those that know these systems best.

The Tax Institute

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Small-scale property developments: tax issues

by Rajan Verma, CTA, Director, Velocity Legal

Rising property prices in Australia has resulted in an increasing trend of small-scale property developments being undertaken by unsophisticated "one-time" developers. The motivations of these developers are sometimes profit driven, but most of the time they are driven by a desire to own their own home. This article explores the income tax, duty and GST implications of these small-scale property developments. As the article explains, the tax and duty implications of even small, unsophisticated developments can be extremely complicated to work through and very costly for those caught unaware. However, this article demonstrates that, with careful planning, the tax and duty costs may be significantly reduced.

Overview

When the COVID-19 pandemic reached Australian shores in early 2020, many feared that the economic consequences of the extended lockdowns in Victoria would result in significant drops in residential property prices.[1] However, that did not happen. Instead, regional and metropolitan property prices across Victoria rose dramatically, with the media reporting in February 2022 that Melbourne house prices had increased 35% since 2019.[2]

Naturally, rapidly increasing prices make it more difficult for younger Victorians and first home buyers to purchase their own home. On the other hand, rising prices also create significant equity for existing homeowners. It is therefore unsurprising to see an increasing trend of:

- younger Victorians joining forces with their friends and family to get into the property market. The strategy generally goes like this:
  - two or more parties (which could include friends, couples, siblings, or parents with their adult children) jointly purchase a block of land. The block may have an existing house, or it may be vacant;
  - they then obtain planning approval to develop and subdivide the land into two or more new dwellings;
  - finally, the parties partition the land with the result that each of them gets their own property, which they may use as their principal place of residence, an investment, or that they may simply sell for a profit; and
- existing homeowners seeking to unlock equity in their properties by subdividing and selling off part of their landholdings. A common example of this is the case of an older couple (usually with adult children) who own a large block of land which they have used as their main residence for several decades. They now wish to subdivide the block, potentially demolish the existing home, and build two or three new homes which they may either keep or sell for a profit.

As we all know, property development raises a myriad of tax issues. A development can give rise to income tax, GST and transfer duty costs. If these costs are not appropriately managed or planned for, the development may end up being far more expensive than expected.

This article explores the typical tax considerations which arise in these small-scale development scenarios.

Income tax considerations

The usual trigger points for income tax in a small-scale development are:

- on partition of the interests in the development (if there is a partition);
- on sale of the developed lot(s); and
- if the land is already owned by the developer, a pre-development transfer of the land may also be required.

For the avoidance of confusion, a "partition" refers to the exchange or rearrangement of jointly owed assets. In the context of property development, this involves two or more persons who jointly own two or more properties agreeing that one party will take one while the other takes the other. By way of example:

- X and Y jointly purchase a block of land;
- the block of land is subdivided into two lots, lot X and lot Y. On subdivision, X and Y jointly own lots X and Y; and
- X and Y decide to partition their interests so that X takes lot X and Y takes lot Y.

In essence, X has disposed of their 50% interest in lot Y to Y. In consideration, Y has disposed of their 50% interest in lot X to X.

Each of these three potential triggers are discussed further below:

Income tax consequences on partition

In the author's experience, most lay persons are surprised to learn that the partition or exchange of properties can trigger a tax liability. This is because generally, no money

changes hands under a partition — all that happens is the various interests in the property are divvied up between the owners.

However, in TD 92/148, the Commissioner makes it clear that a partition will result in a disposal and acquisition of property. The following example is provided in TD 92/148:

> "**Example:** A and B were joint owners of a one hectare block of land acquired in 1986. In 1992, they subdivide the land. A took a one-half hectare block (block 1) and B took the other one-half hectare block (block 2). A acquired a 50% interest in land constituted by block 1 in 1986 and acquired the remaining 50% interest from B in 1992. Similarly, B acquired a 50% interest in the land constituted by block 2 in 1986 and acquired the remaining 50% interest from A in 1992. A and B have each disposed of their 50% interest in that land constituted by blocks 2 and 1 respectively, in 1992."

In the oft-cited case of *Johnson and FCT*,[3] the Federal Court observed, in the context of a partition, that:

> "Dividing the parcel in two for the purposes of a transfer to each joint owner effectively requires those owners to relinquish ownership of the CGT assets in the shares in the other parcel in return for clear title to the shares in the parcel they are acquiring. It is as if the CGT assets contained in each share have to be unpacked and redistributed so that the taxpayer ends up holding half the number of shares in his or her own right — and those shares do not contain any CGT assets belonging to the other (former) joint owner.
>
> This rearrangement and reallocation of the ownership of CGT assets constitutes a disposition of the CGT asset, and is therefore a CGT event: s 104-10."

It is worth noting that a CGT roll-over is available for strata title conversions under Subdiv 124-D of the *Income Tax Assessment Act 1997* (Cth) (ITAA97). Unfortunately, the scope of that roll-over is limited and it has little to no application to most partition scenarios.

Is there a taxable profit?

Having identified that a partition is a taxing point for income tax purposes, the next issue which arises is whether there is a gain or profit. This is determined by working out the market value of the newly created lots at the time when the partition happens.

Unfortunately, due to the time it takes to obtain planning approval, it can often take more than one year for permits to be obtained. Once builders and finance are arranged, it will then take at least another year to construct the new dwellings (in the case of a simple two-lot subdivision). In a rapidly rising property market, prices will have likely increased over that time. Moreover, the mere act of obtaining a planning and development approval often results in an increase in the value of land.

Fortunately, the costs of acquiring and developing the land can be taken into consideration when working out the profit.[4] This would typically include:

- the purchase price of the land;
- transfer duty on purchase;
- conveyancing costs;
- legal and accounting costs (to the extent not immediately deductible);
- costs to obtain planning approval (including retention of architects, engineers, town planners and/or draftspersons); and
- construction costs.

By way of simple example, suppose X and Y (as described above) jointly spend:

- $1m to purchase the land (including transfer duty and conveyancing costs);
- $50,000 to obtain planning approval; and
- $1.1m to construct the two new dwellings in lots X and Y.

At completion, each of lots X and Y is worth $1.2m. If they partition their interests at this time, then:

- X makes a profit equal to:

Market value of 50% of lot Y transferred		**$600,000**
Less: 25% of land cost (attributable to lot Y)	($250,000)	
25% of planning approval (attributable to lot Y)	($12,500)	
25% of construction costs (attributable to lot Y)	($275,000)	($537,500)
Profit made by X		**$62,500**

- Y makes a profit of the same amount in respect of lot X.

If it were possible to subdivide the land prior to constructing the new dwellings and partitioning the land at that time, then the gain can be limited to just the passage of time and the positive effect of obtaining planning approval. This will generally result in a lower gain and therefore a better tax outcome than partitioning after construction is complete. However, practically, this may not be possible unless the relevant authority (usually the local council) permits the subdivision prior to the construction of the dwellings in accordance with the endorsed plans.

In essence, the shorter the time frame between the initial acquisition and the partition, the lower the income tax (ie capital gains tax) is likely to be.

Is the profit taxable on revenue account or capital account?

Having identified that there is a profit on partition, the next question is whether that profit is taxable on revenue account or capital account. This distinction is important because there are a number of tax concessions which are available in respect of capital gains, but not revenue gains. For example:

- the general 50% CGT discount under Div 115 ITAA97;
- the main residence exemption under Subdiv 118-B ITAA97; and

- the small business CGT concessions under Div 152 ITAA97.

Broadly, there are three ways that profits from a property development can be taxed. They include:

1. on revenue account, as profit from a business activity;
2. on revenue account, as an "isolated profit-making undertaking or scheme"; or
3. on capital account, as a mere realisation of a capital asset.

In the context of a small-scale property development, where the parties involved are first-time (and likely one-time) developers, it is unlikely that their development activities will constitute a business. However, they can still be taken to be an isolated profit-making scheme which also attracts revenue treatment.

There is a significant body of case law and ATO material which discusses when a gain will be on revenue or capital account.[5] In the interests of restricting the length of this article, the author has not replicated that detailed analysis here. However, Table 1 summarises the factors which are typically used to determine whether a development is on revenue or capital account.

Going back to the example of X and Y, suppose that X entered into the development with the intention of acquiring a long-term main residence. In contrast, Y entered into the development with the purpose of selling their lot at a profit.

Applying the principles above, it is likely that, on partition, any gain or profit made by X on the partition would be treated as being on capital account. This means that the profit made by X of $62,500 (as calculated above) would be treated as a capital gain. Importantly, this gain would be discountable under Div 115 ITAA97, even if the subdivision happened less than a year prior, provided the original parcel of land was acquired more than 12 months ago. This is because the subdivision of land is not taken to result in a disposal or an acquisition of that land.[16] Accordingly, X can reduce their capital gain from $62,500 to $31,250.

In the case of Y, however, the profit on partition is likely to be assessed on revenue account since Y entered into the development with the purpose of making a profit. This means that Y would not be entitled to claim the 50% CGT discount and would be left with assessable income of $62,500.

Table 1. Factors in determining revenue versus capital treatment

Factor	Comments
Landowner's purpose when they acquired the land	If there is a purpose of making a profit on acquisition of the land, the proceeds will be taxable on revenue account.[6] *Revenue*: Taxpayer purchases land with the intention of developing for quick sale for a profit. *Capital*: Taxpayer purchases property for use as a home, farm or long-term investment and much later decides to realise it.
Length of time of ownership of the property	The longer the land is held without any profit motive, the less likely the development proceeds will be taxed on revenue account.[7] *Revenue*: Taxpayer obtains permits and/or develops land soon after purchasing it. *Capital*: Taxpayer has owned the land for several decades and decides to develop and sell due to a change of circumstances.
Size and scale of the development	The larger the development, the more likely it will be taxed on revenue account.[8] However this is not determinative.[9]
Purpose of selling the land	If a significant purpose of the development is to make a profit, the development is more likely to be assessed on revenue account.[10] *Revenue*: Taxpayer completes development to generate profits to fund future projects. *Capital*: Taxpayer wishes to downsize and unlock equity to repay debt or fund retirement.
Landowner has prior experience in subdividing and developing	A landowner with a prior history of property development is more likely to be assessed on revenue account.[11]
Number of development stages	The greater the number of development stages, the more likely the development will be assessed on revenue account.[12] However, this is not determinative.
Construction of site office or buildings	The construction of any site office or buildings/residences will almost certainly result in the development being assessed on revenue account based on current ATO views and practice.[13]
Extent of landowner's personal involvement	The more heavily involved the landowner is in the development, the more likely they will be assessed on revenue account (in contrast with a passive landowner who engages third parties).[14]
Terms of any land development agreement[15]	A development agreement under which the landowner's share of profit is contingent on the success of the development is more likely to be assessed on revenue account. *Revenue*: Developer's fee structure exposes landowner to financial risk if the development is unsuccessful. *Capital*: Landowner is subject to little or no financial risk under the development.

Main residence exemption

Pursuant to Subdiv 118-B ITAA97, the transfer of a dwelling which is used exclusively as a main residence will be exempt from CGT, provided no other dwelling has been used as a main residence by the taxpayer. Could this exemption be available in a small-scale development scenario?

Imagine a scenario where:

- two siblings (X and Y) purchase existing premises as equal tenants in common;
- on settlement, X and Y move into the premises as their main residence;
- they decide to subdivide the back yard and build a new home there. The existing premises at the front will be retained without change; and
- once completed, the siblings partition their interests so that X takes the established premises at the front and Y takes the new premises in the back.

As the front property has been used as a main residence since its purchase, it may be possible for the siblings to claim the main residence exemption when they partition their interests. Specifically, when Y transfers their interest in the established premises to X, Y can claim the main residence exemption as they have used the established premises as their main residence.

Unfortunately, this does not work the other way for the transfer of the rear lot. While the rear lot was previously part of the land on which the dwelling rested, its character has since changed. It is now a separate lot with its own dwelling. It is important to bear in mind that the main residence exemption applies to dwellings used as a main residence.[17] The exemption can then extend to land which is used in conjunction with the dwelling, subject to the two hectare limit.[18] However, it does not apply to land when it is transferred separately to a dwelling which was used as a main residence.[19]

The dwelling on the rear lot is a brand new CGT asset[20] which has never been used as a main residence by anyone. Accordingly, when X transfers their interest in the rear lot to Y, the main residence exemption will not be available to that transfer.[21]

Income tax consequences on sale

At some point in time after a partition is completed, the new lots may be sold.

