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The Tax Institute

Taxation *in* Australia

M&A: the public/private company dichotomy
Clint Harding, CTA, and Danielle Ou, ATI

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

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

Insights from the Institute

Regular columns

Tax News – at a glance

by TaxCounsel Pty Ltd

October – what happened in tax?

The following points highlight important federal tax developments that occurred during October 2022. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 248 (at the item number indicated).

FBT record-keeping: draft amendments

The Treasury has released exposure draft legislation which is intended to reduce compliance costs for employers finalising their FBT returns by empowering the Commissioner to allow them, where it is appropriate to do so, to rely on adequate alternative records instead of obtaining statutory evidentiary documents, such as prescribed employee declarations. **See item 1.**

Franked distributions and capital raising

Exposure draft legislation has also been released that would give effect to the previous government's announcement in the *2016–17 mid-year economic and fiscal outlook* that an integrity measure would be introduced to prevent the distribution of franking credits where a distribution to shareholders is funded by particular capital-raising activities. **See item 2.**

International corporate tax reforms: consultations

On 4 October 2022, in a joint media release with the Assistant Minister for Competition, Charities and Treasury, the Treasurer announced that the government had opened consultations on international corporate tax reforms as part of its commitment to ensuring that multinationals pay their fair share of tax. **See item 3.**

Games and sports exemption

The Commissioner has released a final ruling in relation to the exemption from income tax provided for a society, association or club established for the encouragement of a game or sport (TR 2022/2). **See item 4.**

Use of an individual's fame

The Commissioner has released a draft determination that deals with the ordinary income implications of arrangements where an individual with fame establishes a related entity (for example, a family trust or company), the individual enters into an agreement with the related entity for the use of their name, image, likeness, identity, reputation and signature, and the related entity then agrees with other entities for their authorised use of the individual's fame in return for a fee (TD 2022/D3). **See item 5.**

Non-commercial losses safe harbour

A final practical compliance guideline released by the Commissioner outlines a safe harbour that allows an individual taxpayer with a non-commercial business loss for an income year that would otherwise have to be carried forward, to manage their tax affairs as if the Commissioner had exercised the discretion to allow the loss to be deducted in the income year (PCG 2022/1). **See item 6.**

Residency tests: individuals

The Commissioner has issued a draft ruling that outlines the residency tests for individuals for tax purposes as set out in s 6(1) of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) and his view on when the ATO will consider a person to be a resident of Australia (TR 2022/D2). **See item 7.**

Reimbursement agreement: assessment upheld

The Federal Court (Thawley J) has held that an agreement to carry out various steps, including a buy-back of shares, constituted an agreement that fell within the reimbursement agreement provisions in s 100A ITAA36 (*BBlood Enterprises Pty Ltd v FCT* [2022] FCA 1112). **See item 8.**

GST input tax credits lost

The AAT has held that a partnership was not entitled to GST input tax credits because more than four years had elapsed after the day on which the relevant BAS was required to be given to the Commissioner (*JHKW and FCT* [2022] AATA 2875). **See item 9.**

Deductions against rental income

The AAT has held that the deductions (primarily interest) allowable to a taxpayer in respect of a dwelling which she owned and let to a Mr Daouk (who she had married after his coming to Australia but with whom the taxpayer lived off and on because of marital difficulties) were limited to the rental income received by the taxpayer (*Rizkallah and FCT* [2022] AATA 3081). **See item 10.**

Repairs or improvements

In a recent decision, the AAT has considered the issue of whether certain works carried out by a taxpayer in relation to a rental property were repairs or capital improvements (*Wulf and FCT* [2022] AATA 3094).

President's Report

by Jerome Tse, CTA

Big ticket moments to round out 2022

Between The Tax Summit and the Federal Budget, we've ticked off some major milestones as the end of 2022 approaches, writes President Jerome Tse.

As we head toward the end of the year, we've wrapped up a couple of major milestones in the tax professional's calendar – The Tax Summit and the updated Federal Budget announcement. While these are two very different experiences, both are focused on supporting our members to increase their knowledge and grow their careers.

A successful Tax Summit experience

As you know, we held our biggest event of the year, The Tax Summit, at the end of last month, at the ICC, Sydney. An event of this magnitude requires many months of effort from our volunteer organising committee, from our speakers, and from our staff. Now that the event is over and the dust has settled, I can safely say it was well worth it.

The Tax Summit program is the most comprehensive look at the tax landscape of any event we hold. Over three days, we canvassed issues from across the tax space, and had the opportunity to engage with members and practitioners on what matters most to them. This is invaluable for us, as we seek to always support you in better and more targeted ways.

There were too many wonderful speakers to name them all here, covering topics ranging from superannuation to trusts to technology. We were joined by past Institute President and driving force behind our *Case for Change* paper, Andrew Mills, CTA (Life), for his reflections on the late Justice Graham Hill and on tax reform. Malcolm Turnbull AC delivered an insightful analysis of our current economic climate, and ATO Second Commissioner Jeremy Hirschhorn gave us a window into the ATO's 2024 vision and the future of tax administration. Karen Payne, CTA, Inspector-General of Taxation and Taxation Ombudsman, was, as always, insightful on the role and investigations of her office.

Seeing our community, including practitioners from all walks of life and lived experience, come together once more was a very special experience. I saw many of you aboard *The Jackson* superyacht and at the gala dinner, and being able to catch up in person and make new connections was certainly a treat. My congratulations to the finalists and winners of our Tax Adviser of the Year Awards, a group of outstanding tax professionals who we are proud to count as members.

Next year, The Tax Summit will be held from 5 to 7 September in Melbourne. I look forward to seeing you there.

Takeaways from the Federal Budget

The other big news recently was the updated Federal Budget from the Labor Government, which brought with it news on a handful of announced but unenacted tax measures. Our Tax Policy and Advocacy team produced a fantastic analysis report unpacking key measures, and our free member webinar further unpacked those measures with a major impact for you and your clients.

The Tax Counsel's Report in this issue of the journal further details key points from the Federal Budget, but some notable measures include increased funding for various compliance programs, proposed changes to the off-market share buy-back rules for listed companies, and new reporting requirements for multinationals with the aim of improving tax transparency.

A number of significant measures, like reform to the NALI provisions, amendments to the residency rules (for individuals and corporates) and reforms to Div 7A, were notably omitted from the Budget announcements. Their fate, along with many other announced but unenacted measures, continues to hang in the balance and the uncertainty for taxpayers and tax practitioners remains.

As always, we remain prepared to support you through any changes arising, and we remain committed to advocating for a better tax system for all.

CEO's Report

by Giles Hurst

The Tax Summit 2022: monumental and magnificent

CEO Giles Hurst reflects on the success of The Tax Summit in October.

It has now been three weeks since The Tax Summit at the ICC, Sydney, but I hope you'll indulge me a little longer as I reflect on the experience in this month's report.

Any event that the Institute puts on is crafted with care and requires much effort and dedication from those involved. The Tax Summit, as President Jerome Tse has said, is our biggest event of the year, and requires hard work, passion and dedication in spades to achieve the high standards we set ourselves. This year, I think we have yet again proven that when the tax profession gets together, wonderful things happen.

It was a busy and rewarding three days of expert speakers, insights and networking that I was very glad to be a part of. In particular, I was impressed by the calibre of technical insight presented by our excellent speakers. It's no small thing to present your research, analysis and ideas in a forum of this size – it requires much planning and hard work, and that's without mentioning the prospect of public speaking (nerve-wracking for many of us!). My thanks go out to all of the speakers who contributed their expertise to make the event what it was.

Thanks also to the organising committee who volunteered countless hours to ensure that everything went smoothly and that we were able to hold a world-class event.

Another notable aspect of the Summit experience was the networking events and opportunities. The welcome reception aboard *The Jackson* superyacht really set the tone of excitement for the rest of the event. And on Thursday night, the gala dinner was a high point in the program, not only for the chance to dust off our tuxes and dancing shoes, but also for the chance to recognise our Tax Adviser of the Year Award finalists and winners. I would like to echo Jerome in congratulating the winners of our Tax Adviser of the Year Awards, who represented the true spirit of the tax profession – commitment, diligence and enthusiasm.

For everyone who came along to The Tax Summit, I trust you found the experience worthwhile and picked up some practical tips and insights to take back to your everyday practice. We design programs – especially those as extensive as that of The Tax Summit – with the goal of ensuring that everyone who attends walks away having gained valuable knowledge.

Thank you for the energy and enthusiasm you brought to the event. I was very glad to be able to connect with you all in person once more, and it really does make all the difference to have people engaged and excited. You make the Tax Summit what it is.

Next year, we'll be holding The Tax Summit in Melbourne from 5 to 7 September. It's exciting to be bringing this iconic event to a new city. I look forward to seeing you there.

Federal Budget

In other recent news, the Labor Government has announced its updated Federal Budget for 2022–23. Our team was on the ground that night, working to prepare a report analysing key measures of interest to our members. We do this for each Budget announcement, so you have access to timely and trusted analysis as soon as possible.

I hope the report has been a useful resource and that you reach out to our team if you should need any further support in tackling changing policy in the wake of the Federal Budget announcement.

Our free member webinar analysing outcomes from the Federal Budget announcement is always popular, and this time was no different. Our Tax Policy and Advocacy experts bring decades of expertise from different areas of the tax space and it is a pleasure to see them do what they do best.

Tax Adviser of the Year Awards

Congratulations to the 2022 winners!

The Tax Institute is thrilled to announce the winners of the **2022 Tax Adviser of the Year Awards.**

CHARTERED TAX ADVISER OF THE YEAR

Kenneth Woo, CTA

PwC

EMERGING TAX STAR OF THE YEAR

Mark Peters, ATI

Herbert Smith Freehills

INHOUSE TAX ADVISER OF THE YEAR

Chris Merjane, FTI

ResMed

TAX ADVISER OF THE YEAR – ACCOUNTANT

Stephen Holmes, CTA

WMS Chartered Accountants

TAX ADVISER OF THE YEAR – LAWYER

David Earl, FTI

PwC

COMMUNITY CHAMPION

Sandra Farhat, FTI

EY

The Tax Institute

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Tax Counsel's Report

by Julie Abdalla, FTI

Updated Federal Budget 2022–23

In this month's column, we consider the themes of the updated Federal Budget 2022–23 and what the Budget means for our tax system and tax reform.

What the Budget announced

The government has been upfront about its objectives and, as expected, the updated Federal Budget 2022–23 (the Budget) did not deviate from previous Labor announcements and was a restatement of several.

Among other things, the Budget was directed at:

- easing cost-of-living pressures by expanding accessibility and increasing the number of weeks covered by the Paid Parental Leave scheme; increasing the maximum Child Care Subsidy rate; expanding eligibility for downsizer contributions; and encouraging pensioners to downsize by reducing the financial impact;
- addressing Labor's federal election commitments with regard to multinational tax integrity and tax transparency through measures which: amend Australia's interest limitation (thin capitalisation) rules; deny deductions for payments relating to intangibles held in low- or no-tax jurisdictions; and introduce tax transparency reporting for certain taxpayers. These measures are proposed to apply from income years commencing 1 July 2023 onwards; and
- increasing funding to the ATO through the targeted funding of programs linked to underlying revenue collections. Although we welcome additional funding for the ATO, it is concerning that the funding is caveated by significant restrictions in respect of its timing and use. It is unfortunate that further announcements were not proposed to address the under-resourced areas, many of which support the provision of minimum service and support standards, such as those areas which develop interpretive guidance and resolve disputes.

What the Budget was silent on

It was pleasing to see the Budget provide certainty on the non-assessable non-exempt tax treatment for certain state and territory COVID-19 relief payments made prior to 30 June 2022. The government also specifically addressed eight announced but unenacted measures (ABUMs) that it will not proceed with which can be found in our Updated Federal Budget 2022–23 Report.

Although the Budget took small steps towards addressing the steadily growing list of ABUMS, it was disappointingly silent on several significant measures which The Tax Institute considers are of highest priority. These include:

- non-arm's length income (NALI) provisions for superannuation funds: the former government announced its intention to make legislative amendments to ensure that individuals do not face significant reductions in their superannuation balances arising from low-risk activities that enliven the NALI provisions. The government has remained silent on whether it will implement the former government's announcement;
- corporate tax residency: the Board of Taxation (the Board) recommended technical amendments to the law to ensure that companies incorporated offshore would be treated as Australian residents for tax purposes if they have a "significant economic connection" to Australia. The former government announced that it would adopt this recommendation. Reform of the individual tax residency rules also remains uncertain; and
- Div 7A reform: the previous government proposed changes to the Div 7A rules to improve their integrity and operation based on recommendations made by the Board. Taxpayers would benefit from certainty over these measures and the tax profession would welcome further detailed consultation prior to the enactment of legislation.

The need for tax reform

There is still an overwhelming list of ABUMs that remain unaddressed. Further, there has been no sign that the government has considered any kind of mechanism to ensure that the list itself does not continue to grow out of hand.

However, of greatest concern was the lack of recognition and a holistic approach to address the growing amount of government debt. It is economically and socially irresponsible for the government to simply tinker at the edges of the system and hope that Australia's existing tax regime will be able to fund this debt without major reform.

Some may argue that now may not be the ideal time to examine holistic tax reform. However, we consider that it is an opportunity for this government to leave a legacy as one which challenged the status quo and delivered sustainable solutions for the benefit of all Australians and future generations. This government must acknowledge that, for Australia's tax system to support the recovery, and further growth, of our economy, holistic tax reform is crucial.

We encourage you to read our *Case for Change* discussion paper and *Incoming Government Brief*, and we welcome your thoughts.

Tax News – the details

by TaxCounsel Pty Ltd

October – what happened in tax?

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

Government initiatives

1. FBT record-keeping: draft amendments

The Treasury has released exposure draft legislation which is intended to reduce compliance costs for employers finalising their FBT returns by empowering the Commissioner to allow them, where it is appropriate to do so, to rely on adequate alternative records instead of obtaining statutory evidentiary documents, such as prescribed employee declarations.

The proposed amendments (which will give effect to a 2020–21 Budget announcement) will reduce and simplify FBT record-keeping requirements for employers while producing similar compliance outcomes with lower compliance costs, consistent with the government's commitment to remove "red tape" for business.

More particularly, the proposed amendments would:

- give the Commissioner power to make legislative instruments determining, for FBT record-keeping purposes, the kinds of adequate alternative records which may be kept and retained by employers in lieu of statutory evidentiary documents for specified fringe benefits; and
- provide that employers are taken to have kept and retained a statutory evidentiary document for a specified fringe benefit for FBT record-keeping purposes if they keep and retain those adequate alternative records determined by the Commissioner for the specified fringe benefit.

Exposure draft legislative instruments (and associated explanatory material) dealing with travel diaries and relocation transport expense payments have also been released.

2. Franked distributions and capital raising

Exposure draft legislation has also been released that would give effect to the previous government's announcement in the *2016–17 mid-year economic and fiscal outlook* that an integrity measure would be introduced to prevent the distribution of franking credits where a distribution to shareholders is funded by particular capital-raising activities.

The list in s 202-45 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) of distributions that are unfrankable is to be amended to include distributions funded by a capital raising. For this purpose, a distribution by an entity will be taken to be funded by a capital raising if, broadly:

- the distribution is not consistent with an established practice of the entity of making distributions of that kind on a regular basis;
- there has been an issue of equity interests in the entity or another entity; and
- it is reasonable to conclude in the circumstances that either:
  - the principal effect of the issue of any of the equity interests was to directly or indirectly fund some or all of the distribution; or
  - any entity that issued or facilitated the issue of any of the equity interests did so for a purpose (other than an incidental purpose) of funding the distribution or part of the distribution.

In line with the announcement in the *2016–17 mid-year economic and fiscal outlook*, the amendments are to apply retrospectively to distributions made on or after 12 pm, by legal time in the Australian Capital Territory, on 19 December 2016.

In addition to the existing period of review, the Commissioner will be able to amend assessments made before the commencement of these amendments within 12 months after the amendments have commenced to give effect to the amendments but only for distributions made on or after 12 pm, by legal time in the Australian Capital Territory, on 19 December 2016.

3. International corporate tax reforms: consultations

On 4 October 2022, in a joint media release with the Assistant Minister for Competition, Charities and Treasury, the Treasurer announced that the government had opened consultations on international corporate tax reforms as part of its commitment to ensuring that multinationals pay their fair share of tax.

It is pointed out in the media release that, during the election campaign, the government had announced its support for the OECD/G20 two-pillar solution on reforms that included a global minimum corporate tax rate of 15%.

Australia was one of 130 countries that endorsed the solution to address tax challenges arising from digitalisation and globalisation. This historic global effort will help to ensure that multinationals pay their fair share of tax, to stop the "race to the bottom" on corporate tax rates, and to support the domestic and global economy.

As a next step, the Treasury has released a consultation paper, *Global agreement on corporate taxation: addressing the tax challenges arising from the digitalisation of the economy*.

The paper is seeking views on how the proposed global corporate tax solution would operate in Australia, and how Australian stakeholders view the benefits, challenges and impacts.

The Treasurer said that Australia's ongoing engagement in the OECD-led multilateral process complements the government's multinational tax integrity package that will address tax loopholes exploited by multinational companies.

The Commissioner's perspective

4. Games and sports exemption

The Commissioner has released a final ruling in relation to the exemption from income tax provided for a society, association or club established for the encouragement of a game or sport (TR 2022/2).

The exemption is provided by item 9.1(c) of the table in s 50-45 ITAA97 and is referred to in TR 2022/2 as the "games and sports exemption". Some points of interest in the ruling are noted below. The ruling uses the word "club" to cover the expression a society, association or club.

A club qualifies for the games and sports exemption where it:

- is established for the main purpose of the encouragement of a game or sport;
- is not carried on for the purposes of its individual members' profit or gain; and
- meets other special conditions under s 50-70 ITAA97.

Society, association or club

The phrase "society, association or club" refers to a voluntary organisation of people associated together for a common or shared purpose. This description is consistent with the *Macquarie Dictionary* definition of each word. A society, association or club may be constituted as an unincorporated association or be formally recognised by incorporation.

Not-for-profit

To qualify for the games and sports exemption, a club must be not-for-profit. The club must not be carried on for the purpose of individual members' profit or gain, either while the club is operating or on its winding-up.

Club members may receive communal membership benefits, such as the use of the facilities that are incidental to the club's objects. This will not prevent the club meeting the not-for-profit requirement. The club may also pay members reasonable remuneration for services that they perform for the club.

Clubs can use various mechanisms to ensure that they meet the not-for-profit requirement. "Not-for-profit" clauses in governing documents are the most common way. These prevent the distribution of profits or assets for the benefit of particular persons while the club is operating and on its winding-up.

Game or sport

"Game" and "sport" are not defined terms and take their ordinary meaning, shaped by the statutory context in which they appear. Some activities are obviously games or sports, for example, netball or football. For other activities, characterisation as a game or sport can be demonstrated by evidence of a competitive element and by participants' compliance with the conventions and rules of the activity.

The meanings of "game" or "sport" also extend to:

- non-athletic activities, such as chess or bridge;
- activities where people use machines to participate, such as motor racing; and
- non-competitive activities, such as mountaineering.

A common feature of a game or sport is a set of conventions, expectations and rules. This contributes to the element of organisation that is commonly indicative of a game or sport. While written or defined rules are not essential, the imposition of such rules and conventions in an organised group of participants can convert an otherwise ordinary leisure activity into a game or sport (for example, hunting, fishing and walking).

While competition is a very common feature of a game or sport, it is not essential or determinative. The presence of competition can be an important indicator where the activity is not obviously a game or sport.

To qualify as a game or sport, participants must share a common understanding that the activities they perform are the activities of a particular game or sport.

Games and sports can be contrasted with activities where a thing, object or animal is the essential focus, or where the activities are merely a means to some other end.

Activities such as stamp and coin collecting, body building and train modelling are not games or sports. The activities that give rise to the desired results lack the features of competitions or rules and are not games or sports by their nature. Similarly, keeping guinea pigs or fish is not a game or sport. The activities of participants in car owner clubs are not participation in sports for similar reasons. Those participants' focus is on their common interest in a type or make of motor vehicle and not on any sport or game-like activity.

Activities that could appear to be a game or sport may be merely a means to other ends. Where the activities are not organised in a sport or game-like way, and some other purpose is predominant, the activity will not be a game or sport. For example, dancing can be organised in a game or sport-like way but it is often a means of promoting sociability, participation and relaxation. In such cases, it does not constitute a game or sport.

The fact that a game or sport is undertaken by club members or within a club does not mean that the club is established for the encouragement of that game or sport. The activity must also be considered in the context of determining the club's main purpose. For example, a fishing competition can be a sport. However, a fishing competition conducted by a club may be a minor activity that is incidental to its main purpose, such as promoting sociability, communal activities or some other purpose.

TR 2022/2 gives examples of activities that would be considered games or sports and examples of activities that would not be considered games or sports.

5. Use of an individual's fame

The Commissioner has released a draft determination that deals with the ordinary income implications of arrangements where an individual with fame establishes a related entity (for example, a family trust or company), the individual enters into an agreement with the related entity for the use of their name, image, likeness, identity, reputation and signature, and the related entity then agrees with other entities for their authorised use of the individual's fame in return for a fee ("fame") (TD 2022/D3).

TD 2022/D3 is only concerned with income from the use of the individual's fame. It does not apply to income from the provision of services (such as where the individual is engaged by a related entity to provide services to a third party), nor does it apply to fees earned by a related entity from exploiting copyright, trademark or registered design rights licensed to the related entity.

In Australian law, an individual with fame has no property in that fame and therefore cannot vest or transfer any property in their fame to another entity. Exploitation of an individual's fame can be done by way of agreement for a fee. Where a related entity is a party to such an agreement, it is incapable of authorising the use of the individual's fame by other entities as the agreement does not vest any property in the related entity. The fees paid for use of the individual's fame will be ordinary income of the individual (and assessable to them under s 6-5 ITAA97).

The common law of Australia does not recognise as a proprietary right an individual's ability to exploit their fame separately from an accompanying business. Consequently, there is no recognised proprietary right (common law or otherwise) in an individual's fame that is capable of transfer or assignment.

While an individual does not have a recognised proprietary right in their fame, they may have a limited cause of action if their fame is used in a manner which misleads the public, or a significant portion of the public, into thinking that some form of association or endorsement exists between the individual and the product or services of another.

Under an action for "passing off", the relevant property that is protected is the goodwill of the individual's business that would likely be injured due to improper use. Goodwill cannot be dealt with or assigned independently of that individual's business.

An individual with fame can exploit that fame by authorising others to use their fame for a fee. However, such an agreement would not vest any property in the individual's fame in the other entity. As a result, the related entity is not in a position to exploit the image of the individual with fame. The agreement between the related entity and the individual would merely authorise that which would otherwise be actionable. As a result, the other entity cannot derive income attributed to the use of the individual's fame. Accordingly, the income derived under the purported sub-licensing of those rights to a third party is the ordinary income of the individual. The related entity is receiving an amount that is being applied or dealt with on the individual's behalf.

This can be distinguished from a circumstance where a related entity engages the individual with fame to provide services. For example, the individual with fame may be engaged by the related entity to attend product launches and promotional events for a third party. In these circumstances, contractual payments by the third party to the related entity can be assessable to the related entity under s 6-5 ITAA97. However, consideration would also need to be given in these circumstances to the potential application of the personal services income rules (Pt 2-42 ITAA97) or the application of the general anti-avoidance provisions (Pt IVA of the *Income Tax Assessment Act 1936* (Cth) (ITAA36)).

Example

A family trust is established by a media personality. The trustee of the family trust enters into a deed with the individual which grants a right to use and exploit the fame of the individual throughout Australia. The trustee contracts with a business for the use of the media personality's photo and name on the packaging of their product for a fee. Payment by the business is made to the trustee. However, the income from this use of the individual's fame is ordinary income of the individual. This is because, while the trustee has a right to use that fame, the deed does not provide any property to the trustee which could allow a third party to use it for a fee. Therefore, the individual should include that fee amount in their assessable income in the relevant income year.

When the final determination is issued, it is proposed to apply to income years commencing both before and after its date of issue, subject to a transitional compliance approach. Where an arrangement is subject to the transitional compliance approach, it is proposed that the final determination will only apply to income derived from that arrangement in the 2023–24 income year and later income years.

The transitional compliance approach arises out of the fact that the Commissioner acknowledges that the views on alienation set out in TD 2022/D3 differ to the practical compliance approach in allowing limited alienation of income taken in PCG 2017/D11. The Commissioner also acknowledges that individuals may have entered into arrangements on the basis of PCG 2017/D11.

Under the transitional compliance approach, the Commissioner will not devote compliance resources to apply the views expressed in TD 2022/D3 to income derived before 1 July 2023 from arrangements entered into in good faith that are consistent with the principles outlined in PCG 2017/D11 where they were entered into before 5 October 2022 (the date of the release of TD 2022/D3).

This compliance approach is to apply both before and after the issue of TD 2022/D3 in respect of the 2018–19, 2019–20, 2020–21, 2021–22 and 2022–23 income years. However, where the Commissioner is asked to issue or amend assessments, or is asked or required to state a view (for example, in a private ruling or in submissions in a litigation matter), he will do so consistently with the views set out in TD 2022/D3. This includes circumstances where the Commissioner identifies a tax risk during the course of an unrelated review or audit activity.

6. Non-commercial losses safe harbour

A final practical compliance guideline released by the Commissioner outlines a safe harbour that allows an individual taxpayer with a non-commercial business loss for an income year that would otherwise have to be carried forward, to manage their tax affairs as if the Commissioner had exercised the discretion to allow the losses to be deducted in the income year (PCG 2022/1).

One of the circumstances (specified in s 35-55(1)(a) ITAA97) in which the Commissioner may exercise this discretion is where the business activity was or will be affected by special circumstances outside the control of the operators of the business activity, including drought, flood, bushfire or some other natural disaster. PCG 2022/1 points out that, in recent years, special circumstances such as flood, bushfire and COVID-19 impacts may have caused the non-commercial loss rules to apply to a taxpayer's business. If this happens, and a taxpayer does not meet one of the other requirements for the loss to be offset against their other income, the taxpayer would need apply to the Commissioner for him to exercise discretion to allow them to do so.

PCG 2022/1 outlines a safe harbour that, provided the relevant conditions are satisfied, will allow a taxpayer to manage their tax affairs as if the Commissioner had exercised the discretion in s 35-55(1)(a). It does not, however, apply to amounts deferred in previous income tax years under the non-commercial loss rules. Also, it does not prevent a taxpayer from applying for an exercise of the discretion in the usual way if their circumstances do not fall within the terms of the safe harbour.