Where the sale happens immediately after the partition is completed, it is likely that the profits from sale will be assessed on revenue account as a business or isolated profit-making undertaking or scheme.[22] In contrast, if the new lot is used as a home or an investment property for a number of years, the profits on sale will more likely be assessed on capital account.[23]

In much the same way as described above in respect of the example of X and Y, the taxable gain or profit will factor in the acquisition cost of the property. The difference this time is that the costs of acquisition will include the market value of the interest acquired under the partition (plus any other costs incurred as part of the partition).

By way of example, suppose that 10 years after the partition of lots X and Y between X and Y (as described above), X decides to sell lot X. The relevant background facts are:

- at the time of partition, lot X was worth $1.2m; and
- X sells lot X for $2.5m.

Since X has held lot X for 10 years, it is likely that the sale of lot X will be assessed on capital account. Accordingly, for CGT purposes, X will receive capital proceeds of $2.5m.

In order to work out X's cost base, each of their interests in lot X must be considered separately. Specifically:

- X has the 50% interest which they acquired with the original land acquisition. Based on the calculations above in respect of the transfer of lot Y, X would have a cost base of $537,500[24] in respect of this interest in lot X; and
- X has the 50% interest which they acquired under the partition with lot Y. The market value of this interest on acquisition (ie partition) was 50% × $1.2m = $600,000.

Accordingly, X's total cost base would be $537,500 + $600,000 = $1,137,500.

X would therefore make a capital gain of $2,500,000 – $1,137,500 = $1,362,500 on sale.

As lot X has been held for more than 12 months, the 50% CGT discount under Div 115 ITAA97 would be available. Accordingly, the assessable capital gain would be reduced to $681,250.

Finally, if X has used lot X as their main residence, they may be entitled to claim the main residence exemption. If the full main residence exemption is available, any capital gain made by X can be disregarded.

If Y were to sell lot Y immediately after partition, the cost and profit calculations would be completed in a similar way, although it would be expected that the profit would be much less given the short period of holding. Importantly, Y's profit would be assessed on revenue account. This means that Y would not be able to claim the 50% CGT discount.

Income tax considerations on interim transfer

In situations where the property is already owned by the developer, there may be a need to restructure the ownership of the property in preparation for the development. For example:

- the property may be owned by parents who want to subdivide the block so that they can build a new home for one or more of their children; or
- the property may be owned by one or more family members who wish to subdivide and develop the property for sale at a profit.

In either of these scenarios (and similar variants), a transfer of the property may be required or may be beneficial for the following reasons:

- the child is contributing to the development costs or required to raise bank finance. Having the child on title will facilitate this and may be required by the financier;
- there may be tax concessions like the main residence exemption which are available pre-development but will not be available post-development[25] that can be used to "step up" the cost base of the property and reduce future tax liabilities;
- if the property is to be developed and sold, transferring the property to a company or trust pre-development can result in less overall taxes due to the development profits being assessed at lower tax rates than if the property had remained with the original owner(s); and
- the duty costs of transferring the property pre-development are likely to be lower than the duty costs post-development due to the property increasing in value because of the development and subdivision.

GST considerations

GST considerations can arise at multiple points during a small-scale development, including:

- when the land is originally purchased;
- during the development of the land;
- on partition; and
- when the land is ultimately sold.

However, before getting into the GST implications, it is important to consider whether the development arrangements give rise to any kind of GST entity that may require separate GST registration or could otherwise affect the GST implications of the development moving forward. This is discussed below.

GST entity

From a GST perspective, a co-owned development could give rise to:

- a general law partnership;
- a tax law partnership;
- a GST joint venture; or
- a "non-entity joint venture".

Partnerships

While partnerships are not separate legal persons at law, for GST purposes, they are treated as entities separate from the partners and are therefore able to register for GST in their own right.[26]

A "general law partnership" is defined as an association of persons carrying on business in common with a view of profit.[27] A "tax law partnership" is an association of persons in joint receipt of income. The key difference between the two is that, in a general law partnership, the partners are carrying on a business, whereas, in a tax law partnership, they are not.

In the context of small-scale developments, a general law partnership is unlikely to arise since the co-owners will not usually be carrying on a business jointly (ie they are usually unsophisticated, "once-off" developers).

A tax law partnership could arise if the parties purchase an existing property and lease that property out before developing it. However, in the context of a small-scale development, this is unlikely to affect the GST treatment of the development since:

- the rental property is likely to be residential premises, meaning that any rent received will be input-taxed. As a consequence, the tax law partnership would not be required to register for GST as it will not make any taxable supplies; and
- even if taxable supplies are being made (ie because the property is vacant or commercial premises), the tax law partnership will likely come to an end once the development commences as the co-owners will no longer be in joint receipt of income if the existing premises are demolished or otherwise vacated.

Accordingly, most small-scale developments should not be treated as a partnership.

Joint ventures

At its core, a joint venture is an arrangement between two or more parties where there is a sharing of product or output (as opposed to profits as per a partnership).[28] As small-scale developments typically involve the creation of new properties and a partition of those properties, they will generally meet the definition of a "joint venture".

For GST purposes, there are two types of joint ventures: "GST joint ventures" and "non-entity joint ventures".

GST joint ventures are joint ventures which satisfy the requirements of Div 51 GSTA99. Under these types of joint ventures, a nominated joint venture operator is appointed to handle the GST obligations on behalf of the participants. In order to form a GST joint venture, the requirements of s 51-5 GSTA99 must be satisfied. Some of the key requirements include:

- the joint venture must be for an approved purpose. The construction of residential or commercial premises is an approved purpose;[29]
- each participant must satisfy the "participation requirements" in s 51-10 GSTA99. Among those participation requirements, each participant must be registered for GST;
- the participants must agree in writing to the formation of the joint venture as a GST joint venture;[30] and
- the nominated joint venture operator must notify the Commissioner of the formation of the joint venture as a GST joint venture.[31]

Most small-scale developments will not qualify to become a GST joint venture because not every participant is likely to be registered for GST. Specifically, in those developments where the aim is to create a new principal place of residence, GST registration will not be required.

This then leaves the "non-entity joint venture". A non-entity joint venture is defined as a contractual arrangement:[32]

"(a) under which 2 or more parties undertake an economic activity that is subject to the joint control of the parties; and

(b) that is entered into to obtain individual benefits for the parties, in the form of a share of the output of the arrangement rather than joint or collective profits for all the parties."

Most small-scale developments will meet this definition and therefore qualify as a non-entity joint venture.[33] Non-entity joint ventures are not treated as separate entities for GST purposes[34] and therefore cannot separately register for GST. Accordingly, participants in a non-entity joint venture will be treated as separate entities for GST purposes and will account for GST on the development separately.

GST on purchase

Depending on the nature of the land when it is purchased, GST implications may arise which could affect the purchase price on acquisition.

Going back to first principles, GST is payable on taxable supplies and taxable importations.[35]

A "taxable supply" is made when:[36]

- a supply is made for consideration;
- the supply is made in the course or furtherance of an enterprise carried on by the supplier;
- the supply is connected with an "indirect tax zone";
- the supplier is registered or required to be registered for GST; and
- the supply is not "GST-free" or "input-taxed".

In the context of a property purchase, most of the requirements for a taxable supply will be met. The main issues to be considered include:

- whether the property being acquired is "input-taxed". Ordinarily, the sale of established residential premises will be input-taxed, provided they do not qualify as "new residential premises";[37] and
- if vacant land is being purchased, whether the vendor is registered or required to be registered for GST. This is because vacant land will not qualify as residential premises[38] and will therefore generally be subject to GST unless some other exception applies.

As the supplier, the vendor will ordinarily be liable for the GST.[39] Accordingly, if the sale price under the contract for sale is expressed as being inclusive of GST, the purchaser may have little regard for the GST consequences on acquisition. However, the GST consequences on acquisition may have implications for the purchaser down the track. This is discussed further below in relation to the GST considerations on sale.

GST during the development phase

During the development phase, construction and development costs must be met to facilitate the construction of new homes, subdivision of land, and partition of ownership interests. GST will typically apply to those expenses.

Depending on the circumstances, the landowner/developer may be entitled to claim some or all of the GST incurred on the development costs. This will depend on the expense qualifying as a "creditable acquisition".[40]

A "creditable acquisition" arises when the following requirements are met:[41]

- the landowner acquires anything solely or partly for a creditable purpose;
- the supply of the thing to the landowner is a taxable supply;
- the landowner provides, or is liable to provide, consideration for the supply; and
- the landowner is registered or required to be registered.

A critical requirement for a "creditable acquisition" is to have a "creditable purpose". A creditable purpose arises when:

- the landowner acquires a thing (ie incurs the development expense) in carrying on their enterprise; and
- the expense:
  - does not relate to making supplies that would be input-taxed; or
  - is not of a private or domestic nature.

In the context of a small-scale development (ie assuming the development involves the construction of residential premises only), the developer's ability to claim credits on the development expenses will depend on whether they are developing the land for the purposes of:

- building a new home for use as a main residence or as a long-term investment property — in this case, GST credits cannot be claimed because the development costs will not be incurred for a "creditable purpose" (ie because the expense is private or domestic, or relates to the making of input-taxed supplies) and nor will the owner be required to register for GST; or
- building a new home for immediate or short-term sale at a profit — as the sale of new residential premises is subject to GST (ie it is not "input-taxed"),[42] GST credits can be claimed on development expenses in this scenario.

As a development will typically involve the subdivision of multiple residential lots, it may be the case that different GST treatments apply in respect of each lot. Using the example of X and Y described earlier in this article, suppose:

- X's intention with respect to lot X is to retain it long-term as their main residence; and
- Y on the other hand, plans to sell lot Y in the short-term.

In that scenario, the development costs incurred by X will not be creditable, whereas the development costs incurred by Y would be.[43] As the development costs are likely to be

combined, an apportionment of the costs would be required in this situation.

The following formula in s 11-30(3) GSTA99 must be applied to work out the amount of credit which can be claimed:

Full input tax credit × Extent of creditable purpose × Extent of consideration

where:

- "extent of consideration" is the extent to which the landowner provides, or is liable to provide, the consideration for the acquisition, expressed as a percentage of the total consideration for the acquisition;
- "extent of creditable purpose" is the extent to which the creditable acquisition is for a creditable purpose, expressed as a percentage of the total purpose of the acquisition; and
- "full input tax credit" is what would have been the amount of the input tax credit for the acquisition if it had been made solely for a creditable purpose and the landowner had provided, or had been liable to provide, all of the consideration for the acquisition.

Using the example of X and Y, suppose:

- X and Y incur total development costs of $1.15m, inclusive of GST, to subdivide and develop lots X and Y; and
- lots X and Y are of equal size and value, and the development expenses have been spent equally on each lot.

In that case, Y would be entitled to input tax credits of $52,272.50 in respect of the development expenses for lot Y, calculated as follows:

$104,545 (ie 1/11th of total development costs of $1.15m) × 100% (extent of Y's creditable purpose) × 50% (assuming Y pays half the development costs)

While the example above is relatively simple, there may be other more complex scenarios where working out the extent of the creditable purpose is more difficult. The ATO has indicated in GSTR 2006/4 that there is no prescribed method for determining the extent of creditable purpose, and that any fair and reasonable basis can be used. In the development context, some possible methods could include:

- a cost allocation based on financial modelling contained in a business plan;
- allocating costs by way of relative floor space of the lots to be sold; or
- allocating costs based on expected values or profit of the lots to be sold.

Whichever method is adopted, records must be kept which clearly show the basis on which the extent of creditable purpose was determined.[44]

Change of purpose or intention

If the last two years have taught us anything, it's that things can change dramatically and unexpectedly. In the context of a small-scale property development, a developer may undertake their project with the clear intention of retaining or selling their lots but find themselves having to change their strategy due to shifting market conditions or personal circumstances.

Where the developer's actual use of the residential premises differs from their planned use, an adjustment is required under Div 129 GSTA99. The ATO states at para 8 of GSTR 2009/4:

> "The amount of the input tax credit to which an entity is entitled depends on the extent to which the acquisition or importation is for a creditable purpose. The Commissioner's view is that the creditable purpose tests in sections 11-15 and 15-10 focus on an entity's intended use of an acquisition or, in other words, an entity's planned use. After an acquisition or importation is made, the extent to which it is actually applied or used for a creditable purpose may be different from the intended use. Adjustments for changes in the extent of creditable purpose are provided for in Division 129."