For a taxpayer to qualify for the safe harbour, all of the criteria listed below must be met in an income year and the taxpayer must have made a tax profit from their business activity in the immediately preceding income year. The relevant criteria are:

- the taxpayer satisfied the income requirement in s 35-10(2E) ITAA97;
- the taxpayer made a loss from their business activity, excluding any amounts deferred from a previous income year under s 35-10(2)(b);
- the taxpayer's business activity was affected by one or more of the following events:
  - flood (including where ATO flood support was received);
  - bushfire (including where the taxpayer qualified for an ATO bushfire lodgment and payment deferral); or
  - a government-imposed lockdown, business closure and/or restriction due to COVID-19;
- the event meant that:
  - the taxpayer was not able to carry on their business activity, or unable to carry it on to the same scale as the taxpayer usually carried on their business activity; or
  - some or all of the taxpayer's customers were not able to access the business activity, or access it in the same way as they usually did; and
- the taxpayer has not applied for a private ruling requesting that the Commissioner exercise the "special circumstances" discretion in relation to their business activity in the relevant income year.

The taxpayer must have relevant evidence to support that they are eligible for the safe harbour.

PCG 2022/1 gives several examples, including the following:

> **Bushfire: eligible to use the safe harbour**
>
> Ismoth operates an established beekeeping business. At the commencement of the 2019–20 income year, the business maintained 100 hives that provided pollination services to agricultural enterprises and produced honey for sale. The business had generated small tax profits in recent years, including in the 2018–19 income year.
>
> In December 2019, the business activity was impacted by bushfire, resulting in a loss of approximately half the hives. In previous years, the average loss of hives was approximately 5% per year. Ismoth's other income remained stable and she met the income requirement in the 2019–20 income year. Ismoth's beekeeping business returned a loss in the 2019–20 income year.
>
> Ismoth maintains evidence of the loss of hives to demonstrate the impact of the bushfire on her business activity.
>
> In this case, Ismoth is eligible to use the safe harbour.
>
> **COVID-19: eligible to use the safe harbour for current year's loss only**
>
> Mary operates a food truck. Mary meets the income requirement in the 2019–20 income year.
>
> The business activity made a loss of $15,000 in the 2017–18 income year. Mary was not eligible to use the losses and they were deferred. The business generated a tax profit of $10,000 in the 2018–19 income year. Mary offset $10,000 of her carried forward losses against that income; however, the remaining $5,000 was deferred and carried forward.
>
> A government-imposed lockdown in response to COVID-19 meant that Mary could not operate her business from March to June 2020. In the 2019–20 income year, the business made a loss of $7,000. Mary maintains evidence of the lockdown's impact on her business.

In this case, Mary is eligible to use the safe harbour to offset the $7,000 loss from the 2019–20 income year against her other income but cannot use the safe harbour to offset the $5,000 loss previously deferred.

COVID-19: income requirement – not eligible to use the safe harbour

Virat operates a successful boutique clothing design and manufacture business, which supplies several independent retail stores across Australia. In recent income years, the business has made tax profits.

During a number of months in the 2020–21 income year, a series of government-imposed COVID-19 restrictions limited Virat's ability to manufacture and supply clothes to his customers. Virat's business activity made a loss in that year.

Virat's other taxable income and net investment losses were greater than the income requirement of $250,000.

In this case, while Virat's business activity was affected by special circumstances outside his control and the business made a loss, Virat is not eligible to apply the safe harbour because he did not meet the income requirement. However, Virat could apply to the Commissioner for the exercise of the discretion in the usual way.

7. Residency tests: individuals

The Commissioner has issued a draft ruling that outlines the residency tests for individuals for tax purposes as set out in s 6(1) ITAA36 and his view on when the ATO will consider a person to be a resident of Australia (TR 2022/D2).

TR 2022/D2 explains that the definition of "resident of Australia" has four alternative tests and that an individual will be a resident if they meet any one (or more) of the tests but a non-resident if they do not meet any of the tests.

TR 2022/D2 further explains that residency under the first three tests is determined by considering all of the individual's relevant facts and circumstances. No single fact determines the outcome and the significance of facts varies from case to case. Because of this, there are no "bright-line rules" or any single factor that can be said to be paramount.

The draft ruling also explains that:

- residency is about an individual's connection to Australia; and
- an individual can be a resident for tax purposes of more than one country at the same time.

TR 2022/D2 does not address or discuss in detail:

- the Commonwealth superannuation fund test (being the fourth residency test for individuals);
- dual residency;
- double tax agreements; or
- the residency of companies.

When finalised, TR 2022/D2 will consolidate and replace the material in IT 2650 and TR 98/17. It will also update the views reflected in those rulings to take into account developments in case law (including *Harding v FCT*,[1] *Pike v FCT*[2] and *Addy v FCT*.[3] IT 2650 and TR 98/17 have been withdrawn with effect from the date of issue of TR 2022/D2 (6 October 2022).

Recent case decisions

8. Reimbursement agreement: assessment upheld

The Federal Court (Thawley J) has held that an agreement to carry out various steps, including a buy-back of shares, constituted an agreement that fell within the reimbursement agreement provisions in s 100A ITAA36 (*BBlood Enterprises Pty Ltd v FCT*[4]).

During the 2014 income year, a company with retained earnings (IP Co) bought back shares held in it by the trustee (IP Trustee) of a discretionary trust (IP Trust). The proceeds of the buy-back (about $10m) paid by IP Co to IP Trustee were deemed by s 159GZZZP ITAA36 to be a dividend for tax purposes. However, the share buy-back dividend constituted corpus of the trust for trust purposes. The deemed dividend was fully franked.

Although it had never before received income, the IP Trust also received income in the 2014 income year of about $300,000. A newly introduced corporate beneficiary (BE Co) was made presently entitled to the trust income of $300,000. The consequence of BE Co being presently entitled to the trust income was that it was assessed on the trust's net income, which included the share buy-back dividend. The tax payable by BE Co in relation to the share buy-back dividend was wholly offset by the franking credits attached to the deemed dividend. The trustee was not liable to pay income tax because all of the trust income had been distributed.

For the 2013–14 income year, the Commissioner issued:

- to the IP Trustee: an assessment dated 11 August 2020, taxing the IP Trustee in respect of the relevant trust income on the basis that s 100A ITAA36 deemed the beneficiary not to be presently entitled to that income; and
- to BE Co: an amended assessment dated 15 August 2019, on the basis that s 207-150(1) ITAA97 disentitled BE Co from claiming a tax offset in respect of the franking credits because the deemed (share buy-back) dividend was made as part of a "dividend stripping operation" as defined in s 207-155 ITAA97.

Thawley J held that:

- the assessment dated 11 August 2020 issued to the IP Trustee was an original assessment. It was not excessive on the contended basis that it was an amended assessment issued outside of the limited amendment period;
- s 100A ITAA36 applied to deem BE Co not to be presently entitled to the trust income;
- the IP Trustee was taxable to the extent to which the Commissioner contended; and

- if s 100A ITAA36 did not apply, s 207-150 ITAA97 did apply, because the deemed dividend was part of a "dividend stripping operation" as defined by s 207-155 ITAA97.

It may be noted that, when the buy-back occurred, the relevant participants in the arrangements were clients of the accounting company, Fordham Business Advisers Pty Ltd. A further six private groups that were then clients of Fordham Business Advisers Pty Ltd implemented what were said to be similar arrangements in the 2013–14 income year. Proceedings relating to five of those groups were stayed, pending the outcome of the present proceedings.

The taxpayer has lodged an appeal to the Full Federal Court from the decision of Thawley J in the *BBlood Enterprises* case.

It may also be noted that the Commissioner's appeal from the decision of Logan J in *Guardian AIT Pty Ltd ATF Australian Investment Trust v FCT*,[5] which concerned the operation of s 100A ITAA36, has been heard by the Full Federal Court (but not yet decided).

9. GST input tax credits lost

The AAT has held that a partnership was not entitled to GST input tax credits because more than four years had elapsed after the day on which the relevant BAS was required to be given to the Commissioner (*JHKW and FCT*[6]).

The day on which a BAS is required to be given to the Commissioner is set out in the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GSTA99) or, alternatively, is a day otherwise allowed by the Commissioner (s 31-8 GSTA99).

The applicant (one of the partners) had lodged the partnership's BAS for the quarterly tax periods between 1 July 2012 and 31 March 2017 on 21 June 2021. Each BAS was lodged on a day that exceeded four years after the relevant BAS was required to be lodged. Based on the evidence before it, the AAT considered that the applicant was not provided with a further period in which to lodge the partnership's BAS by the Commissioner.

The AAT rejected the applicant's submissions that their keeping in contact with the Commissioner throughout the period in question meant that they had been granted continuous extensions to the period in which they were required to give the BAS in question to the Commissioner. There was no evidence before the AAT to suggest that such an extension of time was requested and the applicant's evidence was that they did not realise they had to make such a request.

The operation of s 93-5 GSTA99 meant that, if an extension of time to lodge a BAS has not been granted before the expiry of four years after the day on which it was required to be given to the Commissioner, the entitlement to input tax credits immediately ceased.

10. Deductions against rental income

The AAT has held that the deductions (primarily interest) allowable to the taxpayer in respect of a dwelling which she owned and let to a Mr Daouk (who she had married after his coming to Australia but with whom the taxpayer lived off and on because of marital difficulties) were limited to the rental received by the taxpayer (*Rizkallah and FCT*[7]).

The taxpayer reported rental income of $12,000 and $12,200 received from Mr Daouk in the relevant income years (the 2016 and 2017 income years) and claimed interest expenses in the relevant years of $11,900 and $13,600, respectively. The actual outgoings for the property for the two income years were $13,281 and $16,077.

The taxpayer's evidence was that she purchased the property with the intention of residing there which she did following the settlement of the purchase in September 2010. Following her marriage to Mr Daouk in August 2015, they lived together at the property. When they experienced marital problems, the taxpayer returned to live at her parents' house, and she rented the property to Mr Daouk. It was her intention to resume living with Mr Daouk once they had resolved their marital problems.

Based on the evidence before it, the AAT found that the losses and outgoings incurred by the taxpayer in excess of the rental income derived from the letting of the property were not "necessarily incurred in" gaining or producing assessable income. It was evident that the taxpayer rented the property to Mr Daouk so that he would have a place to live in close proximity to her which would facilitate their attempt to reconcile their relationship. The rent paid by Mr Daouk was sufficient to cover the taxpayer's mortgage repayments and was not intended to gain or produce assessable income. It followed that the losses and outgoings incurred by the taxpayer in excess of the rental income derived from letting the property were not "necessarily incurred in" gaining or producing assessable income and were not deductible under s 8-1 ITAA97.

In reaching this conclusion, the AAT said that it was very difficult to determine an appropriate apportionment of the losses and outgoings, and that the working rule suggested in IT 2167 (non-economic rental etc) should be applied. This allowed income tax deductions for losses and outgoings incurred in connection with the rental property to be allowed up to the amount of rental income that had been substantiated. The result of the application of this working rule was that there would be a net rental income of zero, which would result in no change to the current assessments as determined under the audit and objection decisions.

The AAT did, however, remit the administrative penalties which the Commissioner had imposed at 50% by 25%.

TaxCounsel Pty Ltd
ACN 117 651 420

References

1 [2019] FCAFC 29.

2 [2019] FCA 2185.

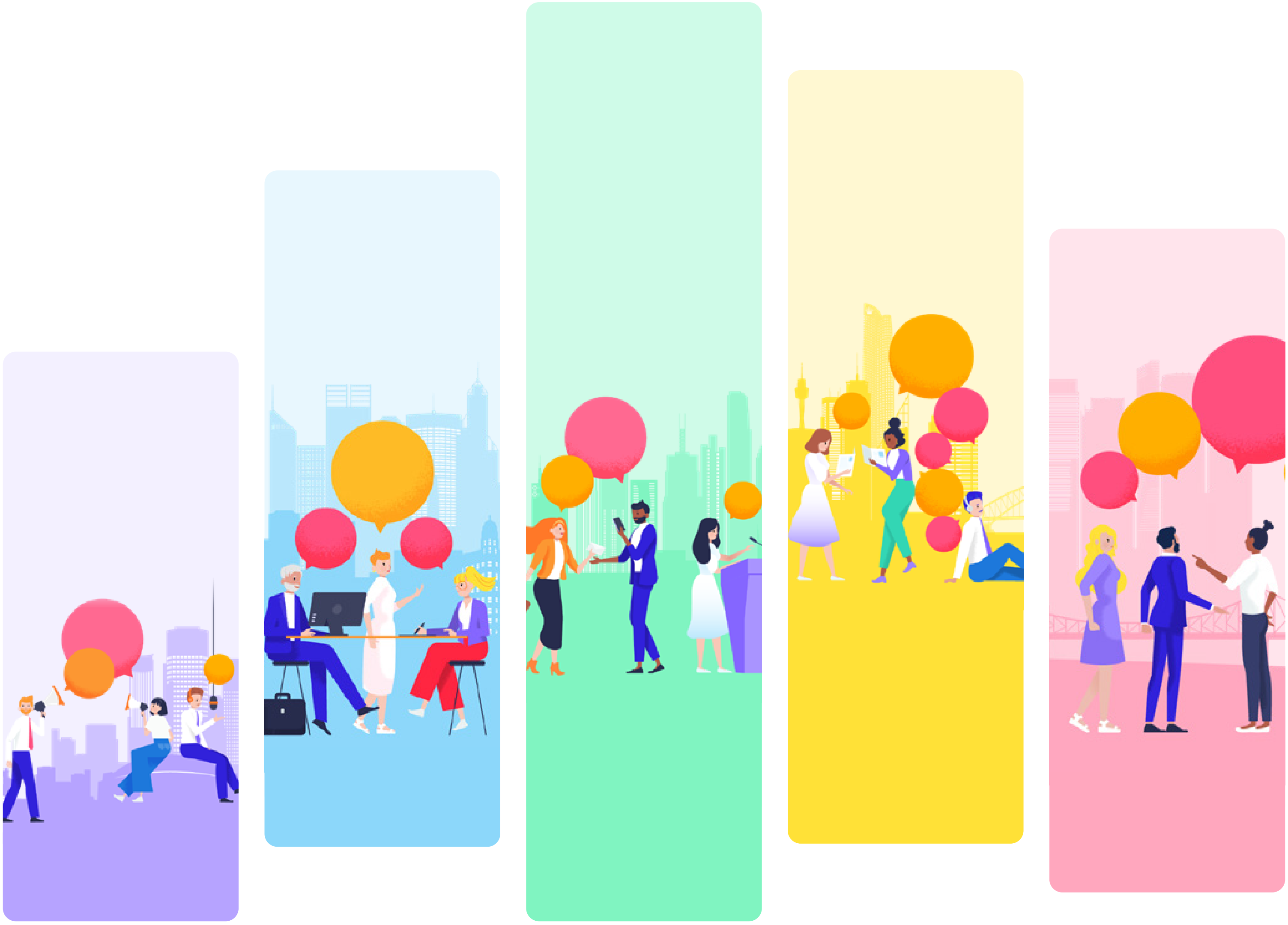
3 [2019] FCA 1768.