Depending on how input tax credits have been claimed by the developer, the adjustment may take the form of:

- an increasing adjustment, where the developer has claimed more input tax credits than they were entitled to claim based on their actual usage of the property. This would occur when the developer intended to sell the new residential premises but ended up retaining them for long-term residential rental or for use as a main residence; or
- a decreasing adjustment, where the developer has claimed less input tax credits than their actual usage of the property allows. This would occur when the developer intended to retain the premises for long-term rental or use as a main residence but ended up selling them as new residential premises.

An adjustment is only required if the change in purpose occurs during an "adjustment period". An adjustment period is defined in s 129-20(1) GSTA99 to mean the period starting at least 12 months after the end of the tax period to which the development cost is incurred and ending on 30 June in any year. Thus, every adjustment period must end on 30 June except in limited circumstances.

The limited circumstances include:

- where the entity has a concluding tax period under s 27-40 GSTA99.[45] This will occur where the entity dies, ceases to exist, ceases to carry on an enterprise, or ceases to be registered for GST. In any of those situations, the concluding tax period is an adjustment period; and
- if the thing acquired by the entity giving rise to the adjustment is disposed of, or is lost, stolen or destroyed, then the next period ending 30 June is treated as a final adjustment period.[46]

In the context of a small-scale property development, these exceptions are likely to apply. Specifically, if X is a one-time developer, their enterprise (and hence their GST registration) will end when lot X is sold. For that reason, X's

adjustment period will be limited to their concluding tax period being the tax period in which lot X is sold.

Once it has been determined that an adjustment is required, the next step is to work out the amount of the adjustment. Subdivision 129-C GSTA99 prescribes the process for working out the adjustment. In essence, the adjustment is made by comparing the intended creditable use with the actual creditable use[47] in accordance with the following formula:

Adjustment amount = full input tax credit × difference between intended application and actual application

By way of simple example, suppose X (as described above) changes their mind and decides to sell lot X immediately after completion. In this scenario, assume that the actual creditable use for lot X is now 100%. Assume also that the intended creditable use was 0% (ie because X intended to retain lot X as their long-term main residence). In that case, the adjustment would be:

$52,272.50 (ie 1/11th of total development costs of $1.15m × 50% paid by X) × (100% – 0%)

If the development is completed on 27 March 2022 and the sale happens immediately thereafter, the adjustment will occur in the adjustment period ending 31 March 2022 (assuming that this is a concluding tax period for X).

GST on partition

The ATO is of the view that GST can apply to a transfer of property under a partition agreement if the transfer is made in the course or furtherance of an enterprise carried on by a co-owner.[48] So, for example:[49]

- two developers jointly acquire land for the purposes of constructing new residential apartments for sale at a profit. On completion of construction, the developers enter into a partition agreement with the result that one developer takes half the residential apartments and the other developer takes the remainder; and
- both developers go on to sell their respective apartments as new residential premises. In this case, each developer has transferred their half-share of apartments under the partition in connection with their respective enterprises. GST will apply to the transfer of apartments under the partition.

However, if the transfer does not occur in the course of the co-owner's enterprise, GST will not apply. Following the example of X and Y:

- X wishes to retain lot X for use as their main residence;
- Y wishes to sell lot Y for a profit;
- the transfer of the half-interest in lot Y by X will not be subject to GST as X has completed the transfer for the purposes of acquiring a main residence;
- however, the transfer of the half-interest in lot X by Y will be subject to GST as Y has completed the transfer for the purposes of acquiring 100% of lot Y which Y will then sell as new residential premises.[50]

The imposition of GST on partition arrangements can give rise to practical complications due to the fact that there is no liquid cash received to help fund any GST liabilities.

Finally, it is noted that the margin scheme can be claimed in respect of a taxable transfer of property made under a partition arrangement, provided the requirements of the margin scheme are met.[51] This means that an agreement in writing will be required specifying that the margin scheme applies in relation to the partition.

GST on sale

The eventual sale of the developed lots may give rise to GST consequences, depending on the timing of sale after the development is completed.

Using the example of X and Y:

- if X later sells lot X after having used that property as their main residence for many years (more than five years), the eventual sale should be input-taxed and no GST consequences will arise; and
- if Y sells lot Y immediately after the development and partition is completed, the sale of lot Y will qualify as a sale of "new residential premises" and will therefore be taxable.

Where residential land is concerned, it is customary for the sale price to be inclusive of GST. This is because the purchaser will usually not be registered and therefore unable to claim back any GST on the sale. Accordingly, the GST cost for Y will fall on Y without the ability to gross up the sale price.

The amount of GST payable by Y will depend on whether the margin scheme applies. Where the margin scheme applies, Y will pay GST on the "margin" (being the difference between the sale price and the purchase price of the property, not including any development costs), rather than 1/11th of the sale price.[52] This can result in a GST saving for Y, particularly where the sale price is inclusive of GST.

In order to qualify for the margin scheme, Y must:

- agree in writing with the purchaser that the margin scheme will apply.[53] This agreement must be made before the supply is made and is typically done by specifying that the margin scheme applies in the sale of land contract; and
- not have acquired lot Y through a supply that was ineligible for the margin scheme.

A supply of property is ineligible for the margin scheme if:[54]

- the property was originally acquired under a taxable supply without applying the margin scheme;
- the property was acquired by the vendor from a previous transferor who was ineligible to apply the margin scheme; or
- the property was acquired in circumstances where all of the following apply:
  - the acquisition was GST-free pursuant to the going concern exemption[55] or farm land exemption;[56]

- the previous transferor was registered or required to be registered for GST purposes; and
- the previous transferor acquired the property without applying the margin scheme.

As discussed above, the circumstances and manner in which X and Y acquired the land initially, and how Y acquires the remainder of lot Y under the partition, will affect whether Y can claim the margin scheme when they ultimately sell lot Y.

Specifically, for Y to be able to claim the margin scheme:

- the property would need to have been acquired by X and Y in circumstances where either:
  - GST did not apply to the sale (eg if they bought existing residential premises which were input-taxed); or
  - if GST did apply, the vendor chose to apply the margin scheme; and
- when X and Y partition the lots, the acquisition from X must either be:
  - not subject to GST. As noted above, if X intends to retain lot X as a main residence, the supply of lot Y by X would not be subject to GST; or
  - if the circumstances were different and X was planning on selling lot X as new residential premises, X must choose to apply the margin scheme when they transfer their 50% interest in lot Y to Y.

Duty considerations

Generally, duty on the transfer of land in Victoria is payable by the purchaser.[57] Accordingly, in a small-scale development scenario, the relevant duty points will be:

- when the land is originally purchased;
- on an interim transfer (if required); and
- on partition.

Duty on purchase

In a typical case where land is purchased from a third party, duty will apply in the usual manner. However, care must be taken to ensure that no sub-sales duty or foreign purchaser surcharge duty will apply.

Foreign purchaser additional duty

Where Victorian land is acquired by a "foreign purchaser", the foreign purchaser additional duty (FPAD) will apply.[58] This duty applies at a rate of 8% in addition to the standard rates of duty, and therefore is a significant cost.

A "foreign purchaser" is defined broadly in s 3 of the Duties Act to include:

- a foreign individual — this will generally include someone who is not an Australian citizen, Australian permanent resident or a New Zealand citizen holding a special category visa;
- a foreign corporation — this will include a company which is incorporated outside of Australia or any company in which another foreign person, foreign company or foreign trust has a controlling interest; and
- a foreign trust — this is very broadly defined to include a trust in which any foreign person, foreign company or another foreign trust has a substantial interest. A discretionary trust will be a foreign trust if even one member of the class of discretionary beneficiaries includes a foreign person/company/trust.[59]

In the context of small-scale developments, it is unlikely that there will be any foreign persons involved. However, care should be taken in cases where Australian residents are co-developing with foreign parties who may be intending to take an interest in the land.

Sub-sales duty

Part 4A of Ch 2 to the Duties Act contains the "sub-sale rules". In essence, these rules have the effect of imposing multiple rounds of duty on what is essentially a single transfer of land in certain circumstances.

> "Where a new purchaser is nominated after applications for development are lodged ... a second round of duty could apply."

Sub-sale duty can apply where a contract for the purchase of land is signed and additional consideration is provided by a subsequent purchaser for the right to have the property transferred to them.[60] An example where this could arise is if:

- X signs a contract to purchase property;
- prior to settlement, X nominates Y to complete the purchase;
- Y provides consideration to X for the nomination; and
- Y completes the purchase.

A further example where sub-sale duty can apply is where a contract for the purchase of land is signed and land development occurs in relation to the property prior to another entity being nominated to complete the purchase.[61] This category of "sub-sales" is the one which catches developers out for the following reasons:

- the concept of "land development" is extremely broad and can include lodging a permit application with the local authority (even if such permit has not been granted);[62]
- this category of sub-sale duty can apply even if no additional consideration is provided; and
- while sub-sales between relatives are exempted, there is no exemption for the nomination of a related family trust.

Thus, if X were to (1) sign a contract to purchase land "and/or nominee", (2) were to apply for a planning permit,

and (3) nominated a family trust which X controls to complete the purchase, then sub-sale duty would apply.

In addition, sub-sale duty can also apply in respect of certain option arrangements where:

- an owner of land grants an option to purchase land to a person;
- the option holder then provides a transfer right in relation to the property to another person; and
- at some time after the option is granted but before the transfer right is provided or the property is transferred, land development occurs in relation to the property.[63]

In such circumstances, both the original purchaser under the contract and the nominated/alternative purchaser may be subject to duty, resulting in double duty on the purchase of land. Further rounds of duty can apply if there are multiple nominations or transfer rights provided in respect of the single sale of land.

In the context of a small-scale development, care should be taken in situations where a contract for the purchase of land is a long settlement, with the intention of applying for permits to subdivide and develop prior to settlement. Where a new purchaser is nominated after applications for development are lodged, and the nominee is not a relative of the contracted purchaser, a second round of duty could apply.

To prevent the sub-sales duty from applying, the nomination of the ultimate purchaser should be made *before* any permit applications are lodged with the relevant authority.

Duty on transfer

As discussed above, in circumstances where the property is already owned by the developer, it may be necessary to restructure the ownership of the property prior to development.

In most cases where the ownership of property changes, transfer duty will apply in the usual way. Examples where transfer duty will apply include situations where the property is transferred:

- from an individual to a trust (unless the trust is a "bare trust"[64]);
- from an individual to a company;
- from a company to a trust; and
- from a parent to a child.

In these situations, a cost/benefit analysis needs to be undertaken to determine whether the benefits of restructuring the ownership of the property outweigh the duty cost. That said, there are various exemptions from duty that can apply to certain transfers. For example, the following transfers may be exempted from duty:

- from a trust to an individual who is a beneficiary or unitholder of that trust.[65] This can be useful where the property is being developed for the purposes of providing a new main residence for the beneficiary (ie where individual ownership is preferable);
- from a trust to a company, provided the company is a beneficiary or unitholder of that trust. This can be useful where the trust owns other assets and it is desirable to move the property out before the development in order to quarantine any risk from the development;
- between domestic spouses, provided the property is the principal place of residence of the couple.[66] This can be useful where one spouse owns the property and they want to transfer a share to the other spouse so that the development profits can be split between them. However, note the requirement for at least one of the spouses to continue using the property as their principal place of residence for at least 12 continuous months after the transfer;[67]
- transfers into or out of superannuation.[68] This can be useful in circumstances where it is desirable to complete the development within superannuation, or where it is necessary to undertake the development outside of superannuation (eg because of funding issues); and
- certain transfers of farmland between relatives and/or related companies and trusts.[69]

Accordingly, before undertaking a development, careful consideration should be given to the structure for the development and to the potential duty concessions which may be available to facilitate a restructure of ownership.

Duty on partition

The Victorian Duties Act contains a specific exemption for partition arrangements. Pursuant to s 27 of the Duties Act:

> "(1) In determining the duty to be paid on any dutiable transaction that gives effect to a partition or division of any estate in land, the Commissioner must, before assessing the duty (if any) payable on the transaction, deduct from the value of that estate the value of the beneficial interest in that estate held prior to the transaction by the transferee.
>
> (2) Subsection (1) does not apply when determining the duty chargeable at the rate set out in section 18A or 28A."