4 [2022] FCA 1112.

5 [2021] FCA 1619.

6 [2022] AATA 2875.

7 [2022] AATA 3081.



Tax Tips

by TaxCounsel Pty Ltd

Construction points

The recent decision of the Federal Court in the *BBlood Enterprises* case highlights several issues of interest relating to the construction of the taxation laws.

Background

The imposition of tax depends in each case on the terms of the relevant statutory provision or provisions.

There are many situations in which the meaning of a statutory provision is clear and the issue will be as to the way the provision applies in the particular circumstances. But not infrequently, an issue of statutory construction will arise and the cases abound with judicial observations as to how the construction issues that may arise are to be approached.

That construction difficulties arise is not at all surprising as the federal taxation laws have recently been described as being "oppressively complex".[1] In the context of the former CGT provisions in the *Income Tax Assessment Act 1936* (Cth) (ITAA36), Hill J in *FCT v Cooling*[2] said:

> "This brings us then to subsections (6) and (7) [of former s 160M ITAA36] upon which the Commissioner founded his submissions. While both subsections present difficulties of construction, the former is drafted with such obscurity that even those used to interpreting the utterances of the Delphic oracle might falter in seeking to elicit a sensible meaning from its terms."

But the fact that a provision may be expressed in apparently simple terms may belie the fact that there are inherent difficulties in the language used. This may be illustrated by the terms of the first limb of the former s 26(a) ITAA36 which simply provided that a taxpayer's assessable income included the profit arising from the sale of property acquired by the taxpayer for the purpose of profit-making for sale. The inherent issues raised by the wording of this provision are well known, for example, the issues of: the identity of the property acquired and sold; what constitutes a sale; whether the reference to the purpose was to the sole, the main or one of several purposes; and the calculation of a profit in some circumstances.

The Tax Law Improvement Project of the 1990s achieved some elements of simplification at the outset with the enactment of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) which addressed some critical issues (including that raised by Hill J in the *Cooling* case). However, that Act has since become ever more complex.

The recent decision

This article considers several construction issues that arose in *BBlood Enterprises Pty Ltd v FCT*.[3] The facts and decision in that case are discussed in the Tax News column of this issue of the journal.[4] The main construction issues that arose related to the operation of s 100A ITAA36 (reimbursement agreements) which is contained in the trust provisions of Div 6 ITAA36, and to the operation of the imputation provisions of the ITAA97.

General approach to construction

Before considering the construction issues that arose in the *BBlood Enterprises* decision, the general approach to statutory construction should be noted. There are many statements which consider the approach but, for present purposes, the following passage from the judgment of Kiefel CJ, Nettle and Gordon JJ in *SZTAL v Minister for Immigration and Border Protection*[5] will suffice:

> "The starting point for the ascertainment of the meaning of a statutory provision is the text of the statute whilst, at the same time, regard is had to its context and purpose. Context should be regarded at this first stage and not at some later stage and it should be regarded in its widest sense. This is not to deny the importance of the natural and ordinary meaning of a word, namely how it is ordinarily understood in discourse, to the process of construction. Considerations of context and purpose simply recognise that, understood in its statutory, historical or other context, some other meaning of a word may be suggested, and so too, if its ordinary meaning is not consistent with the statutory purpose, that meaning must be rejected."

Definitions: relevance of the defined term

A key provision in s 100A ITAA36 is the definition of the expression "reimbursement agreement" in subs (7) which reads as follows:

> "(7) Subject to subsection (8), a reference in this section, in relation to a beneficiary of a trust estate, to a reimbursement agreement shall be read as a reference to an agreement, whether entered into before or after the commencement of this section, that provides for the payment of money or the transfer of property to, or the provision of services or other benefits for, a person or persons other than the beneficiary or the beneficiary and another person or other persons."

One argument for the taxpayers in the *BBlood Enterprises* case was that the meaning of the term "reimbursement agreement" required that "the payment of money, transfer of property or provision of services or other benefits referred to in s 100A(7) be, in substance, a reimbursement for the beneficiary being made presently entitled to trust income".[6]

Rejecting this argument, Thawley J said:[7]

> "Section 100A(7) supplies the definition of 'reimbursement agreement' for the purpose of s 100A(1). Section 100A(7) is deliberately broad in its scope. It is intended to capture all agreements within the ordinary meaning of its terms, construed in context. A part of the statutory architecture is that 100A(7) is '[s]ubject to subsection (8)'. Subsection 100A(8) excludes all arrangements except those entered into with the requisite 'tax avoidance' purpose. I use the phrase 'tax avoidance' purpose as shorthand for the purpose described in s 100A(8) … This indicates that s 100A(7) was deliberately broad with s 100A(8) providing restriction. Further, s 100A(13) excludes from the meaning of the word 'agreement', those agreements which are entered into in the course of ordinary family or commercial dealing. Because s 100A(7) is broad, the practical issue will often be as to the application of the exclusionary components in s 100A(8) and (13) …
>
> Contrary to the [taxpayers'] submissions, the terms of s 100A(7) should not be read down so as to be limited to the specific types of mischief which were identified in the 1978 EM as then being of concern."

It may be noted that, in the context of a statutory definition, the issue of the relevance of the term defined in construing the definition was addressed by the Full Federal Court in *Eichmann v FCT*[8] in the context of the definition of "active asset" in s 152-40 ITAA97 that applies for the purposes of the CGT small business reliefs. In a joint judgment, the court (McKerracher, Steward and Stewart JJ) said:

> "… we have not been assisted by the use of the label 'active asset' in construing s. 152-40(1)(b). It has long been established that '[i]t would be quite circular to construe the words of a definition by reference to the term defined': *Owners of Shin Kobe Maru v. Empire* Shipping *Co Inc* (1994) 181 C.L.R. 404 at 419."

What if there is a drafting error?

Having regard to the conclusions that he had reached on the interpretation and application of s 100A ITAA36, it was necessary for Thawley J to consider issues that arose under the imputation provisions and, in particular, s 207-35(6) ITAA97 which provides as follows:

> "(6) Despite any provisions in Division 6 of Part III of the *Income Tax Assessment Act 1936*, for the purposes of that Division, increase the assessable amount by *so much of the franking credit amount as is equal to*:
>
> (a) [not presently relevant] …
>
> (b) if the trustee of the trust is liable to be assessed (and pay tax) under section 99 or 99A of that Act – the sum of:
>
> (i) the trustee's share of the franking credit on the distribution; and
>
> (ii) the amount mentioned in section 207-37."
> (emphasis added)

The Commissioner submitted that s 207-35(6) increased the "assessable amount" in respect of which the IP Trustee was liable to be assessed under s 99A ITAA36, by the sum of:[9]

- the IP Trustee's share of the share buy-back dividend (under s 207-55 ITAA97) – being the whole of the share buy-back dividend; and
- the IP Trustee's share of the franking credit on the share buy-back dividend (under s 207-57 ITAA97) – being the whole of the franking credit.

The applicants contended that:

- s 207-35(6) ITAA97 should be construed literally as increasing the "assessable amount" only by the amount of the franking credit (and not also by the amount of the share buy-back dividend) due to the words of limitation "so much of the franking credit amount as is equal to" in the opening words of the subsection; and
- increasing the "assessable amount" (defined in s 207-35(5)(c)) did not increase the amount in respect of which the IP Trustee was liable to be assessed under s 99A ITAA36. Section 207-35(6)(b) operated to increase the "assessable amount", being the amount that would be assessed under s 99A if Div 6E ITAA36 did not apply and applies despite the provisions of Div 6 ITAA36 and "for the purposes of that Division".

Thawley J said that, by the time of the oral closing submissions, the taxpayers had accepted that something had gone wrong in the drafting of the provision. His Honour said that what the legislature in fact intended was obvious from the statutory context. Where the trustee of a trust is liable to be assessed under s 99A, s 207-35(6) was intended to require the amount assessed to be increased by so much of the "franking credit amount" as was equal to the "trustee's share of the franking credit" and the "amount mentioned in section 207-37". His Honour said:[10]

> "What the legislature in fact intended is obvious from the statutory context. Where the trustee of a trust is liable to be assessed under s 99A (or the other provisions mentioned in s 207-35(5)(c)), s 207-35(6) was intended to require the amount assessed to be increased by so much of the 'franking credit amount' as was equal to the 'trustee's share of the franking credit' and the 'amount mentioned in section 207-37'."

The fact that something had gone wrong in the drafting of s 207-35(6) ITAA97 was also made clear by its terms. It was at best mischievous, and at worst a nonsense, to require a person to increase something by "so much of X" as is equal to the sum of X and Y.

Thawley J said that, if the target of a legislative provision was clear, the court's duty was to ensure that it was hit rather than to stand by and solemnly record that it has been missed.[11]

Thawley J also said that the difficulties in, and constraints on, construing legislation where the legislation is perceived to have missed its intended target were considered by the High Court in *Taylor v The Owners – Strata Plan No. 11564*.[12] Reference was made by the majority in that case to four "conditions" which are often referred to in this context as at least relevant to the question of whether a court can construe a provision as if it contained additional words to give effect to its evident purpose. The "conditions" were, in summary:

1. the precise purpose of the provision can be identified;
2. there has been an inadvertent failure to deal with an eventuality that must be dealt with if the provision is to achieve its purpose;
3. the words that parliament would have included can be clearly identified; and
4. the words that might be read into the text are consistent with the wording otherwise adopted.

His Honour said that the first three "conditions" were intended to reflect the three conditions identified by Lord Diplock in *Wentworth Securities Ltd v Jones*.[13] The fourth "condition" was intended to reflect a "condition" adopted by McColl JA in the decision of the New South Wales Court of Appeal in the *Taylor* case.[14]

Thawley J went on to say:[15]

> "The High Court [in the *Taylor* case] accepted that Lord Diplock's three conditions should be treated as prerequisites and, accordingly, necessary. The High Court did not decide whether Lord Diplock's three conditions are always, or even usually, 'necessary and sufficient' … The High Court endorsed the fourth condition as at least relevant.
>
> The present case is different to the statutory construction issue summarised in *Taylor* at [18], the subject of the four 'conditions'. What is involved here is not the addition of words, but the moving of words from a place which has the effect of defeating the evident statutory object to a place where those words would ensure the statutory target is hit. Notwithstanding, the 'conditions' (framed differently to apply to the present circumstances) provide a useful framework for analysing whether it is permissible to construe the legislation as it was evidently intended or whether the process of construction is one which requires too much surgery or is 'too much at variance with the language in fact used by the legislature' so as to render the construction impermissible: *Taylor* at [38]."

Thawley J said that the considerations he took into account were whether:[16]

> "(1) the precise intended purpose of the provision can be identified with certainty;
>
> (2) there has been an inadvertent drafting error;
>
> (3) the words that the legislature would have used (or the place where those words should in fact appear) can be clearly identified;
>
> (4) the words that would have been used are (or the placement of them is) consistent with the wording (or structure) otherwise adopted."

His Honour said that, as to (1), he had identified the precise purpose of s 207-35(6). As to (2), he was satisfied that the drafter and the legislature inadvertently made an error. As to (3), he was satisfied that the legislature would have enacted the provision in the following way had it not made the drafting error (strike through and underlining added):

> "(6) Despite any provisions in Division 6 of Part III of the *Income Tax Assessment Act 1936*, for the purposes of that Division, increase the assessable amount by ~~so much of the franking credit amount as is equal to~~:
>
> (a) … [not presently relevant] …
>
> (b) if the trustee of the trust is liable to be assessed (and pay tax) under section 99 or 99A of that Act – the sum of:
>
> (i) <u>so much of the franking credit amount as is equal to</u> the trustee's share of the franking credit on the distribution; and
>
> (ii) the amount mentioned in section 207-37."

As to (4), Thawley J said that the suggested wording was consistent with the wording otherwise adopted by the drafter.

His Honour said that the wording was, accordingly, not too much at variance with the language in fact used or incongruous or unreasonable or in any disconformity with the statutory scheme. It may be that the drafting of the provision in this way would have resulted in cosmetic and inconsequential changes to other provisions, but this did not provide an impediment to the correct construction of s 207-35(6). The consequence was that, properly construed, the effect of s 207-35(6) was as set out above.

Authority of special leave refusal

A further issue of interest considered by Thawley J was what the precedential value is of the High Court's refusal to grant special leave to appeal from a decision. The relevant decision in respect of which the application for special leave was being sought was the Full Federal Court's decision in *FCT v Prestige Motors Pty Ltd*.[17] In that case, the taxpayer was the applicant for special leave and argued for a construction of s 100A(7) ITAA36 which was said to be consistent with the mischief to which the provision was directed, such that the words "effectively, as a reimbursement or quid pro quo for the present entitlement" should be read into the end of s 100A(7).

The High Court refused the taxpayer's application. The reasons for the refusal were delivered by Gaudron J in *Prestige Motors Pty Ltd as Trustees of the Prestige Toyota Trust v FCT* (*Prestige Motors SLA* case) and were as follows:[18]

> "We are of the view that there is no error involved in the Full Court's construction of section 100A of the *Income Tax Assessment Act*. Accordingly, special leave is refused."

Thawley J said that the High Court's reasons for dismissing an application for special leave amount to dicta and do not create binding precedent; they provide "guidance" and can be of "persuasive value".[19] The persuasive value of reasons given on an application for special leave varies, depending on the circumstances. In the *Prestige Motors SLA* case, the point was critical to the application for special leave and it was the subject of oral debate between the judges hearing the application for special leave and experienced tax counsel. The reasons had persuasive value. Thawley J said that, in any event, they were consistent with the construction of s 100A which he had come to.

TaxCounsel Pty Ltd

References

1 Steward J (as he then was) in *Auctus Resources Pty Ltd v FCT* [2020] FCA 1096 at [84].

2 [1990] FCA 204 at [79].

3 [2022] FCA 1112.

4 See item 8 at page 252.

5 [2017] HCA 34 at [14].

6 [2022] FCA 1112 at [107].

7 [2022] FCA 1112 at [121] and [122].

8 [2020] FCAFC 155 at [45].

9 Reference should be made to the facts of the case which are given at page 252.

10 [2022] FCA 1112 at [281].

11 *Kingston v Keprose* (1987) 11 NSWLR 404 at 424.

12 [2014] HCA 9 at [60].

13 [1980] AC 74.

14 *Taylor v The Owners – Strata Plan No. 11564* [2013] NSWCA 55.

15 [2022] FCA 1112 at [289] and [290].

16 [2022] FCA 1112 at [290].

17 [1998] FCA 221.

18 [1998] HCATrans 279.

19 [2022] FCA 1112 at [126]. Thawley J cited: *North Ganalanja Aboriginal Corporation & Waanyi People v Queensland* [1996] HCA 2 at [643]; *Algama v Minister for Immigration & Multicultural Affairs* [2001] FCA 1884 at [62]; and *X7 v R* [2014] NSWCCA 273 at [97].

Mid Market Focus

by Nilan Gandhi, ATI, HLB Mann Judd

Non-resident discretionary CGT distributions

Recently issued taxation determinations provide further guidance on the Commissioner's view on the tax treatment of capital gains distributed to foreign residents by Australian resident trusts.

Introduction

The CGT provisions are contained in the *Income Tax Assessment Act 1997* (Cth) (ITAA97). Furthermore, Subdiv 855-A ITAA97 outlines the CGT implications where a foreign beneficiary receives a capital gain from an Australian resident trust.

It is worth noting that, where a foreign resident (a non-resident of Australia for tax purposes) disposes of a CGT asset that is not taxable Australian property (TAP), any capital gain or capital loss from the CGT event is disregarded (s 855-15 ITAA97).

The Commissioner finalised TD 2022/12 and TD 2022/13 on 31 August 2022. These determinations were previously issued in draft as TD 2019/D7 and TD 2019/D6.

TD 2022/12 and TD 2022/13

TD 2022/12 and TD 2022/13 will have retrospective application to arrangements.

The Commissioner has reaffirmed his view on capital gains distributed to a foreign resident beneficiary in accordance with the trustee's distribution of income resolution. The Commissioner's views are that:

- s 115-220 ITAA97 operates to assess the trustee under s 98(3) of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) on the capital gain attributable to the foreign resident beneficiary;
- the foreign resident beneficiary is also taken to have made capital gains under s 115-215(3) ITAA97, with a credit being allowed to that beneficiary under s 98A(2) for tax paid by the trustee;
- as the trust is not a fixed trust, s 855-40 ITAA97 does not apply to disregard the foreign resident's capital gain, nor does s 855-10 ITAA97 apply to disregard the capital gain which the foreign resident beneficiary is taken to have made under Subdiv 115-C ITAA97;
- s 855-40 will only disregard a capital gain that a foreign resident beneficiary receives from a fixed trust which is a result of a CGT event happening to a CGT asset of that fixed trust where that CGT asset is not TAP. The rationale behind this provision is that it would provide comparable tax treatment to the foreign resident beneficiary if it had owned that CGT asset directly;
- capital gains made on non-TAP that are distributed to foreign resident beneficiaries of a discretionary trust (a non-fixed trust) will not be disregarded under s 855-40; and
- the rules contained in s 855-40 will encourage foreign residents to invest in Australian trusts as it removes the tax burden for the foreign residents on capital gains made in a fixed trust.

Paragraph 1.3 of the explanatory memorandum (EM) to the New International Tax Arrangements (Managed Funds and Other Measures) Bill 2004 explained that s 855-40 was introduced to align the tax treatment of foreign residents investing in fixed trusts more closely with the tax treatment of foreign residents investing directly in assets in Australia (TD 2022/13).

Federal Court Decision

On 28 April 2020, the Federal Court handed down its decision in *Peter Greensill Family Co Pty Ltd (trustee) v FCT*.[1] The case considered whether capital gains distributed to a foreign resident beneficiary were assessable to the resident trustee (Peter Greensill Family Co Pty Ltd). The case also considered whether the capital gains were disregarded under s 855-10(1) ITAA97 where the beneficiary was deemed to have made the capital gains under Subdiv 115-C ITAA97.

The *Greensill* case examined the interaction of the trust provisions in the ITAA36 (Div 6 and Subdiv 6E) and the CGT provisions in the ITAA97 (Subdiv 115-C and Div 855). As may be recalled, Subdiv 6E was enacted and Subdiv 115-C was changed following the landmark decision in *FCT v Bamford*.[2]

When deciding the case and examining the provisions, Thawley J considered the concepts of statutory interpretation examined by the High Court in *FCT v Consolidated Media Holdings Ltd*.[3]

In the *Greensill* case, an Australian resident discretionary trust made a substantial capital gain ($58m in the 2015 to 2017 income years) on shares in an Australian company, such shares not being TAP. The trustee both resolved to distribute the capital gains to a foreign resident beneficiary (a resident of the United Kingdom) and transferred some other shares in the same company to the foreign resident in specie (also giving rise to a capital gain by the trustee).

The applicant argued that the capital gains distributed to Mr Greensill were "capital gains from a CGT event" that could be disregarded by the operation of s 855-10 ITAA97. In particular, s 855-10 states:

"(1) Disregard a capital gain or capital loss from a CGT event if:

(a) you are a foreign resident, or the trustee of a foreign trust for CGT purposes, just before the CGT event happens; and

(b) the CGT event happens in relation to a CGT asset that is not taxable Australian property."

In summary, the court held in favour of the Commissioner, finding that s 855-10(1) did not apply because:

- the trustee (ie the taxpayer) was not a foreign resident;
- it was of no consequence that the beneficiary was a foreign resident; and
- the trust was not a foreign trust.

Further, and importantly, the provisions that tax capital gains required amounts to be calculated which were included in assessable income of the trust and the beneficiary. The court found that the amounts were not a capital gain from a CGT event but were amounts that the CGT provisions required to be calculated that did not have any particular character.

The court also found that the ITAA97 includes specific provisions (see s 855-40 ITAA97) to exclude capital gains made by beneficiaries of a fixed trust, which in turn indicated that s 855-10(1) did not apply where a capital gain is made by beneficiaries of a non-fixed trust (such as a discretionary trust).

Appeal

On 10 June 2021, the Federal Court handed down its decision and dismissed the taxpayer's appeal in the *Greensill* case.

The Federal Court rejected the taxpayer's arguments and found that there was no reason to interpret s 855-10(1) ITAA97 other than in accordance with its own terms. The court found that:

- s 855-10(1) did not apply so as to disregard any of the trust estate's capital gains;
- Subdiv 115-C ITAA97 applies in relation to the trust estate's capital gains because the trust estate had a net capital gain in the relevant income years which was taken into account when working out the trust estate's net income;
- the deemed capital gain worked out under Subdiv 115-C was not a capital gain to which s 855-10 applied;
- the amount of capital gain referred to in s 115-225(1)(a) was the capital gain of the trust estate in relation to which the section applied. It was not a reference to any capital gain of the beneficiary;
- furthermore, s 855-10 identified the capital gain to be disregarded as one that was "from a CGT event". The expression "CGT event" was defined in s 995-1 ITAA97 to mean any of the CGT events described in Div 104 ITAA97. The capital gain treated as the beneficiary's capital gain by s 115-215(3) ITAA97 was not, however, a capital gain from a CGT event described in Div 104, but a capital gain that the beneficiary was deemed to have made by operation of s 115-215(3); and
- hence, s 855-10 did not apply on its terms either in the context of Subdiv 115-C or in relation to a beneficiary after the capital gain of the trust estate had been attributed to the foreign beneficiary by the application of Subdiv 115-C. That s 855-10 did not have operation in the context of Subdiv 115-C was reinforced by the contrasting language of s 855-40.

Principles of statutory interpretation in the Greensill case

As highlighted above, the importance of the interpretation of the relevant provisions was essential to the decision of Thawley J. His Honour stated:[4]

"That Div 855 should be understood, through the process of statutory construction, as having been intended to operate in this way is supported by the legislative history and extrinsic material."

The role that legislative history and extrinsic material can take in the task of statutory construction was explained by the High Court in *FCT v Consolidated Media Holdings Ltd* (citations omitted):[5]

"'This Court has stated on many occasions that the task of statutory construction must begin with a consideration of the [statutory] text'. So must the task of statutory construction end. The statutory text must be considered in its context. That context includes legislative history and extrinsic materials. Understanding context has utility if, and in so far as, it assists in fixing the meaning of the statutory text. Legislative history and extrinsic materials cannot displace the meaning of the statutory text. Nor is their examination an end in itself."

Thawley J went on to highlight the *Tax Laws Amendment (2006 Measures No. 4) Act 2006* (Cth) that enacted Div 855 and noted that the EM said nothing about Div 855 changing the taxation of capital gains deemed to be made by foreign resident beneficiaries under s 115-215 ITAA97. His Honour noted that the EM stated, at para 4.113:

"Amendments made by this Bill move a specific treatment for capital gains and capital losses made by foreign residents from interests in, or through interests in, fixed trusts from Subdivision 768-H into Division 855. The general operation of the CGT and foreign resident rules will ensure that a capital gain or capital loss on an interest in a fixed trust made by a foreign resident is disregarded if that interest is not taxable Australian property. The provisions specifically dealing with the distribution of capital gains to foreign beneficiaries will continue to operate."

In relation to the applicant's arguments, his Honour stated:[6]

"Much of the applicant's argument proceeded upon the assumption that there existed a policy objective of not taxing foreign beneficiaries of resident trusts in respect of CGT events in relation to CGT assets which were not taxable Australian property. The applicant's process of construction then analysed the statutory provisions through this lens. This approach falls foul of the caution expressed in *Certain Lloyd's Underwriters v Cross* [2012] HCA 56 … at [26] that a danger to be avoided in construing a statute is making an *a priori* assumption about a statute's purpose and construing the statute to coincide with the assumption. The correct process is the inverse: the purpose is to be derived from what the legislation says, not from an assumption about the desired or desirable operation of the provisions. The policy objective asserted by the applicant is not to be found in the legislative history identified above and nor is it supported by the terms of former s 160L of the ITAA 1936 or the capital gains tax regime when it was introduced."

Conclusion

The Commissioner's views in TD 2022/12 and TD 2022/13 further cement the Federal Court's decision in the *Greensill* case that an Australian discretionary trust may not be the most tax-efficient structure for holding non-TAP CGT assets where the capital gain is intended to be distributed to foreign resident beneficiaries.

It is important that foreign resident beneficiaries of discretionary trusts are aware of the risks of amended assessments following the finalisation and release of TD 2022/12 and TD 2022/13.

Nilan Gandhi, ATI
Manager – Tax Consulting
HLB Mann Judd

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1 [2020] FCA 559.
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3 [2012] HCA 55.
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Higher Education

Obtaining your tax agent licence

The dux of CommLaw3 Study Period 1 2022 discusses why she chose the Tax Institute Higher Education to help her obtain her tax agent licence.

Raveena Paul
Accounting Supervisor
Cambooya Pty Ltd, NSW

Please provide a brief background of your career in tax.

I am a chartered accountant with nine years of experience in accounting and tax. After graduating, I worked in public practice at a chartered accounting firm called Malcolm Gray, specialising in tax advisory and compliance for SMEs, trusts and estates. I moved to Sydney in 2019 and worked at a mid-tier firm for a year, before shifting away from public practice and taking up my current role at Cambooya as a supervisor. The family office space has given me the opportunity to broaden my experience and build on my knowledge of tax and finance.

Why did you choose to study with The Tax Institute Higher Education?

I chose to study with The Tax Institute Higher Education because I wanted to obtain my tax agent licence. Since it is the country's leading professional tax association and provider of tax education, I was able to find a course that met the requirements for obtaining that licence.

Why did you decide to study our CommLaw3 subject?