The Victorian State Revenue Office explains the application of s 27 in its Revenue Ruling DA.017. Using the earlier example of X and Y:

- prior to the partition, X and Y each own 50% of the land which makes up lots X and Y. The combined value of these lots is $2.4m. This means that the value of each of X and Y's interests is $1.2m;
- after the partition:
  - X will own 100% of lot X; and
  - Y will own 100% of lot Y;
- Assuming that lots X and Y are of equal size and value, the value of each of lot X and Y is $1.2m;
- accordingly, the value of the interests which X and Y held prior to the partition is the same as the value of the lots that they acquired after the partition. Applying s 27(1), there would be no duty payable for either X or Y.

This exemption is of significant benefit to small-scale developers as it means that they can partition their interests without paying full rates of duty on the land. Where the partition exactly matches each landholder's interests on title before the partition, no duty will apply.

If there is any difference (eg because the lot sizes and values do not precisely match the owners' interests on title), duty will only be payable to the extent that a greater interest is acquired. An example of this is contained in Revenue Ruling DA.017:

> "X and Y own land in Victoria valued at $100,000 with a respective 30% and 70% interests in the land. The land is partitioned under an agreement such that after the partition, each has an interest of $50,000 in the land.
>
> No duty would be charged on the transfer of Y's interest in the land because the value of Y's interest in the land prior to the partition (ie $70,000) exceeds the value after the partition (ie $50,000). Duty would be charged on the transfer of X's interest in the land because the value after the partition (ie $50,000) is greater than that before the partition (ie $30,000). Duty would therefore be charged on the transfer of the interest in land to X and calculated on a value of $20,000."

Finally, it is worth noting the carve-out in s 27(2) for situations covered by s 18A or 28A of the Duties Act. Sections 18A and 28A impose the FPAD (described above). This means that, if a partition of Victorian land involves any foreign person, that foreign person will not be eligible for duty relief under the partition exemption. This could be particularly relevant where:

- the land was originally purchased by a foreign person or persons. In that scenario, not only would the foreign person(s) pay FPAD on the initial purchase, but they would also pay the FPAD again if they partition their ownership; and
- one or more of the owners has become a foreign person after purchasing the land, but before it is partitioned. In that scenario, those foreign persons would not be eligible for the partition exemption.

As can be seen, even "simple" partitions can give rise to considerable tax issues. Professional advice should always be obtained by landowners undertaking even small-scale property developments.

Windfall gains tax

The windfall gains tax (WGT) is a new Victorian state-based tax which applies to property value gains which arise as a result of a rezoning or amendment to a planning scheme. The WGT is set to apply from 1 July 2023.

It is beyond the scope of this article to discuss the full detail of the WGT. However, it is important to note that, in the context of small-scale developments, the WGT will not apply where:

- the land in question is residential land of up to two hectares in size. Importantly, for this exclusion to apply, the land must:
  - have a habitable residence that can lawfully be used as a place of residence; or
  - have a residence being constructed or renovated on the land in circumstances where, before the construction or renovation commenced, the land was capable of lawfully being used as a place of residence or there was a residence on the land that was uninhabitable; and
- the uplift in value caused by the rezoning is $100,000 or less.

Most small-scale property developments should fall into one if not both of the exclusions listed above and therefore the WGT should not apply in most cases. However, in situations where vacant land is involved or the uplift in value exceeds $100,000, consideration will need to be given as to whether the WGT could apply.

When applicable, the WGT is a significant impost. Accordingly, careful consideration should be given to whether the WGT could apply, as a small-scale development may not be financially viable if it does.

Conclusion

As this article demonstrates, property development gives rise to complex tax considerations, even for small-scale developments and even when there is no profit-making motive. Care must therefore be taken by developers and their advisers to ensure that the income tax, duty and GST implications are appropriately managed.

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This article is an edited and updated version of "Tax Issues for small-scale property developments" presented at The Tax Institute's VIC Tax Forum held in Melbourne on 26 to 27 May 2022.

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3 [2007] AATA 1322 at [15] and [16].

4 See the comments of Deane J in the Full Federal Court decision of *Whitfords Beach Pty Ltd v FCT* 79 ATC 4648 at 4666, and the subsequent Full Federal Court decision of *Whitfords Beach Pty Ltd v FCT* [1983] FCA 97.

5 The author has previously published a paper which explores this in detail: "Small scale property development" presented at The Tax Institute's 2021 Yarra Valley Tax Retreat held on 3 to 4 June 2021. That paper is available at www.taxinstitute.com.au/tiseminarpresentation/small-scale-property-development-presentation.

6 See *McCurry v FCT* [1998] *FCA 512*, *Moana Sand* Pty Ltd v FCT [1988] FCA 401, and TR 92/3.

7 See *Ruhamah Property Co Ltd v FCT* [1928] HCA 22, *FCT v Williams* [1972] HCA 31, and *Casimaty v FCT* [1997] FCA 1388.

8 See *Stevenson v FCT* [1991] FCA 224, *FCT v St Hubert's Island Pty Ltd (in liq)* [1978] HCA 10, and TR 92/3.

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10 See *McCurry v FCT* [1998] FCA 512.

11 Australian Taxation Office, *Draft property and construction website guidance*, para 16, released on 9 July 2018. This guidance has now been withdrawn.

12 See *Stevenson v FCT* [1991] FCA 224.

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14 See *Stevenson v FCT* [1991] FCA 224, *Statham v FCT* [1988] FCA 463, and *Casimaty v FCT* [1997] FCA 1388.

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16 S 112-25 ITAA97. See also TD 7, TD 92/148, and PBR 1051757260120.

17 Ss 118-110 and 118-115 ITAA97.

18 S 118-120 ITAA97.

19 Ss 118-115(2), 118-120 and 118-165 ITAA97.

20 S 112-25 ITAA97.

21 For an example of this, see PBR 1051786568488.

22 See the discussion above in relation to the income tax treatment of profits on partition.

23 See example 2 in TR 92/3.

24 See the table on page 93 for detailed calculations.

25 See the "Main residence exemption" heading above for a discussion on the application of the main residence exemption.

26 S 184-1(1) of *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GSTA99). See also MT 2006/1.

27 S 5(1) of the *Partnership Act 1958* (Vic); s 195-1 GSTA99.

28 See para 11 of GSTR 2004/2.

29 S 51-5(1)(a) GSTA99; reg 51-5.01(1)(f) of the *A New Tax System (Goods and Services Tax) Regulations 2019* (Cth).

30 S 51-5(1)(e) GSTA99.

31 S 51-5(1)(eb) GSTA99.

32 S 995-1 ITAA97.

33 For example, see PBR 1051426020916.

34 S 184-1(1A) GSTA99.

35 S 7-1(1) GSTA99.

36 S 9-5 GSTA99.

37 Subdiv 40-C GSTA99.

38 *Vidler v FCT* [2010] FCAFC 59 at [37]. See also para 92 of GSTR 2012/5.

39 S 9-40 GSTA99.

40 S 7-1(2) GSTA99.

41 S 11-5 GSTA99.

42 S 40-65(2)(b) GSTA99.

43 See GSTR 2009/4.

44 See *GXCX and FCT* [2009] AATA 569 at [25], and *FKYL and FCT* [2016] AATA 810 at [23], where the importance of contemporaneous records and evidence was highlighted.

45 S 129-20(1) GSTA99.

46 S 129-25 GSTA99.

47 Working out the actual creditable use requires a further apportionment. The ATO provides guidance on how this apportionment can be made in GSTR 2009/4.

48 Paras 48 and 57 of GSTR 2009/2.

49 Paras 66 to 70 (example 4) of GSTR 2009/2.

50 Paras 79 to 85 (example 6) of GSTR 2009/2 provide a similar example.

51 Para 100 GSTR 2009/2.

52 S 75-10(1) and (2) GSTA99.

53 S 75-5(1) and (1A) GSTA99.

54 S 75-5(3) GSTA99.

55 Subdiv 38-J GSTA99.

56 Subdiv 38-O GSTA99.

57 S 12 of the *Duties Act 2000* (Vic) (Duties Act).

58 S 28A of the Duties Act.

59 S 3B(2) of the Duties Act.

60 S 32B of the Duties Act.

61 S 32I of the Duties Act.

62 S 3(1) See also the Victorian State Revenue Office's commentary at www.sro.vic.gov.au/subsales.

63 S 32P of the Duties Act.

64 S 35 of the Duties Act.

65 Ss 36 (fixed trusts), 36A (discretionary trusts) and 36B (unit trusts) of the Duties Act.

66 S 43 of the Duties Act.

67 S 43A of the Duties Act.

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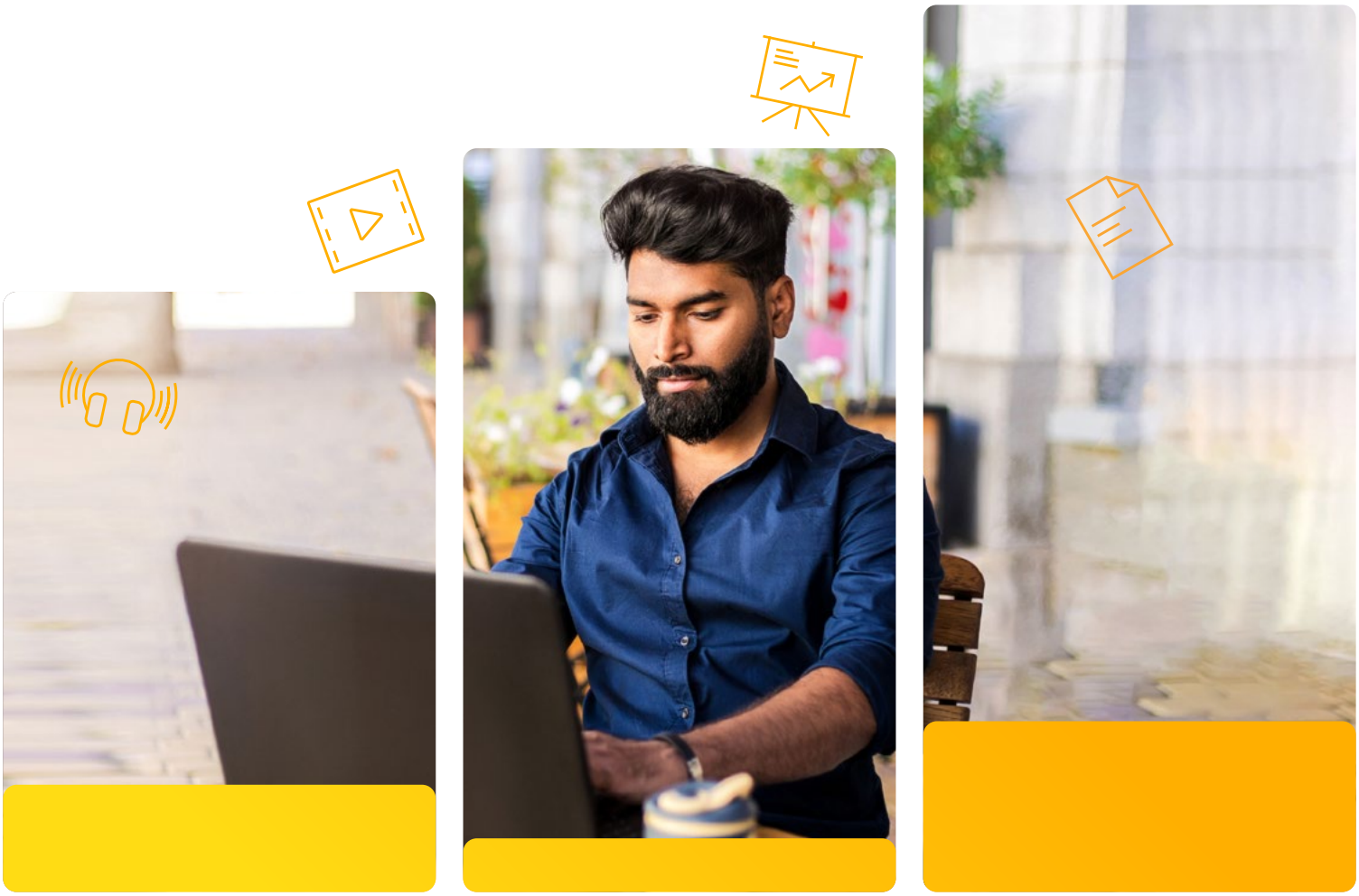

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R&D: navigating disputes

by Stephen Chen, CTA, Partner, MinterEllison

The fundamental question in the vast majority of claims under the research and development tax incentive is whether the relevant activities constitute eligible R&D activities. The complexity and integral nature of the eligibility provisions have resulted in a number of decisions considering the operation and application of the provisions, mostly in favour of Industry, Innovation and Science Australia. Nevertheless, two recent decisions, *Moreton Resources and PKWK* were found in favour of the taxpayer claimants. This article will provide a summary of recent decisions concerning the eligibility provisions, and explore the significance of *Moreton Resources and PKWK*, what distinguished them from other decisions and what they mean for the future of R&D disputes.