I studied CommLaw3 because it formed part of the eligibility criteria for me to register as a tax agent with the Tax Practitioners Board (TPB). This course is part of the Tax Agent Program.

What skills and knowledge have you taken away from the CommLaw3 subject?

I have gained a deeper knowledge of real and personal property transactions, as well as consumer, insurance, and finance law. For me, the most interesting part of the subject was studying intellectual property law, particularly copyright and trademarks, as I hadn't studied this area of law prior to undertaking this course.

How did you juggle study, work and other commitments?

It's important to set realistic expectations and goals that you can achieve. I did my best to stick to the module timetable which outlined the learning and activities for each week, along with revision guidelines. This meant that, during the 11-week study period, I spent most of my weekends studying.

Having said that, my office was extremely supportive throughout the study period, which made it easier to juggle everything.

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

When it comes to keeping up with key changes in the law, I find the monthly tax updates extremely useful. The Tax Institute membership has provided me with an avenue to study and network, which may lead to further study in the future. As I progress in my career, I will consider undertaking the Chartered Tax Adviser program.

M&A: the public/private company dichotomy

by Clint Harding, CTA, Partner, and
Danielle Ou, ATI, Lawyer, Arnold Bloch Leibler

Is there a dichotomy between public and private companies when it comes to how the relevant tax laws apply, and how those laws are administered, in the context of mergers and acquisitions and restructuring transactions? This is a common question many practitioners ask when advising in this space and it would seem that, just as in some families, there is a favourite child out of the two. This article seeks to unpack the key issues to be aware of when navigating this dichotomy between private and public companies, and highlights where private and public companies are treated differently, either by the legislation itself or administratively by the Commissioner of Taxation.

Introduction

The merger and acquisition (M&A) environment has changed significantly in recent times. The end of 2021 and the start of 2022 saw record M&A activity in Australia, in line with global trends, as companies hungry for more capital began to stretch their legs in response to low interest rates. With greater levels of economic uncertainty featuring in the second half of 2022 and going into 2023, we will likely see a different M&A environment, focused on restructures and the disposal of non-core business lines and perhaps distressed assets.

There has also been a renewed focus by the ATO on private companies and groups transacting in the Australian market. The ATO's Top 500 program and Next 5000 program represent an extension of the ATO's previous Top 320 program targeting private groups and high-wealth individuals. A specific concern pointed out by the ATO in the Top 500 and Next 5000 programs is the application of CGT provisions in the context of restructures and atypical transactions. The 2022 Budget announced a further investment in this program, representing an ongoing commitment to evaluate and more closely scrutinise private company activity.

What the past few years have shown us is that tax professionals need to be on top of what in this article is termed "the M&A toolbox", particularly when working with private companies and groups. This toolbox includes:

- access to the various CGT reliefs, in particular, scrip-for-scrip roll-over relief under Subdiv 124-M of the *Income Tax Assessment Act 1997* (Cth) (ITAA97);
- the demerger provisions under Div 125 ITAA97; and
- the provisions applying to the taxation of earnouts under Subdiv 118-I ITAA97.

This dichotomy can in part be traced back to the history and policy intention of the CGT roll-over regime from the Ralph review,[1] being economic growth and the promotion of simplicity, certainty and fiscal adequacy in the Australian tax system. In the same breath, the Ralph review also recommended restricting CGT roll-over relief and demerger relief so that it cannot be accessed by closely-held companies, which are effectively private companies, due to the difficulty in valuing private company shares and the risk of tax avoidance. The idea that private companies are more likely to act mischievously as they are under less public scrutiny, and so more prone to activity which can be viewed as tax avoidance, is a view that many believe is still held by the Commissioner. The "tax gap" work done by the ATO and outlined in the 2020–21 annual report[2] may go some way to support such a view.

Drawing on the authors' experience of using the M&A toolbox to assist private companies[3] in a range of transactions, this article walks through key issues that private companies should be aware of when transacting in the M&A space and how to navigate this space when fighting against the tide of these perceptions.

CGT roll-over relief: equal value exchange requirement

In the authors' experience, two factors drive much of the complexity when applying the roll-over provisions to private companies:

- establishing the market value of the company; and
- issues arising when working with multiple classes of shares.

These two issues are often linked due to the requirement generally applying to the roll-over regime that what you receive in exchange for what you are giving up should have the same value.

It goes without saying that public or listed companies rarely face these difficulties because the share price is readily ascertainable, and in the majority of cases, there will only be ordinary shares on issue.

The authors have seen family companies with over 20 different classes of shares on issue, and it is not trite to say that such circumstances can create a level of difficulty 20 times of what would normally be the case.

In this section of the article, the nuances of the scrip-for-scrip roll-over found in Subdiv 124-M ITAA97 are focused on.

The general conditions that must be satisfied for Subdiv 124-M ITAA97 to apply are:

1. the exchange of shares/options or similar interests in the target company is for shares in another company;
2. the exchange is in consequence of a "single arrangement";
3. a capital gain would have arisen but for the roll-over relief;
4. the required choice and notifications are made to apply the roll-over relief;
5. the special rules for non-arm's length transactions are satisfied;
6. the arrangement is not excluded from roll-over relief; and
7. the acquiring entity does not breach the rules regarding new debt and equity.

The importance of transacting at arm's length for private companies

To satisfy conditions (1) and (5) above, closely-held entities must prove that they are transacting at arm's length to access full scrip-for-scrip roll-over relief.[4] Two issues arise that are especially problematic for private companies if they do not satisfy this arm's length requirement:

1. the acquiring company will only be allowed to exchange shares/options (or similar interests) for replacement shares with the exact same rights and obligations in the target company. This can be difficult for private companies which often have different classes of shares on issue with different rights attached; and
2. parties are required to meet additional conditions before roll-over relief can be applied. Specifically, they must prove that the replacement shares substantially reflect the market value of the original shares in the target company. This only applies to entities with less than 300 members just before the arrangement, which will predominantly be private companies.[5]

It is also important to note that the Commissioner has confirmed that the structure of s 124-780(4) and (5) ITAA97 means that "dealing at arm's length" should not be construed as meaning the parties exchange their shares for a fair price or market value.[6]

The arm's length conditions in many ways represent a compromise to the recommendations in the Ralph review, which envisaged the scrip-for-scrip roll-over relief to only apply when at least one of the transaction entities is "widely-held". This was in response to the *Platform for consultation report's* questions on whether roll-over relief should be confined to publicly listed companies due to the issues with valuing unlisted companies, and to minimise the risk of tax avoidance.[7]

So, what does it mean to transact at arm's length? Importantly, the fact that there is no ownership connection between the parties is not determinative, on its own, of whether the parties are dealing with each other at arm's length.[8] Instead, the ATO will look beyond the relationship or connection between the shareholders and the acquiring entity to the nature and circumstances of the dealing.[9] In particular, whether the parties colluded to achieve a particular result, or if one of the parties has submitted the exercise of its will to the discretion of the other. The lack of independent will in the formation of the transaction will indicate a lack of real bargaining.[10]

ATO ID 2004/498 shows that the Commissioner may still deem a transaction non-arm's length even when parties to the transaction receive independent valuations, the consideration paid by the acquiring entity is considered reasonably equivalent to the market value, and each shareholder obtains professional advice.

In ATO ID 2004/498, the Commissioner found on the facts that the shareholders in a closely-held company had agreed as a group to the major terms and conditions of the restructure. As a result, the Commissioner ruled that the newly incorporated acquiring company did not bargain as a party dealing at arm's length with the shareholders. The mere fact that independent advice had been sought, and an independent valuation provided, did not mean that the transaction occurred at arm's length.[11]

> "The idea that private companies are more likely to act mischievously … is a view that many believe is still held by the Commissioner."

Private companies must ensure that they clearly substantiate the nature and circumstances of the dealing to prove that they are acting on arm's length terms. However, this exercise may be more difficult for private companies than for public companies due perhaps, in part, to the nature of the governance arrangements and record-keeping practices of private companies. It should be noted that the Commissioner has clearly emphasised the importance of keeping contemporaneous evidence that the transaction occurred on an arm's length basis.[12]

Managing the "single arrangement" requirement

Section 124-780(2)(c) ITAA97 requires all owners who are party to the transaction be able to participate in that transaction. And that the participation must be done on substantially the same terms as all other owners under a single arrangement. This condition is particularly difficult to navigate for private companies which typically have various classes of shares on issue, or shareholder agreements in place. In contrast, meeting this provision is simpler for public companies as, unless the company's constitution provides otherwise, there is a presumption that all shares on issue have the same rights.[13]

The facts and circumstances outlined in ATO ID 2004/800 reflect a common issue faced by private companies. Specifically, the interpretative decision concerns a shareholder who has additional rights under a shareholder agreement, and therefore expects their consideration to be greater than what the other owners of the company will be receiving under the transaction (ie issue of preference shares). This is common when working with private companies where the buyer wants all of the shareholders to be "cashed out" but for one key shareholder (usually the manager or founder) who is to continue as a shareholder and have "skin in the game".

The risk for taxpayers is clearly that structuring a transaction in this way would represent *different offers* being made to the shareholders (ie this would fail condition (2) above), and so scrip-for-scrip roll-over relief would not be available. This issue was also presented before the full Federal Court in *FCT v Fabig*.[14] Here, a shareholder agreement (which existed before the transaction) meant that, if the shareholders sold their shares to the same purchaser, the consideration for the sale would be split differently to their equity ratio. The Federal Court determined that the Administrative Appeals Tribunal erred in concluding that, because the purchaser was indifferent as to how the consideration would be apportioned between the shareholders, participation was available on the same terms. Instead, the court ruled that the shareholder agreement meant that the shareholders could not accept the purchaser's offer on substantially the same terms as it would be a breach of their contractual obligations. Therefore, participation did not occur on substantially the same terms.

A solution could be to opt for a partial roll-over where all shareholders are offered a combination of cash and scrip, or preference shares and scrip, with a maximum limit in place. Shareholders are then able to independently arrange themselves to accept the desired outcome. However, no assurance can be given to the acquiring company, leaving this a significant risk for the buyer. There may also be integrity issues with the arrangement. It is important to note that, in a cash-and-scrip offer exchange (ie opting for a partial roll-over), the cash component does not qualify for roll-over relief.

Significant and common stakeholder provisions

Where the original interest holder is a "significant" or "common" stakeholder under s 124-782 ITAA97, the original interest holder and the replacement entity must jointly choose for the original interest holder to obtain the roll-over. Section 124-782 predominately targets closely-held companies, as widely-held entities are taken as having no significant stakeholders.[15]

In addition, if the significant or common stakeholder provisions apply, the historical cost base of the original shares will transfer and act as the acquiring entity's cost base in the original shares. This is an exception to the general rules under s 110-25 ITAA97, where the market value is used as the first element of the cost base calculation of the original interest in the hands of the acquiring entity (ie a market value step-up to the cost base). An arrangement that is intentionally structured to ensure that the common and significant stakeholder test is not met will reduce or eliminate the roll-over effect. The definition of significant and common stakeholder is summarised below:[16]

- **significant stakeholders**: an entity will be considered a significant stakeholder when, on an associate-inclusive basis, it has a significant stake in the original entity prior to the arrangement *and* in the replacement entity just after the arrangement has been completed;[17] and
- **common stakeholders:** similar to the significant stakeholder definition, an entity will be considered a common stakeholder, on an associate-inclusive basis, when it holds 80% or more of the voting rights, an entitlement to dividends or an entitlement to distribution of capital in the original entity prior to the arrangement and in the replacement entity.[18]

The significant and common stakeholder provisions will catch private companies where shareholders retain a material interest in the company after acquisition, such as founders when a private equity firm acquires a start-up company.

A key issue to be aware of in transactions which involve the significant or common stakeholder provisions is the potential application of s 115-45 ITAA97. Section 115-45 denies the application of the CGT discount rules that would normally apply when a taxpayer is disposing of equity in an entity. Specifically, in circumstances where the taxpayer would not satisfy the CGT discount rules if they disposed of the underlying assets of the entity directly. This provision does not apply if the entity has at least 300 equity holders (eg shareholders) and control of the company or trust is not and cannot be concentrated. Therefore, this provision is unlikely to apply to public companies.

In particular, s 115-45(5) means that a CGT discount will be denied if the "notional capital gain" of the company after a relevant CGT event[19] (eg the disposal of shares) is more than half of the "notional capital gain" worked out before the relevant CGT event.[20] Therefore, transactions where the common or significant stakeholder provisions apply (meaning that the taxpayer is required to inherit the historical cost base of an entity instead of receiving a market value uplift) may be caught by this provision if the cost base of the asset is significantly lower than its market value.[21]

Private companies accessing demerger roll-over relief

The rules on demerger transactions are found in Div 125 ITAA97. Generally, a demerger happens when a business restructures the organisation by carving out an entity from under the head entity, so that the underlying owners (usually shareholders) acquire direct ownership in both the carved-out entity (ie the demerged entity) and the head entity.

In general, the demerger rules result in any capital gain or loss that a demerger entity makes from a CGT event happening to its ownership interest in a demerged entity under a demerger being disregarded.[22] Similarly, capital gains as a result of the demerger are disregarded for shareholders.[23] For shareholders and the demerged entity, dividends or capital distributions are non-assessable non-exempt under s 44(3) and (4) of the *Income Tax Assessment Act 1936* (Cth) (ITAA36), unless s 45B or 45BA ITAA36 applies.