Overview

> "We don't want to change. Every change is a menace to stability. That's another reason why we're so chary of applying new inventions."
>
> – Aldous Huxley (1894 to 1963), *Brave New World*, 1932

The concept of change in the context of the research and development tax incentive (RDTI) provisions is a novel one. The introduction of the RDTI in 2011 was intended to address some of the definitional issues plaguing its predecessor, the research and development tax concession regime, and ultimately promote innovation and generate new knowledge. This is set out in para 2.7 of the explanatory memorandum to the Tax Laws Amendment (Research and Development) Bill 2010:

> "The rationale of the new R&D tax incentive lies in the potential for R&D activities to generate new information that benefits the wider Australian economy, while the risk of scientific and technological uncertainty may discourage them from taking place. A tax incentive that induces such R&D activities to proceed may provide a public benefit (in the form of the spread of additional knowledge) that ultimately exceeds the cost of the incentive."

Notwithstanding parliament's sentiment at the time, in practice, the RDTI provisions, and in particular the definition of "core R&D activities" in s 355-25 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97), have been problematic and no less burdensome than the former regime. The definition of "core R&D activities" is drawn out and even interminable, and the purported requirement of preparing and maintaining robust documentation sufficient to satisfy the evidentiary burdens attaching to the definition has often proven unsurmountable. The issues have resulted in the many cases litigated over the RDTI eligibility provisions overwhelmingly decided in favour of Industry, Innovation and Science Australia (previously known as Innovation and Science Australia (ISA)). Unsurprisingly, this has left taxpayers deterred and pessimistic about their prospects once their R&D disputes venture into the realms of the Courts and the Administrative Appeals Tribunal (AAT).

Nevertheless, in recent years, there has been cause for optimism from the perspective of taxpayers. While the RDTI eligibility provisions have largely remained unchanged since their introduction, the law and jurisprudence underpinning the provisions have continued to evolve. In particular, this has been as a result of the two major victories by taxpayers on the application of the RDTI provisions, being the Full Federal Court's decision in *Moreton Resources Ltd v Innovation and Science Australia*[1] (*Moreton Resources*) and the AAT decision of *PKWK and Innovation and Science Australia*[2] (*PKWK*). Indeed, prior to *Moreton Resources* and *PKWK*, the only other occasion where a taxpayer experienced success in litigation in this arena was the 2016 AAT decision of *JLSP and Innovation Australia*[3] which was largely on account of the taxpayer being able to adduce comprehensive contemporaneous documentation as evidence of the core R&D activities. The principles arising from *Moreton Resources* and *PKWK*, in the context of "core R&D activities", are the focus of this article, as is a consideration of how taxpayers may wish to approach and pursue R&D claims in future.

Core R&D activities

Legislative history

The predecessor to the RDTI was the research and development tax concession regime which was introduced in 1986 and previously set out in s 73B of the *Income Tax Assessment Act 1936* (Cth) (ITAA36). The predecessor to s 355-25 ITAA97 was s 73B(1) ITAA36, which defined "research and development activities" as follows:

> "73B(1) In this section, unless the contrary intention appears —
>
> 'research and development activities' means —
>
> (a) systematic, investigative and experimental activities that involve innovation or high levels of technical risk and are carried on for the purpose:
>
> (i) of acquiring new knowledge (whether or not that knowledge will have a specific practical application); or
>
> (ii) creating new or improved materials, products, devices processes or services; or …"

In 1996, s 73B(2B) was added, which rendered the definition of "research and development activities" narrower and more difficult for taxpayers to satisfy. It stated:

> "(a) activities are not taken to involve innovation unless they involve an appreciable element of novelty; and
>
> (b) activities are not taken to involve high levels of technical risk unless:
>
> (i) the probability of obtaining the technical or scientific outcome of the activities cannot be known or determined in advance on the basis of current knowledge or experience; and
>
> (ii) the uncertainty of obtaining the outcome can be removed only through a program of systematic investigative and experimental activities in which a scientific method has been applied, in a systematic progression of work (based on principles of physical, biological, chemical, medical, engineering or computer sciences) from hypothesis to experiment, observation and evaluation, followed by logical conclusions."

When the RDTI provisions were introduced in 2011, parliament's intention was clearly to design a more streamlined set of provisions to enable taxpayers to access the R&D incentives where appropriate, citing the new amendments as:[4]

> "… the biggest reform to business innovation support for more than a decade. It cuts red tape and provides a more targeted incentive for companies to invest in R&D. The new R&D tax incentive is also an opportunity to ensure that public support for business R&D is consistent with the underlying rationale for government intervention and delivers value for money for taxpayers."

Definition of "core R&D activities"

Paramount to the RDTI provisions is the definition of "core R&D activities" in s 355-25, in particular s 355-25(1) which reads:

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

The various limbs in s 355-25(1) will be considered further in the context of recent decisions.

R&D cases on eligibility

Moreton Resources was the first matter concerning the RDTI provisions which was appealed to the Full Federal Court and, accordingly, the first Full Federal Court victory for the taxpayer. *PKWK*, an AAT decision, offers significant insight into how AAT disputes might be decided in the future, particularly in respect of its observations on independent experts and contemporaneous documentation. Both decisions were comprehensive victories for the taxpayer. Since the Full Federal Court's decision in *Moreton Resources*, there have been six separate decisions handed down in respect of R&D eligibility, excluding *PKWK*. ISA was successful in each of the six decisions. This follows a similarly unsuccessful period prior to *Moreton Resources*, whereby the outcome of RDTI decisions was as follows:

Decision	Date of decision	Outcome
Ultimate Vision Inventions Pty Ltd and Innovation and Science Australia[5]	27 June 2019	AAT affirms decision of ISA[6]
JLSP and Innovation Australia[7]	22 January 2016	AAT sets aside ISA's decision
Docklands Science Park Pty Ltd and Innovation Australia[8]	16 December 2015	AAT affirms decision of ISA

While each of the relevant decisions over the last three years concerning R&D eligibility in the context of the RDTI provisions will be summarised, the focus of this article will be on *Moreton Resources* and *PKWK* and how these two recent decisions might influence R&D disputes going forward.

Moreton Resources

Facts

In or around 2006, the taxpayer, Moreton Resources Ltd (Moreton), set out to develop an underground coal gasification (UCG) facility near Kingaroy, Queensland, comprising a gas processing plant and a gas turbine power plant. Prior to the construction of the plant, Moreton undertook a pilot project to test the viability of the UCG technology. The pilot plant eventually failed, culminating in the Environmental Protection Agency ordering the facility be shut down in or around March 2010.

Subsequent to this, Moreton conducted various activities between the 2012 and 2014 financial years, largely in relation to the remediation of the pilot plant. The relevant projects that Moreton sought to have registered as R&D activities were broadly:

- designing and developing a synthesis gas (syngas) cleaning and power generation pilot plant, including supporting activities (known as the Kingaroy project);
- using the learnings from the Kingaroy project to design and develop a second UCG syngas processing plant and to determine the most appropriate economical uses for syngas, including supporting activities (known as the Wandoan project); and

- the development of a conceptual water model and rehabilitation plan following the UCG pilot plant experimentation (the new project).

The above activities were the subject of an application that Moreton filed seeking registration of the activities as eligible R&D activities. This registration was initially granted by ISA. However, on a thorough investigation of the relevant activities being carried out, ISA subsequently revoked registration on 21 August 2015 and confirmed the decision following internal review. The taxpayer subsequently initiated an application for review in the AAT.

AAT decision

The decision of the AAT was handed down on 10 September 2018 by DP Forgie, affirming ISA's decision that the relevant activities were not R&D activities.

Central to the dispute was the meaning of "experimental activities" as contained in the definition of "core R&D activities" under s 355-25 ITAA97. Both parties agreed that the phrase should be given its ordinary meaning. Moreton submitted that what constitutes an "experimental activity" is determined by the meaning of the word "experiment" and relied on the AAT decision of *JLSP and Innovation Australia*[9] which held that the ordinary meaning includes a test or trial, or an act or operation for the purpose of discovering something unknown or testing a principle, supposition etc. On the other hand, ISA submitted that an activity should not be accepted as an experimental activity merely because it is carried out for the purpose of discovering something unknown, but rather the evidence should establish that a hypothesis was formulated and the activities were carried out to test that hypothesis.

The AAT considered both contentions and stated that the words "experimental" and "experiment" would "include actions, deeds or pursuits that seek to discover something previously unknown or that are carried out to test a theory or supposition".[10] It was ultimately determined that the activities were not "experimental" because the activities did not involve testing a principle and the outcomes of the activities were not unknown as they were able to be determined on the basis of existing knowledge or experience. In summary, "experimental activities" did not cover activities that are conducted for the purpose of demonstrating a known fact.

In addition, there was no pattern of work that could be regarded as a "progression of work" of the sort described in s 355-25(1)(a) ITAA97.[11] Unlike in *PKWK*, the AAT decision did not consider each of the limbs of s 355-25(1) separately or discretely.

The taxpayer subsequently sought an appeal of the AAT decision to the Full Federal Court.

Full Federal Court decision

On 25 July 2019, the Full Federal Court decision of *Moreton Resources* was handed down, overturning the earlier decision of the AAT. Fundamentally, the Full Federal Court held that the AAT had erred in its interpretation of the "core R&D activities" under s 355-25(1), stating that the words "experimental activities" did not serve to narrow the definition of "core R&D activities". Paragraph 147 of the decision reads:

> "The effect of the Tribunal's construction was that the word 'experimental' in the opening line of s 355-25(1) narrowed the types of activities that could qualify as 'core R&D activities' beyond the requirements of paragraphs (a) and (b). In other words, on the Tribunal's approach, to determine whether activities are 'core R&D activities' one first considers whether the relevant activities are 'experimental' activities. If they are not, they cannot qualify as 'core R&D activities'. If they are, then it is necessary to consider whether they also satisfy the descriptions in paragraphs (a) and (b) … Thus, on the Tribunal's approach, the words 'experimental activities' in the opening line of the provision have real work to do; they do not merely refer to activities of the type described in paragraphs (a) and (b)."

The court further stated at para 148 that:

> "the words 'experimental activities' in the opening line of s 355-25(1) have very little, if any, work to do beyond reflecting the type of activities described in paragraphs (a) and (b) of the subsection [s 355-25]. Paragraphs (a) and (b) contain a detailed description of activities. Activities must meet the descriptions in both paragraphs to satisfy the defined expression 'core R&D activities'."

> "The Full Federal Court gave a timely reminder that s 355-25 needs to be read in … context."

Also commenting in that same paragraph:

> "Given the detail and content of the description in paragraphs (a) and (b), it is difficult to envisage activities that would meet the description in paragraphs (a) and (b) but would not be considered 'experimental activities'."

The outcome of the Full Federal Court appeal of *Moreton Resources* effectively removed the need for taxpayers to satisfy an entire limb of the definition of "core R&D activities", thereby eliminating the potential for ISA to raise dichotomous contentions about the phrase "experimental activities" being separate to the remaining criteria in s 355-25(1). The Full Federal Court also held that activities involving the application of existing technology to a new site may, depending on the facts and circumstances, satisfy the requirements of s 355-25(1).

Separately, the Full Court also expressed scepticism towards the AAT's decision that activities were not "experimental" because they did not involve testing a principle and the outcomes of the activities were not unknown as they were able to be determined on the

basis of existing knowledge or experience. The Full Court held that activities of this nature may, depending on the circumstances, constitute experimental activities.

While the taxpayer was successful in the Full Court appeal, ultimately the matter was remitted back to the AAT on the basis that the court declined to deal with an alternate submission made by the taxpayer that, even if any part of the activities were not "core R&D activities", they could nonetheless be "supporting R&D activities".

ISA declined to seek special leave to appeal to the High Court.

PKWK

Facts

The applicant, PKWK undertook various activities in connection with developing plant to convert municipal solid waste (MSW) into a syngas, using pyrolysis technology. In undertaking these activities, PKWK entered into a consultancy agreement with an entity referred to as PLPD. The consultancy agreement provided for three phases of work:

- phase 1 — provision of a preliminary design report, including a technical summary and design overview and technical specifications for key proprietary equipment;
- phase 2 — the provision of a detailed design report, including technical specifications for the auxiliary equipment; and
- phase 3 — the provision of plant construction drawings.

The services under the consultancy agreement were undertaken in the 2015 income year. PLPD also retained an engineering and project management consultancy firm, Lycopodium Process Industries Pty Ltd (Lycopodium), to review and amend the design and to prepare further drawings and specifications to be incorporated into a scoping report and project implementation plan.

On 19 August 2015, PKWK applied for registration of its activities carried out in the 2015 income year, with said activities including

"(a) **Core Activity 1.1**, "*Process design*", being:

1. Process design involving:
    - Calculating the required equipment sizing, and amending sizing based on the equipment operating efficiency; and
    - Determining how effectively the equipment transferred heat and testing equipment reaction times processing the inputs; and
    - Detailed and mechanical design of the thermal units, including pyrolysis kiln, drum dryer, burning chamber and steam generation boiler; and
    - Experimenting with different volumes of MSW feeds to determine the volume that can be processed by the treatment facility, an analysis of how the inputs chemically react and transfer through the process.
2. Modelling involving:
    - Process simulation of inputs to develop a detailed process design. There wasn't a guarantee of consistent inputs. As a result, the simulation involved various types of MSW compositions to ensure there was flexibility of inputs; and
    - Process simulation involving experimentation with alternative combinations of construction materials to mitigate heat loss.
3. Mechanical design involving:
    - Designing the treatment facility, which required trialling various equipment sizing, and equipment support structures to allow equipment to expand during heat up to reaction at 600° Celsius;
    - Determining the ideal operating conditions to mitigate the impacts of equipment distortions while enabling ongoing equipment operation for the core pyrolysis section; and
    - Designing general plant input and output section."

In addition to the core activities, PKWK also sought registration of various supporting activities.

On 24 November 2015, ISA refused the application for registration, which resulted in PKWK seeking an internal review of the decision. ISA subsequently affirmed its decision of 24 November 2015 after an internal review. In the internal review of its refusal to grant registration of the relevant activities, ISA stated that:[12]

- the applicant had "not demonstrated that the outcomes of its experiments cannot be known or determined in advance on the basis of current knowledge, information or experience" and that the proposal only involved "optimising … technology and processes [known to work] to account for different composition of municipal solid waste streams";
- "the project activity relates to operational challenges that a qualified professional could overcome using their experience and knowledge in the field" and PKWK "has not provided a detailed description of any experiments undertaken to address a scientific theory"; and
- PKWK had "not demonstrated that the activity was conducted for the purpose of generating new knowledge …" and "the knowledge being sought does not go beyond validating existing processes and knowledge in its particular circumstances".

PKWK subsequently sought a review of that decision in the AAT.

During the hearing of the AAT proceedings, viva voce evidence was provided by:

- Mr A, the director of PKWK;
- Mr G, a project manager employed by PLPD;
- Mr Morey, a project manager employed by Lycopodium; and
- two independent experts, Mr Bland for PKWK and Professor Haynes for ISA.

Issues

In relation to the criterion of s 355-25 ITAA97, ISA accepted that the relevant activities comprising activity 1.1 were *activities* within the meaning of s 355-25(1), but did not accept that the relevant activities were not *experimental activities*, nor did it accept that the activities satisfied the other criteria in s 355-25(1)(a) and (b).

Further, in the course of the AAT proceedings, ISA made a number of contentions about the evidence of PKWK, including that:

- there was a distinct absence of documentary records, and specifically there was no reference in the "output documents" to a hypothesis or activities directed towards testing a hypothesis;
- there were fundamental errors in the work performed, with its independent expert observing that there were features in the conceptual process design that were "grossly inaccurate or un-physical"; and
- there was the lack of a logical process, with its independent expert observing that some of the activities claimed by PKWK were done out of order.

AAT decision

The decision of the AAT was handed down on 24 March 2021, setting aside ISA's decision to refuse the application for registration. Senior Member Cameron found that the activities comprising core activity 1.1 were "core R&D activities" within the meaning of s 355-25 and the relevant supporting activities were "supporting R&D activities" within the meaning of s 355-50.

In making its decision, the AAT held the following:

Experimental activities. The AAT made reference to the Full Federal Court decision of *Moreton Resources*, and subsequently relied on the fact that the evidence of PKWK's independent expert was largely unchallenged, both by ISA's independent expert and on cross-examination.

Independent expert evidence. The AAT separately considered the limbs of s 355-25(1), ie whether the outcome could be known or determined in advance on the basis of current knowledge, and whether the outcome could only be determined by applying a systematic progression of work, in the context of the existing evidence, and particularly the independent expert evidence. Some key principles made about the role of ISA's independent expert by the AAT were as follows:

- Professor Haynes engaged in argument that was clearly outside the ambit of a responsible expert, opining that there was no patent protection for PKWK's tube layout. The AAT stated that it did not "understand Professor Haynes to be an expert in the unquestionably complex law of patents";
- the initial letter of instructions provided to Professor Haynes asked him to opine on issues that did not coincide with the legislative tests; and
- no letter of instructions were provided to Professor Haynes by ISA's legal representatives prior to him preparing his second report.

Purpose of generating new knowledge. The AAT held that the term "new knowledge" does not mandate the concept of scientific breakthrough, let alone the resolution of fundamental uncertainty. Rather, the AAT concluded that activities that lead to improved processes can fall within the concept of "new knowledge". The AAT also accepted evidence adduced by PKWK demonstrating key differences between the technology that it was trying to create compared to existing technologies as capable of satisfying the definition of "new knowledge".

In responding to the specific contentions made by ISA, the AAT also held the following:

There was a distinct absence of documentary records. The purpose of the R&D activities does not necessarily need to be evidenced by contemporaneous documentary records, but instead "can be established by viva voce evidence". This is particularly where a witness is found to be credible as Senior Member Cameron concluded:[13]

> "The Tribunal found Mr A to be a credible witness. He is an intelligent, highly qualified and experienced businessman. It should not be lost sight of that he is a graduate of the University of Melbourne Law School with a Bachelor of Laws and also a graduate from the University of Melbourne Business School with a Master of Business Administration. Whilst he was forthright and direct in the witness box, and may present, as undoubtedly, he is, as a hard-nosed successful businessman, he always answered the questions put to him directly, properly, and where occasion called for it, made appropriate concessions. These are the hallmarks of a satisfactory witness. Despite the careful, probing and thorough cross-examination that he was subjected to by counsel for the Respondent, he left the witness box with his credibility intact. There was no reason for him to be untruthful, embellish or exaggerate his evidence. He did not do so. Therefore, the Tribunal accepts his evidence and finds that he was not an unreliable witness."

In addition, the AAT held that documentation does not need to be comprehensive, showing each iteration. Mr Morey had stated that various drafts "are not generally of interest to clients and not always retained". The AAT accepted Mr Morey's evidence, concluding that "at times best engineering practices, such as six decimal place accuracy, will not always be achieved in commercial environments".

There were fundamental errors in the work performed. ISA's independent expert, Professor Haynes, stated that there were fundamental errors in the work performed. Mr Bland disagreed, arguing that, notwithstanding any errors, there was still a systematic progression of work based on established principles of science. The AAT agreed with Mr Bland, stating that:[14]

> "… Mr Bland's assessment is to be preferred. The fact that there are errors in the work product, however they may be described, whether fundamental or otherwise,

> does not necessarily mean that the work was not carried out in a manner consistent with a systematic progression of work based on established principles of science. There may well be errors made for a variety of reasons, but it does not exclude the possibility nonetheless of the conclusion being reached, as has occurred in this matter."

There was a lack of a logical process. The AAT disagreed with ISA's independent expert, Mr Bland, that there was no logical progression of work, arguing that the second witness statement of Mr A indicated that there was one, and while there might be a question of sequencing, that did not necessarily deprive the process of any logic whatsoever.

ISA declined to appeal the AAT decision to the Federal Court.

Relevant R&D eligibility cases since Moreton Resources

H2O Exchange Pty Ltd v Innovation and Science Australia

The first instance AAT decision of *H2O Exchange Pty Ltd and Innovation and Science Australia*[15] was handed down on 14 October 2019. The relevant activities largely consisted of work done in developing a web-based platform for the cross-border trading of water entitlements and water allocations, as well as the creation of an automated conveyancing and registration process.

The AAT upheld ISA's findings that the relevant R&D activities were not eligible R&D activities. It held that there was no uncertainty of outcome able to be determined by applying a systematic progression of work, as the creation of the platform was known to be achievable based on current knowledge, information and experience. The automation of the conveyancing process was also not regarded as achievable given two jurisdictions did not offer online registration of transfers.

On appeal to the Federal Court, Stewart J's decision in *H2O Exchange Pty Ltd v Innovation and Science Australia*[16] upheld the decision of the AAT, confirming that the AAT had not erred in respect of the grounds of appeal.

Coal of Queensland Pty Ltd v Innovation and Science Australia

On 30 January 2020, the AAT handed down the decision of *Coal of Queensland Pty Ltd and Innovation and Science Australia*.[17] The activities conducted by the taxpayer included the design of a selective mining process, a wash-plant beneficiation process, ultra-fine processing and briquetting, and a geochemistry model for environmental waste management. Aside from the issues concerning s 355-25(1), the decision also concerned whether the relevant activities fell within the exception in s 355-25(2)(b) ITAA97, namely, in relation to certain prospecting, exploring or drilling activities. The outcome at all instances was that the exception did apply. Insofar as the application of s 355-25(1), the AAT relied on the evidence of the experts in concluding that the outcome of the work undertaken was predictable based on experience, and the current knowledge available could have been determined in advance and did not generate any new knowledge, and therefore affirmed ISA's decision. On appeal to the Full Federal Court, Logan, Griffiths and Moshinsky JJ held in the 23 April 2021 decision *Coal of Queensland Pty Ltd v Innovation and Science Australia* that the AAT had not erred in coming to its finding.[18]

Havilah Resources Ltd and Innovation and Science Australia

In *Havilah Resources Ltd and Innovation and Science Australia*,[19] the taxpayer, Havilah Resources Ltd, sought registration of various activities that it conducted in relation to three mining projects pertaining to gold, copper and iron ore. The activities concerned hydrogeological and gold tertiary clay investigations. ISA held that the various activities were not eligible R&D activities.

The decision of the AAT on 16 April 2020 affirmed ISA's decision not to register the relevant activities. With regard to the hydrogeological investigations, the AAT held that the knowledge generated through the activities was not conducted for the purposes of generating new knowledge or benefiting the wider Australian economy (as described in s 355-5 ITAA97). In relation to the gold tertiary clay investigations, the AAT concluded that the activities were not carried out for the purpose of generating new knowledge either, but rather for the purpose of acquiring site-specific information for the sole benefit of the taxpayer.

Camalic Pty Ltd and Innovation and Science Australia

In *Camalic Pty Ltd and Innovation and Science Australia*,[20] the relevant activities conducted by the taxpayer related to the development of a software-predictive tool that utilises a large number of variables to predict an increase in shareholder value. On internal review, ISA decided that the activities were not eligible R&D activities. On 3 June 2020, the AAT upheld ISA's decision, stating that the evidence did not support the taxpayer building the software but rather to train an existing machine-learning algorithm, and therefore there was no new knowledge being generated. The taxpayer also failed to adequately describe the activities that it claimed were eligible R&D activities.

Royal Wins Pty Ltd and Innovation and Science Australia

In *Royal Wins Pty Ltd and Innovation and Science Australia*,[21] the taxpayer sought registration for activities conducted in respect of the development of an integrated hybrid gaming algorithm and platform, with the stated objective of the project to "create a system based on a hybrid model game of skill and chance" and to "test and implement the individual standalone games, mathematical algorithms, global mechanical redistribution models and security features". ISA claimed that the activities were not eligible R&D activities.