The original cost base of the pre-demerged entity is also apportioned between the original and the new interest/shares for the shareholders based on relative market values, or an anticipated reasonable approximation of those market values.[24] Shareholders will also inherit the original acquisition date for the replacement interests.[25]

A key characteristic of a demerger is that there is no change in the underlying economic ownership in the demerger group, being the head entity and demerger subsidiaries. This is assessed by confirming that the same proportion of ownership and proportionate market value exist before and after the demerger scheme (known as the "proportionality test").

Unlike the scrip-for-scrip roll-over provisions explored above, the legislation does not distinguish between a private and a public company in the conditions that must be satisfied in order for Div 125 ITAA97 to apply. That said, there are certain requirements where a private group will have to do more work to establish that the conditions are satisfied (discussed below).

Identifying the "restructure" under the demerger provisions

Without going into detail, a demerger broadly occurs when there is a restructuring of the demerger group and, under the restructuring, whether or not a CGT event happens to an entity's original interest in the demerged entity, the shareholder acquires a new interest and nothing else.[26] However, the term "restructuring" is not defined in the ITAA97.

The Commissioner's view, as set out in TD 2020/6, interprets the meaning of "restructuring" as a question of fact which includes all of the steps under a single plan of reorganisation. This latest position has been criticised as a clear departure from the original objects of s 125-70(1) ITAA97 and what was understood by the term more broadly in the market.

The uncertainty created by the Commissioner's latest position makes it difficult to determine what steps are to be included in the reorganisation plan under a demerger. As a result, the most obvious concern is that the Commissioner can deny demerger relief if he considers any subsequent planned or envisaged transactions (which will cause a change in economic ownership of the demerger group) to be part of the demerger scheme.

This definition and application of the restructuring concept by the Commissioner is particularly difficult for private company structures, which are less likely to be planned out completely in advance. In the authors' experience, the key for private companies and groups in managing this uncertainty can be found in thorough and open engagement with the ATO. A ruling is almost a prerequisite for any demerger.

In a recent private ruling application (managed by the authors' firm), where a private company was granted demerger relief by the Commissioner, the taxpayer volunteered for early engagement with the ATO, including to discuss what impact a potential but unplanned capital raising would have in meeting the definition of "demerger" under s 125-70(1) ITAA97. The taxpayer was careful to proactively manage and address the ATO's concerns regarding any potential changes to the future ownership of the demerger group, while also recognising that the purpose of the demerger would require the demerged entity to seek new capital in order to grow the business. In the finalised ruling, the ATO pointed out that it was significant that, while capital-raising may occur in the future, there were no clear plans for the future debt/equity mix of the business or the source of such funding.

Each circumstance will ultimately turn on its own facts, but through open engagement with the ATO, a taxpayer and its advisers are able to identify and focus on those factors that will be the most important to the outcome. It goes without saying that it is important to identify upfront what transactions will form the restructuring plan, and to ensure that shareholders do not undertake any additional transactions that might alter the final economic position of the demerger group without careful consideration of the impact on the availability of demerger relief.

Do you have a "genuine demerger"?

Subdivision 45B ITAA36 will apply when there is a scheme for the provision of demerger/capital benefit, there is a tax benefit as a result of the scheme, and there is more than an incidental purpose of providing the tax benefit having regard to the 18 factors listed in ss 45B(8) and 177D(2) ITAA36.

If Subdiv 45B ITAA36 does apply, the Commissioner may make the following determinations:

- Subdiv 45BA applies so that the whole or part of a demerger benefit is to be disallowed as a demerger dividend, therefore making it taxable as an ordinary dividend under s 44 ITAA36; and
- Subdiv 45C applies which deems an amount of the capital benefit, or part of the benefit, distributed to shareholders as an unfranked dividend paid by the company.

Despite not being found anywhere in Subdiv 45B or Div 125 ITAA36, the Commissioner's latest position in PS LA 2005/21, and in numerous public and class rulings, adopts the concept of a "genuine demerger" as a proxy for satisfying the purpose test in s 45B(2)(c) ITAA36. In the Commissioner's view, a genuine demerger means a scheme driven by genuine commercial imperatives which therefore has business merit, whereby any tax benefit is not incidental to the overriding commercial purpose.

Private companies may find proving that they satisfy this requirement more difficult, particularly as private groups are less likely to have the same history of documentation supporting the commercial advantages for demerging the entities. This may require the engagement of third-party experts, such as management consultants, to prepare a report quantifying (to the extent possible) the benefits of demerging the entities, or the synergies accompanying such a restructure. The Commissioner's position encapsulated in PS LA 2005/21 means that it is important to clearly evidence and record the significant commercial reasons as to why a demerger would lead to greater business efficiency and economic output for the group and for the Australian market.

In the authors' experience advising on recent demergers for private companies, this means first establishing that the taxpayer operates two distinct businesses. Evidence that could be provided to the ATO includes proving that the company has:

- separate businesses and business strategies;
- separate management structures;
- separate financing arrangements;
- separate regulatory requirements; and
- employees and a need to have separate incentivisation schemes.

In addition, evidence that the businesses may have distinctly different investor profiles due to differences in business type, geography, operations, capital management strategies and funding requirements lends to the argument of a genuine demerger.

Earnout payments

Finally, it is worth noting the complexity accompanying earnout arrangements that are a common feature to private company transactions, and less so in listed or public M&As. An "earnout" is a contractual mechanism in a sale agreement that provides for contingent additional payments from a buyer of a company to the seller's shareholders. They are typically "earned" if the acquired business meets certain financial or other milestones, such as revenue-based targets or earnings before interest, taxes, depreciation and amortisation thresholds, after the acquisition is closed.

Subdivision 118-I ITAA97 sets out the requirements for a "look-through" earnout, which enables any capital gain or loss in respect of the earnout right be disregarded for CGT purposes until such time as the right becomes certain.[27] This is opposed to a standard earnout arrangement, which is treated as a separate CGT asset.

"Not reasonably ascertainable" versus deferred consideration

For an earnout right to attract look-through treatment, the right must be for a future benefit that is not reasonably ascertainable at the time the right is created. Therefore, it is important that there is no confusion in the difference between a true earnout clause and consideration that is simply deferred.

Delaying the payment of consideration, for example, making 10% of the purchase price payable on the first anniversary of the sale agreement, is not an earnout. Such consideration is ascertainable and thus must be included in the capital proceeds and the calculation of the capital gain or loss at the time of the CGT event (eg disposal of the shares).

What is the economic performance target?

The value of an earnout must also be reasonably related to an economic performance target of the entity in order to satisfy Subdiv 118-I. The Commissioner does not provide clear guidance on what is considered "reasonable", other than that the value of the financial benefits to be provided should not clearly exceed the amount of the profits themselves. This requirement is often overlooked and creates difficulties for private companies because it introduces an objective assessment as to whether an amount is "reasonable".

Perhaps the better view, in the absence of any guidance, is that the reasonableness requirement be assessed in the context of comparable businesses and approached from the view of ensuring that the consideration represents fair market value. It remains a difficult hurdle and questions will arise as to who is in the best position to ultimately determine whether an earnout amount is reasonable.

The active asset test

Perhaps one of the most difficult factors to satisfy in order to meet the look-through earnout requirements is that relevant CGT assets (ie the shares in the target) must be "active assets" of the company *just before* the share sale is completed. Broadly, this requires 80% or more of the market value of the target company's assets to be active (or connected with the active business of the company). To satisfy this condition, the taxpayer must turn to the definition of "active asset" in Div 152 ITAA97. That brings with it all of the complexities of determining what the active assets are and dealing with issues such as goodwill and intangible assets, for example, internally generated intellectual property.

Given that the correct characterisation of any earnout component of the consideration has an impact on both the buyer and the seller, it is often the case that the parties will want to agree upfront as to the correct treatment of any earnout. For example, the following provision is common in an agreement:

> The parties agree that the Earnout qualifies as a look-through earnout right as defined under section 118-565 of the ITAA 1997 and that the Shares will continue to be Active Assets of the Buyer for the period to which the Earnout Amount relates.

Conclusion

The moral of the story is that the complex tax issues attached to the sale of a private company are often, in the authors' experience, more complicated than those attached to the sale of a public company. There can be issues with obtaining the relevant information, issues with valuation, and complexities arising from the capital structure of the company that simply do not present themselves in the sale of a public company. Therefore, it is important for taxpayers and their advisers to be aware of the key issues in the M&A space.

Clint Harding, CTA
Partner
Arnold Bloch Leibler

Danielle Ou, ATI
Lawyer
Arnold Bloch Leibler

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Tax and estate planning in 2023: the road ahead

by Matthew Burgess, CTA, Director, View Legal

Understanding holistic tax and estate planning is critical for all tax advisers. In 2023, the extraordinary monetary value involved in the intergenerational wealth transfer of Australia's "baby boomer" population will continue to escalate. Arguably, tax-driven estate planning changes have largely avoided significant government and court intervention. However, since around 2018, this previous position appears to have permanently shifted with a range of measures targeted at ensuring baby boomers — and their chosen beneficiaries — pay their "fair share" of tax. Subsequent years have seen significant evolution in a number of areas, including superannuation, the treatment of tax equalisation provisions, trust loan accounts, trust vesting, testamentary trusts, and excepted trust income. Near the start of a new calendar year, it is timely to explore a number of the most critical developments in the tax and estate planning arena over the last 12 months.

Introduction

In light of ongoing changes to the taxation regime and the expanding wealth of Australia's ageing population, there has for many years been a growing need for estate planning to leverage appropriate tax structuring strategies.

Around this time last year, an article in this journal[1] explored a number of key tax and estate planning related changes, including:

- a specific tax detriment following the 2018 Federal Budget attack on testamentary trusts;
- tax equalisation clauses in estate planning exercises;
- tax-aware family law settlements;
- the tax consequences of changes of trusteeship;
- the impact of loan accounts; and
- trust rectification and tax planning.

Twelve months on, this article examines the following key tax structuring and estate planning related developments in 2022, namely:

- trust distributions and trustee duties;
- regulating the assets of related entities;
- asset protection and the "gift and loan back" strategy; and
- superannuation.

Trustee duties and powers under discretionary trusts

The decision of *Mantovani v Vanta Pty Ltd (No. 2)*[2] related primarily to a lost trust deed, an issue explored in previous articles in this journal.[3]

Helpfully, however, the decision also sets out a summary of the key duties owed by a trustee, noting that the office of trustee carries with it a number of strict obligations and duties, many of which are fiduciary in nature.

Fiduciary duties are generally seen as the most onerous of all legal duties and, where they apply, they require a person to act solely in another party's interests.[4]

The case specifically confirms that the duties of a trustee include:

- to become thoroughly acquainted with the terms of the trust and all documents relating to or affecting the trust property;[5]
- to adhere rigidly to the terms of the trust and conform to and carry out the wishes of the settlor as expressed in the deed of trust, which is said to be "perhaps the most important duty" of a trustee;[6]
- to keep and render proper accounts and report to beneficiaries or to a court regarding the administration of the trust;[7]
- to act fairly and impartially between beneficiaries;
- to administer the trust property in a way so as to avoid benefiting one beneficiary, or set of beneficiaries, at the expense of another;[8]
- to make an application for judicial advice where the trustee requires advice or direction in relation to the management or administration of trust property or the interpretation of a trust instrument.[9]

In relation to the last-mentioned duty (ie to seek advice), it should be noted that a failure to seek advice has been held to be at the trustee's "own peril". This is because any departure from the terms of the trust, and any negligence in the performance of the duties of the trust, will amount to a breach of trust.

Similarly, any acts in contravention of the duties imposed on the trustee by the trust or in excess of its powers will also be a breach of trust.[10]

The ability of a court to review, and potentially unwind, a decision of a trustee, including for a breach of fiduciary duties, is in many respects predicated on the trust adviser's mantra profiled often in this journal, namely: "read the deed".

The issues in this regard can be particularly critical in relation to discretionary trusts where, at least in theory, there are few limitations placed on a trustee concerning most key aspects of the administration of the trust.

In a sentence, the rule that the courts appear to apply is that a trustee's decision cannot be reviewed unless, on the material before the trustee, it is one that no reasonable trustee could have made.

What this rule means in any particular factual matrix can, however, be somewhat nuanced.

Key decision

In the case of *Owies v JJE Nominees Pty Ltd*[11] (*Owies*), the appeal court reached an opposite conclusion to the trial judge in relation to the appropriateness of various distributions made by the trustee.

The key error of the initial judge was said to be the adoption "of an unduly narrow view of the evidence and the structure of the trust deed as a whole".

Relevantly, the court confirmed the following key principles in relation to any review of the exercise of a trustee of discretionary powers:[12]

> "In considering the nature of the power to distribute annual income, the starting point must be the nature and purpose of the trust having regard to the terms of the trust deed".

Here, the settlor confirmed in the trust deed their desire to make "provision for the Primary Beneficiaries and the General Beneficiaries". Further:[13]

> "An obvious, but unstated, premise on which the trustee would be expected to discharge its duties is that it would generally be informed about the differing circumstances, needs and desires of each beneficiary as an incident of the familial bonds that underpin the trust and explain its purpose."

If those familial bonds become strained or broken (as they did here), neither the purpose of the trust to provide for the family as a whole, nor the requirement that the trustee properly inform itself, would change.

While the trust deed did contemplate unequal distributions across the beneficiaries (due to the width of the discretionary powers given to the trustee), the exercise of all of the powers had to take into account the purpose of the trust and the default distribution clause that provided that the three children would be entitled in equal shares.

Distributions that did not provide anything to any of the children were considered by the court as being "remarkable".