The AAT subsequently handed down its decision on 28 October 2020 affirming ISA's decision, largely attributing the difficulty in satisfying the eligibility provisions on the lack of documentation, stating that

"[a] threshold difficulty for the Applicant is the absence of documentation or records from which it can be determined what was done in each of the relevant years. This absence of documentation unfortunately permeates every aspect of this review". The AAT also stated that the relevant hypotheses identified were "vague, generalised descriptions" in the nature of commercial objectives as opposed to propositions involving a degree of uncertainty formulated for the purpose of being validated or unvalidated under an experiment.

The future of R&D disputes

Moreton Resources and *PKWK* have significantly changed the landscape of how R&D disputes will be contested in both the AAT and the courts. *Moreton Resources* has clarified an important point of law that will eliminate a significant hurdle in taxpayers satisfying the definition of "core R&D activities" in s 355-25, while *PKWK* offers greater insight into the role of evidence in R&D disputes. The aftermath of the two decisions can ultimately be summarised in the three key principles described below.

Apply the legislative provisions with context

The Full Federal Court gave a timely reminder that s 355-25 needs to be read in the context of the overriding RDTI provisions, and in particular the object of Div 355 ITAA97 which is stated in s 355-5 to "encourage industry to conduct research and development activities that might otherwise not be conducted because of an uncertain return from the activities, in cases where the knowledge gained is likely to benefit the wider Australian economy". Further, the object of Div 355 "is to be achieved by providing a tax incentive for industry to conduct, in a scientific way, experimental activities for the purpose of generating new knowledge or information in either a general or applied form".

Comprehensive contemporaneous documentation is desirable but not imperative

While the decision of *Royal Wins* focused on the absence of contemporaneous documentation and its permeation into every aspect of the AAT review, the decision of *PKWK* strikes a balance between keeping inadequate documentation and comprehensive documentation. The AAT in *PKWK* did emphasise that the level of documentation kept in a commercial setting would not be as detailed or comprehensive as might be found in a university research setting, for example. As mentioned above, viva voce evidence was found to be reliable and accepted as evidence by the AAT.

However, that is not to say that a paucity of documentary evidence is acceptable. Ultimately, taxpayers have the onus of proof with regard to taxation appeals under Pt IVC of the *Taxation Administration Act 1953* (Cth), and must discharge their evidentiary burden. In satisfying the provisions of s 355-25(1), viva voce evidence has its limitations. Demonstrating that a taxpayer has undertaken experimental activities with a "systematic progression of work" or that those activities "proceed from hypothesis to conclusion", for example, would be almost impossible to achieve with viva voce evidence alone. In short, viva voce evidence is necessary to supplement documentary evidence, rather than replace it.

Expert evidence is paramount

Being able to demonstrate compliance with s 355-25(1)(a) is largely reliant on independent expert evidence. Typically, industry experts are able to opine on whether the relevant activities fall within the criterion of s 355-25(1). The decision in *PKWK* noted several things in relation to the conduct of independent experts. First, the paramount duty of an independent expert is to the AAT, rather than to their client, and consequently independent experts should be wary of advocating on behalf of their clients. Second, the circumstances under which independent experts are briefed are important, and in particular they should be asked to opine on the questions posed in the provisions rather than, for example, a paraphrasing of the provisions. As with all disputes, the credibility of an independent expert can come down to a variety of factors, including whether or not appropriate concessions are made by the expert under cross-examination.

Conclusion

The pronounced difficulty experienced by taxpayers in assessing their own prospects at the outset of an R&D dispute has largely been assuaged over the last few years by the influx of decisions on the eligibility provisions in the RDTI. Questions such as how to interpret the undefined term "experimental activities", what constitutes new knowledge, what factors lead to the evidence of certain independent experts being preferred over others, and what level of documentation is required to evidence R&D activities, have been dealt with and considered by the courts and the AAT, with outcomes both for and against the taxpayer.

Moreton Resources also provided ISA with a strong reminder that decisions will not always land in its favour, particularly in the Federal Court where there is little tolerance for a narrow reading of the provisions, given their broader object and context. *PKWK*, on the other hand, is an important decision that seemingly resolves many of the uncertainties plaguing the RDTI provisions. Ultimately, ISA declined to appeal the decision to the Federal Court, meaning that the precedential value of the *PKWK* decision remains limited. Nevertheless, it would be unwise for ISA to simply ignore the decision when considering future claims and disputes.

In any event, existing and future R&D claimants certainly have cause for optimism as they navigate through this brave new world.

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This article is an edited and updated version of "R&D: a brave new world" presented at The Tax Institute's VIC Tax Forum held in Melbourne on 26 to 27 May 2022.

References

1 [2019] FCAFC 120.

2 [2021] AATA 706.

3 [2016] AATA 23.

4 Para 5 of the explanatory memorandum to the Tax Laws Amendment (Research and Development) Bill 2010.

5 [2019] AATA 1633.

6 Noting that the Federal Court of Australia subsequently handed down the decision of *Ultimate Vision Inventions Pty Ltd v Innovation and Science Australia* [2022] FCA 606 on 24 May 2022 after the finalisation of this article. The decision dismissed the taxpayer's appeal and affirmed the decision of the AAT.

7 [2016] AATA 23.

8 [2015] AATA 973.

9 [2016] AATA 23.

10 *Moreton Resources Ltd and Innovation and Science Australia* [2018] AATA 3378 at [186].

11 [2018] AATA 3378 at [266].

12 [2021] AATA 706 at [21].

13 [2021] AATA 706 at [102].

14 [2021] AATA 706 at [242].

15 [2019] AATA 4195.

16 [2021] FCA 11.

17 [2020] AATA 126.

18 [2021] FCAFC 54.

19 [2020] AATA 933.

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Superannuation

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Employee or contractor — clarifying the multi-factorial test: part 2

While The High Court has confirmed that a contract takes primacy over the multi-factorial test, it is still relevant and advisers need to be aware of how these tests apply.

The law in relation to who is an employee compared to who is independent contractor has developed over many years, both in Australia and overseas. Several recent Australian High Court decisions which provide greater clarity on this distinction are discussed below.

PAYG and SG

Note that this is the second article in a series designed to outline some of the issues relating to this important topic. First, we provide a snapshot of the topics covered in "Employee or contractor — PAYG and SG: part 1":[1]

- relevant background to the employee versus contractor distinction;
- what payments the PAYG withholding rules cover; and
- how the superannuation guarantee (SG) rules apply to contractors, especially where there is a payment that is "wholly or principally for the labour of the person" and caught by s 12(3) of the *Superannuation Guarantee (Administration) Act 1992* (Cth) (SGAA).

CFMMEU v Personnel Contracting

The High Court in *Construction, Forestry, Maritime, Mining and Energy Union v Personnel Contracting Pty Ltd*[2] (*CFMMEU v Personnel Contracting*) examined whether a labourer engaged by a labour-hire firm (Personnel Contracting, trading as Construct), who was directed to work for a building client, was an employee or a contractor of the labour-hire firm. There was no contract between the labourer (Mr McCourt) and the builder (Hanssen).

The primary judge of the Federal Court held that Mr McCourt was an independent contractor and the appeal to the Full Federal Court was dismissed. In both cases, the court applied a multi-factorial test by reference to the terms of the contract between Construct and Mr McCourt, as well as the work practices that were imposed by both Construct and Hanssen.

However, the High Court gave primacy to the written agreement and, by majority, held that Mr McCourt was Construct's employee. The following are key extracts from the majority decision:

> "[44] … The 'only kinds of rights with which courts … are concerned are legal rights'. The employment relationship … is … a legal relationship …
>
> [59] Where the parties have comprehensively committed the terms of their relationship to a written contract, the validity of which is not in dispute, the characterisation of their relationship … proceeds by reference to the rights and obligations of the parties under that contract. Where no party seeks to challenge the efficacy of the contract … on the basis that it is either a sham or is otherwise ineffective …, there is no occasion to seek to determine the character of the parties' relationship by a wide-ranging review of the entire history of the parties' dealings. Such a review is neither necessary nor appropriate because the task of the court is to enforce the parties' rights and obligations, not to form a view as to what a fair adjustment of the parties' rights might require."

The High Court confirmed that the factors that are applied in a multi-factorial test of the relationship can be considered to determine whether an employment or a contractor relationship exists. However, the multi-factorial analysis must have regard to the rights and duties established by any contract between the parties.[3] Under the relevant agreement, Construct could dictate who the labourer worked for and the employer's ability to supply a compliant workforce. These factors were key to Construct's business and, thus, an employer–employee relationship existed despite the use of a "contractor" label in the contract.

ZG Operations v Jamsek

The High Court in *ZG Operations v Jamsek*[4] (*Jamsek*) examined whether two truck drivers, Mr Jamsek and Mr Whitby, were employees or contractors.

Mr Jamsek and Mr Whitby were initially employed directly by ZG Operations from 1977. However, in 1985–86, the company negotiated a new arrangement with each driver and their respective spouse as separate partnerships. Each partnership purchased a truck from the company and thereafter maintained their own equipment. Each partnership was paid for the delivery of goods via an invoice. Each driver argued that they were placed under pressure to enter into these arrangements.

Each truck driver, on departure from the company in 2017, claimed that they should be paid their "employee entitlements" that they had missed out on, including annual

leave and SG contributions. (This is not an uncommon claim for a departing purported "contractor" where the person may consider that they missed out on these entitlements — thus, employers need to be mindful of this risk when considering the apparent advantages of hiring a contractor in contrast to an employee.)

The primary judge of the Federal Court concluded that the drivers were independent contractors. However, the Full Federal Court overturned this decision and held that, having regard to the "substance and reality" of the relationship, they were employees.

The High Court unanimously held that Mr Jamsek and Mr Whitby were not employees. In reaching this conclusion, the High Court gave primacy to the written agreement. The following are key extracts from the majority decision:

> "[8] This appeal was heard together with the appeal in [*CFMMEU v Personnel Contracting*] … The circumstance that entry into the contract between the company and the partnerships may have been brought about by the exercise of superior bargaining power by the company did not alter the meaning and effect of the contract …
>
> [48] … this [totality] approach is erroneous in point of principle for the reasons given in *CFMMEU v Personnel Contracting* …
>
> [51] It is necessary to note in these observations of the Full Court the expansive approach taken to determining the 'substance and reality' of the relationship between the parties, and especially the significance attached to the disparity in bargaining power as itself affecting the meaning or effect of what the parties had agreed. This expansive approach accords with that which has been taken in the United Kingdom. For the reasons stated in *WorkPac Pty Ltd v Rossato*[5] and in *CFMMEU v Personnel Contracting*, this expansive approach involves an unjustified departure from orthodox contractual analysis …
>
> [62] The circumstance that this state of affairs was brought about by the exercise of superior bargaining power by the company weighed heavily with the Full Court; but that circumstance has no bearing on the meaning and effect of the bargains that were struck between the partnerships and the company …"

The majority High Court decision in *Jamsek* is consistent with the views of the majority decisions of the High Court in *Workpac v Rossato* and *CFMMEU v Personnel Contracting.* There are now three recent High Court decisions where the rights and obligations of the parties under the contract take primacy over the multi-factorial test where a comprehensive written agreement exists. The High Court has also clarified that the multi-factorial test has a considerably more limited application than previously considered.

High Court focuses on the contract versus the multi-factorial test

The multi-factorial test has been regarded as a key test in determining whether a person is engaged as an employee or a contractor over many years, as reflected in the following cases: *Stevens v Brodribb Sawmilling Co Pty Ltd*,[6] *Hollis v Vabu*,[7] *On Call Interpreters and Translators Agency Pty Ltd v FCT (No. 3)*,[8] and *Dental Corporation Pty Ltd v Moffet*.[9] The "master–servant" control test was the key test relied on before the shift towards the multi-factorial test.

However, the three High Court decisions discussed above, ie *Workpac v Rossato* (which was discussed in part 1), *CFMMEU v Personnel Contracting* and *Jamsek*, reflect a significant shift towards placing the primary focus on the contract in question and a decreased reliance on the multi-factorial test to determine whether a person is an employee or a contractor. However, the multi-factorial test still has a role to play as reflected in the three recent High Court decisions.

First, it assists in deciding whether an employment or a contractor relationship exists, having regard to the rights and obligations of the parties under the contract.

Second, the multi-factorial test can be applied where:

- there is no comprehensive written agreement;
- the agreement is partly oral and partly written, such as in the *On Call Interpreters and Translators Agency* decision; and
- the agreement can be set aside or side-stepped, eg due to sham, invalidity, statutory override or due to an estoppel argument.

The above three High Court decisions highlight that contractual analysis and factual evidence are key to establishing the terms of each contract and the rights and obligations of the parties under the contract. Subsequent factors that may arise after a contract is formed may be irrelevant unless, for instance, there is a valid variation to the contract, such as in *Jamsek* when the employees purchased trucks in 1985–86, set up in partnership with their respective spouses, and each husband and wife partnership agreed to deliver goods for a fee, despite the superior bargaining position that ZG Operations held over each truck driver.

Why does the above matter so much?

The employee versus contractor divide is critical and all employers, principals engaging contractors, employees, contractors, sub-contractors and their families and advisers need to be aware of the numerous ramifications that flow from the particular type of relationship that exists. Unless the right determination is made, the employer or principal may end up with PAYG, SG, payroll tax, work accident insurance cover, employment law, and vicarious liability issues, along with other legal and tax issues. Conversely, a contractor may miss out on valuable employee entitlements, including leave entitlements, SG and protection against unfair dismissal.

There are also substantial risks associated with getting it wrong, as amounts that may be owing from an incorrect application of the law plus applicable penalties could easily

sink a business. As noted above, the "contractors" in *Dental Corporation Pty Ltd v Moffet* and *Jamsek* were both seeking employee entitlements following their departure from the business, including unpaid SG contributions.

The state and territory revenue offices are also undertaking more checks on payroll tax issues, especially where a relevant contract exists, such as in many professional settings where a professional is engaged in a business and is supplied with services by the business the costs of which are deducted from the fees that the professional charges Medicare (if bulk billed) or the end-user client.

Thus, it is recommended that every business should review all of its employee and contractor arrangements, and revise any structures or contracts as needed. Broadly, it is recommended that a business does not engage an individual contractor unless it is abundantly clear that they are a true independent contractor and a comprehensive written agreement exists.

One point of lingering uncertainty is the far reach of the SG rules in respect of contractors under s 12(3) SGAA. The decision in *Dental Corporation Pty Ltd v Moffet* was covered in part 1 of this article, and we still await the appeal from the Full Federal Court decision in *Jamsek v ZG Operations Australia Pty Ltd*[10] on this point. Note that this point from *Jamsek* was referred by the High Court to the Full Federal Court for hearing, with the ATO to be joined as a stakeholder. The primary judge of the Federal Court had previously rejected this point, and the Full Federal Court concluded the truck drivers were employees so did not deal with this (s 12(3)) point.

Conclusion

Many arrangements where a person/service provider are being treated as a contractor give rise to serious questions about the true nature of the relationship, and whether the purported contractor status would withstand scrutiny by the revenue authorities or against a potential employee entitlement claim.

In many ways, it is unfortunate that there is so much complexity and uncertainty relating to a distinction which has such economic importance, particularly in relation to the compliance burdens and risks that this imposes on small to medium enterprises, which are the major employers in Australia.

Indeed, the risks and penalties, including reputational damage, in getting this (employee versus contractor) distinction wrong are substantial and can readily result in some businesses going under. Thus, we consider that a greater focus on getting this right is well-justified.

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1 D Butler and B Figot, "Employee or contractor — PAYG and SG: part 1", (2022) 57(1) *Taxation in Australia* 46.

2 [2022] HCA 1.

3 [2022] HCA 1 at [61].

4 [2022] HCA 2.

5 [2021] HCA 23.

6 [1986] HCA 1.

7 [2001] HCA 44.

8 [2011] FCA 366.

9 [2020] FCAFC 118.

10 [2020] FCAFC 119.

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Alternative Assets Insights

by Jeff Pfaff, ATI, and Irene Kinkade, PwC

Landcom case: GST implications

The *Landcom* case may present an opportunity to revisit the GST implications of certain property transactions in respect of the application of the margin scheme.

Introduction

The Federal Court of Australia decided in favour of the taxpayer on all GST matters in *Landcom v FCT*[1] on 9 May 2022, clarifying that:

- the jurisdiction of the court is able to rule on matters of notional tax for certain government bodies; and
- amalgamated land sold under a single contract can be multiple supplies, which then individually need to be assessed for margin scheme eligibility and to determine the GST payable per supply.

These findings overturn the previous ATO administration of the application of the margin scheme to property transactions, giving rise to an opportunity to revisit the GST implications of certain property transactions.

Key facts

The taxpayer was a state-owned corporation that purchased, sold and developed real property. It owned a number of lots, each with a separate certificate of title, that it intended to sell as a single piece of land to a developer to build residential premises, effectively creating a new suburb. The lots were grouped together for the purpose of preparing two contracts of sale, with 12 lots being the subject of contract B1 and four lots (lots L, M, N and P) the subject of contract B2. These lots had all been held by the state of New South Wales since before 1 July 2000. The lots were previously owned by the NSW Land and Housing Corporation (LAHC) and were transferred from LAHC to the taxpayer on 1 January 2002.

The taxpayer subsequently applied for a private ruling from the Commissioner of Taxation about the operation of a specific margin scheme provision in the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GSTA99) in relation to the transfer of the lots. The margin scheme provision, namely, item 4 of s 75-10(3) GSTA99, that they were requesting a private ruling on applies to the Commonwealth, a state or a territory for property held since before 1 July 2000 where there have been no improvements on the land in question as at 1 July 2000, and has the effect of reducing the GST payable under the margin scheme to nil for eligible property. In particular, the taxpayer was concerned about whether, for the purposes of Div 75 GSTA99, there was one supply of all lots the subject of contract B2 or single supplies of each of lots L, M, N and P.

After receiving an unfavourable ruling, namely, that the sale of the freehold interests in lots L, M, N and P pursuant to contract B2 would be a single supply, and having its objection to the ruling disallowed, the taxpayer lodged an appeal against the objection decision.

At dispute were the following two key matters:

1. whether the Federal Court has jurisdiction to rule on the matter of notional tax; and
2. whether amalgamated land sold in a single contract should, for margin scheme purposes, be viewed as a single or separate supplies and the implication for calculating GST on the margin.

Further details on these matters are set out below.

The case is still within the period for potential appeal by the ATO. However, regard should be had as to whether the timing of objecting to previously issued ATO private rulings related to these matters may lapse for particular circumstances before an appeal is heard.

Whether Federal Court has jurisdiction to rule on the issue of notional tax

According to the Constitution of Australia, the Commonwealth is prohibited from imposing "any tax on property of any kind belonging to a State". However, through a series of elective agreements, state-owned enterprises voluntarily opt to report notional GST amounts. On this basis, the Commissioner contended that the Federal Court had no jurisdiction to entertain the appeal as there was no "matter" that could be the subject of the court's jurisdiction.

The Commissioner further contended that he was not authorised to issue the private ruling or make the objection decision, and that these had been done as a "courtesy" to provide guidance to the taxpayer. The Commissioner described the document issued to the taxpayer in response to its application for a private ruling as a "purported" private ruling.

The Federal Court found in favour of the taxpayer that the court does have jurisdiction to rule on this matter due to the following three circumstances:

1. the item 4 provision for calculating the margin on the sale of the land titles expressly applied to the taxpayer;
2. the taxpayer had a right under the *Taxation Administration Act 1953* (Cth) to seek a ruling about how

a provision of the GSTA99 applied to it or would apply if it took identified steps; and

3. the taxpayer was "dissatisfied" with the private ruling given by the ATO.

Further, the court found that the voluntary inclusion by the taxpayer of notional GST in a GST return resulted in an assessment that gave rise to a debt to the Commonwealth, which was enforceable by the Commissioner. The taxpayer had a real interest in knowing how much notional GST to include, voluntarily, in its GST return.

Importantly, this finding contradicts the ATO guidance released on dispute resolution for notional GST matters of government entities released on 21 April 2022.[2] Taxpayers should revisit the GST outcomes of private rulings applied for on notional tax matters historically, and consider their objection rights, depending on time limits.

Margin scheme considerations for amalgamated land

Broadly, the margin scheme is a concession in the GST law which allows suppliers of certain sales of real property to remit GST of 1/11th of the value added since 1 July 2000. This is subject to a number of provisions which impact this calculation of the margin on which GST is paid, including item 4 of s 75-10(3) GSTA99 which has specific application to government entities. As set out above, this should apply to the Commonwealth, a state or a territory for property held since before 1 July 2000 where there have been no improvements on the land in question as at 1 July 2000, and has the effect of reducing the GST payable under the margin scheme to nil for eligible property.

By a put and call option agreement dated 5 November 2015 (as amended), the taxpayer granted an option to the purchaser, and the purchaser granted the taxpayer an option to require the purchaser, to purchase the lots comprising property B1 on the terms of contract B1, and to purchase the lots comprising property B2 on the terms of contract B2. The contract of sale provided that the parties agreed that the "margin scheme" would be applied to work out the GST payable on any taxable supply of property under the contract.

In particular, the taxpayer was concerned about whether, for the application of the margin scheme, there was one supply of all lots the subject of contract B2 or single supplies of each of lots L, M, N and P. For margin scheme purposes, if there was an improvement on any of the lots, the concession for determining the margin in item 4 would not apply to the entire sale if it were viewed as a single supply. After receiving an unfavourable ruling, namely, that the sale of the freehold interests in lots L, M, N and P pursuant to contract B2 would be a single supply, and having its objection to the ruling disallowed, the taxpayer lodged an appeal against the objection decision.

The Commissioner submitted that the "supply" made by the taxpayer was the sale of all four lots, namely, the entirety of the freehold interests making up what was referred to as property B2. In the Commissioner's view, the "substance and commercial reality" was that the four lots were to be sold in a single transaction with an indivisible purchase price to one purchaser, as a development site for a new suburb.

In relation to the application of the margin scheme to its proposed sale of land, the taxpayer submitted that, even if it was possible for a supply of multiple freehold interests to be a single supply under the basic GST rules, the margin scheme provisions in the special rules treated separately each supply made by selling a "freehold interest in land". It did not matter to the operation of the special rules that the supply of the particular freehold interest to which the provisions were directed might be part of a larger supply for the purpose of the basic rules.

The court found that the margin scheme provisions do not require a consideration of the identification of the "supply" under the basic rules. The policy and context of the margin scheme was different from the context of the general provisions contained in the "basic rules". The focus of the margin scheme, in so far as it applied to selling freehold interests in land, was on the sale of individual interests in land. According to the court, the better construction was that the margin scheme provisions looked to where there had been a supply by selling a particular freehold interest in land and the supplier and recipient had agreed that the margin scheme was to apply. Where that had occurred, the margin was calculated by reference to the particular freehold interest that was sold. It applied whether or not that particular supply, made by selling a freehold interest in land, was part of a larger supply.

The court ruling has broader considerations for the application of the margin scheme in the form of:

- eligibility to apply the margin scheme should be considered on a per supply basis, which may have the consequence that some supplies qualify as opposed to the whole sale of land being subject to GST at the full rate of 10%; and
- the calculation of the margin scheme should be considered on a per supply basis with the various provisions to determine that margin applying based on the factors of that land title, such as whether the land is improved, how it was acquired etc.

The takeaway

Revisit recent similar matters where an adverse private ruling has been given

Consider your objection rights and/or revisiting previous private rulings on notional tax and item 4 margin schemes to assess whether this case overturned that ruling and the subsequent GST outcomes.

Consider the approach taken on the valuation of amalgamated land for margin scheme calculations

Regard should be had to the valuation methodology adopted for amalgamated land to determine the margin on which GST is payable.

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1 [2022] FCA 510.

2 Australian Taxation Office, *Notional GST dispute resolution for government entities*, 21 April 2022. Available at www.ato.gov.au/Business/Government-entities/In-detail/Notional-GST-dispute-resolution-for-government-entities/.

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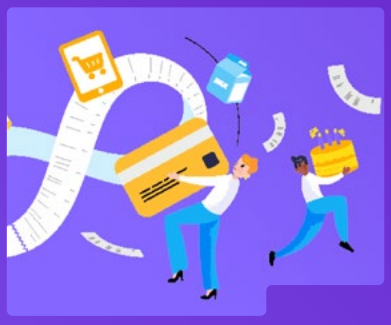

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12 CPD hours

SEPTEMBER
1–2
Thu–Fri

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Taxation *in* Australia ISSN 0494-8343

Publishing House
The Tax Institute
ABN 45 008 392 372

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22-016RES_07/22