As explained in *Pitt v Holt*[14] (*Holt*), there is a distinction between distributions that are plainly beyond power (for example, to a person who is not in fact a potential beneficiary) and those dispositions that are within power, but in respect of which there has been some breach of duty (that is, a distribution to a potential beneficiary where the trustee has failed in its duty to give proper consideration to relevant matters or its duty to give real and genuine consideration to the power).

Using the principles in *Holt* therefore, a breach of trustee duty, for example, due to a failure to give due consideration to the interests of a beneficiary or object of a power, does not automatically lead to the decision being set aside and its consequences reversed. Rather, it is necessary for those aggrieved with the breach to establish that the decision should be set aside; it would then be necessary for the court to determine any defence that might be raised in answer.

That is, the distributions are not void, only voidable – a key factor in *Owies* given that the aggrieved beneficiaries had not applied for the distributions to be set aside. Thus, despite the court concluding that the distributions were inappropriate, they remained undisturbed.

The outcome in *Owies*, where a court-unwinding of historical distributions was essentially only avoided due to a technicality in relation to the way in which the proceedings by the aggrieved beneficiaries were crafted, is a stark reminder for trustees, and trust advisers.

In particular, there are onerous obligations that must be discharged before a trust resolution is valid at law – aside from any questions as to the validity or appropriateness of the proposed distribution from a tax planning perspective.

Furthermore, as shown in a decision involving a well-known Australian business family, namely, *Smorgon v ES Group Operations Pty Ltd*[15] (*Smorgon*), advisers in the tax and estate planning space have additional reason for vigilance in this area.

In *Smorgon*, a disgruntled potential beneficiary of a number of discretionary trusts – despite not being a primary beneficiary of most trusts in the group – applied to court seeking access to a vast array of information concerning the trusts.

While access was denied in relation to many of the trusts, in relation to two trusts where the relevant beneficiary was in fact essentially a "primary beneficiary" (and there were no clauses in the trust deed restricting disclosure), access to the trust deeds, profit and loss statements and balance sheets was given by the court, despite the trustee's attempts to deny the beneficiary.

Related entity assets

The decision in *Lewis v Lewis*[16] is centred on a company restructure, driven by an apparent desire to implement estate planning strategies during the lifetime of the willmaker.

The relevant proposed restructure was summarised in the decision as involving the following broad steps:

- an investment company owned by the willmaker, which owns a significant listed share portfolio, makes a Div 7A loan to the willmaker;
- five new companies, owned by new trusts, acquire the listed shares from the investment company at value,

vendor-financed by the investment company on interest-free and unsecured terms; and

- the vendor-financed loans and are released or forgiven and the investment company is wound up.

Interestingly, the proposal would have triggered a CGT cost of around $500,000. While hindsight always makes restructure planning easier, there were arguably a number of potential alternative pathways that would have achieved the same commercial outcome, without causing a taxable event.

The court confirmed that the transactions would be unwound, with the five companies required to hold all assets on a constructive trust for the original investment company for the following breaches of duty by the willmaker:

- breach of fiduciary and statutory duties as a director by entering into transactions that were not for the benefit of the investment company;
- taking steps whereby the willmaker put herself in a position of conflict between the duty to the investment company and her personal interest – the effect of the transactions was to transfer all of the investment company's assets to five other companies. In particular, the willmaker obtained for herself the power to appoint both capital and income, including to herself to the exclusion of any of her children; and
- breach of the statutory good faith obligations under s 181 of the *Corporations Act 2001* (Cth) to act in the best interests of the corporation and for a proper purpose.

Ultimately, the transactions could only have potentially stood with the informed consent of the other shareholder of the investment company.

In the context of the above case, it is relevant to observe a further key estate planning heuristic, namely, that a willmaker can only transfer assets under the will that they legally and beneficially own. This means that assets ranging from those owned in a joint tenancy, to superannuation fund assets, to assets owned via trusts are all unable to be regulated via a person's will, nor are they able to enjoy access to the CGT roll-over otherwise available on death under Div 128 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).

From first principles, these same rules also apply to assets owned by companies. As seems to be the case in every key area of holistic tax and estate planning, however, care is required in relation to the exception to any general rule.

For assets owned in companies where the willmaker is the sole shareholder and director of the company, there are a series of cases that confirm that it is possible to use a will to mandate the company transfer assets in a certain way. The line of thinking in this regard appears to have first developed in cases in the late 1960s and early 1970s.

For example, in *Re O'Callaghan (dec'd)*,[17] the key relevant conclusion was that where (paraphrasing) "a willmaker who conveys to their executor a direction to reduce into possession an asset not owned by the willmaker, and the executor has from the willmaker the power to do so, the executor is bound to do so, and to deal with it by way of disposition in the way that the willmaker has directed".

In reaching this conclusion, the court referenced a number of early cases that had also supported the outcome, such as *Re Leigh's Will Trusts*[18] and *Re Bowcock (dec'd); Box v Bowcock*.[19]

More recently, in the decision of *Ireland v Retallack*[20] (*Ireland*), no party to the proceedings seemed to question the assumption that the willmaker had the ability to require the executor appointed as "managing director" of a company to deal with the assets of the company as instructed under the will.

While for many estate planning specialists this line of reasoning is unsettling in the context of the mantra that willmakers can only regulate personally owned assets under their wills, on another view, perhaps these cases are simply examples of a pragmatic approach by the courts.

In particular, there would generally be no restriction on a sole shareholder and director achieving their intentions by (for example) amending the constitution for the company specifying issues such as how assets are to be transferred and who the directors will be on certain triggering events, such as death.

> "… the proposal would have triggered a capital gains tax cost of around $500,000 …"

The decision in the case of *Re Lewis's Will Trusts*[21] makes the arguments in the historical cases clear. In this case, the willmaker was the majority shareholder (as opposed to the sole shareholder) in a company. The attempt by the willmaker to mandate how certain assets of the company were to be dealt with on death was held to be invalid. The standard position that assets of a company are not something that individual shareholders have the authority to regulate under their will was confirmed.

At the risk of confusing the position, however, there is authority to suggest an exception to the exception.

In particular, in *Ireland*, the factual matrix was such that the willmaker (who owned 989 of the 990 shares on issue in the relevant company) directed under their will how the assets of the company were to be transferred.

The court confirmed that, so long as the executor "controlled" the company, they were permitted, and indeed obligated, to follow the directions. The only potential limitation to this aspect of the rule was any oppression of the minority shareholder. This possibility was held in this case to be unlikely, given the person holding the one other share was named under the will as the intended recipient of the gift of the company asset.

Arguably, the historical cases highlight a level of ignorance in relation to tax (and duty) consequences. In particular, the gift of an asset by a company due to a direction under a will is likely to trigger both Div 7A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) and CGT consequences (as well as stamp duty), with no roll-overs for the transfers that would generally otherwise be available for gifts under a will.

The decision in *Wheatley v Lakshmanan*[22] provides a modern and detailed analysis of the key rules in this area, with the case starkly highlighting the risks of ignoring the tax consequences of related entities under an estate plan.

At the heart of the factual matrix in this case was a clause in a will that purported to gift to a child of the willmaker an unencumbered commercial property — with a further tax and asset protection-driven direction that the property "be placed into a trust or superannuation fund of (the child's) choice".

However, the relevant property was owned by a company of which the willmaker was, at all material times (ie both at the date of the making of the will and at the date of death), the sole shareholder.

In confirming that the purported gift of the property was ineffective, the court stated:

- the general position is that a willmaker cannot bequeath something that they do not own;
- it may be that, where a willmaker conveys to the executor a direction to reduce into possession an asset not owned by the willmaker, and the executor is armed by the willmaker with the power to get the asset (eg by directing that all relevant assets are to be held on trust under the estate), they will be bound to do so — and then deal with the asset as directed by the will (see *Re O'Callaghan (dec'd)*[23]);
- that is, if there is the conferral of power on executors to deal with shares in a company that owns the assets in question as if they were beneficial owners, coupled with express gifts under the will, this can give rise to an implication that the trustee was required to use the shares of the company to ensure that the assets of the company are transferred as set out in the will;
- that said, the court commented that it may also be that the earlier cases were in fact decided incorrectly — a point that the court did not need to resolve on the basis that, in the will here, the requisite power was not granted to the executor of the will in any event;
- as submitted to the court, the key reason for suggesting that the previous cases may be wrong at law is that they are vague in clarifying how exactly an executor exercising rights as a shareholder can cause the relevant company to divest itself of the assets purportedly bequeathed. That is, the shareholders do not manage the company's affairs, rather, the directors do, and a court should not construe a will in a manner that would or might place the directors in a position where their statutory duties as directors are in conflict with the willmaker's intentions, based on a conflation of ownership with the management (or day-to-day conduct) of a company;
- the further suggestion that there should be a rectification of the will was also rejected due to a lack of evidence that the willmaker intended to create the power for the executor to achieve the gift of the property owned by the company; and
- there was no evidence supporting the ability for the court to correct a "clerical error" — rather, it seemed that either the willmaker did not make clear, or the lawyer drafting the will did not understand, that the property in question was owned via a company.

Ultimately, while the aggrieved beneficiary was granted a cash settlement pursuant to a court order as part of a family provision application, this amount was significantly less than the value of the property in question and was also arguably partially reduced by a tax cost that the estate incurred.

In this regard, a key aspect of the decision related to the tax consequences of the various proposals considered by the court. The potential tax liability was said to be in the region of $1m.

Relying on the advice of a specialist tax adviser, the court made the following observations (in the context of the implications of a company owned by the willmaker distributing one of its assets to a beneficiary under the will):

- the estate, for tax purposes, would be deemed to be a trust under s 6(1) ITAA36;
- any payment of any amount by the company to the executor of the estate would be a dividend assessable under s 44 or Div 7A ITAA36, and, if the moneys were paid to the executor who then used them to pay the purported gift under the will, the recipient of the gift would be subject to income tax on a flow-through basis;
- if instead the company distributed to the estate and no particular beneficiary was eligible to receive those moneys, the trustee would be taxed (at the highest marginal rate) under s 99A ITAA36;
- an argument that the payment by the company to the beneficiary as a form of notional estate order would not constitute a deemed dividend had been rejected by the ATO in a private ruling[24] issued before the trial — the ATO instead determining that the payment would in fact be treated as a deemed dividend under Div 7A;
- this private ruling in turn references TR 2014/5 in concluding that the reasoning from a family law perspective also applies in the succession law setting and, as such, the requirement in s 109J(b) ITAA36 to access an exemption from the deemed dividend regime is not satisfied; and
- the use of the word "unencumbered" in the gift provision of the will was held to be intended to be in its common parlance, that is, referring to mortgages or charges secured on the property, not the embedded tax liability. Thus, any income tax liability should be largely ignored by the court when determining the appropriate provision to be made for the aggrieved beneficiary. This conclusion

was reinforced by the fact that the tax liability only arose subsequent to the sale of the property, on the distribution of the proceeds of sale – and furthermore the purported gift was held to be invalid in any event.

The court also observed that it seemed likely that tax issues "overtook" common sense during the litigation and contributed to the high level of legal and accounting costs, which the court stated it was inclined to place a significant cap on in terms of what the estate would be liable to pay for.

The exact cap in this regard was confirmed in *Wheatley v Lakshmanan (No 2)*.[25] In this subsequent decision, the court held that, in relation to costs that were over $620,000 for the plaintiff and more than $450,000 for the estate, the estate was effectively required to pay its own costs and a net amount of $160,000 of the plaintiff's costs.

This outcome was after a careful analysis by the court, balancing between depriving the plaintiff of a substantial portion of the legacy ordered in her favour and the estate being further burdened by costs. Given the plaintiff received an award of $820,000 as further provision under the initial judgment, her final net position was likely in the region of $350,000.

Tax minimisation, estate planning and asset protection

Where asset protection strategies are problematic due to the tax (and stamp duty) costs of transferring assets, a relatively well known approach is to implement a "gift and loan back" arrangement.

In broad terms, a "gift and loan back" involves the owner of an asset gifting an amount equal to their equity in the asset to a family trust (or low-risk spouse). The family trust then lends an amount of money to the owner and takes a secured mortgage over the property or registers a security interest on the Personal Property Securities Register over the personal assets of the individual that the protection is intended for.

The gift and loan back approach ensures that there are no CGT or stamp duty consequences to achieving asset protection, subject to the claw-back rules under the bankruptcy regime.

Historically, arguably, the leading case in relation to gift and loan back arrangements was seen as *Atia v Nusbaum* (*Atia*).[26] In summary, the circumstances of this case were as follows:

- Dr Atia (a cosmetic surgeon) entered into a gift and loan back style arrangement with his mother;
- when Dr Atia's mother subsequently called in the debt, Dr Atia argued that the loan and mortgage were not intended to be actually binding and were only a pretence to protect against situations where Dr Atia was sued professionally;
- in particular, Dr Atia argued that his mother was only calling in the debt secured by the mortgage because he had married his girlfriend against his mother's express wishes;
- the court found that all aspects of the legal documentation, including a deed of gift, loan agreement and registered mortgage, had been validly signed; and
- the court confirmed that the legal effect of the signed documentation was exactly as the parties intended it to be and there was no mistake or sham involved. This meant that Dr Atia's mother was allowed to enforce recoverability of the debt and, if necessary, exercise her rights under the registered mortgage.

In *Re Permewan*,[27] the focus was on the removal of an executor of a deceased estate. Relevantly, the factual matrix was as follows:

- a son was the executor of a will for his mother;
- the son was involved in assisting the mother in implementing a gift and loan back arrangement to essentially remove all value from the estate around 17 months before the mother's death;
- the legitimacy of the gift and loan back arrangement was being challenged by a daughter of the mother (as a prelude to challenging the estate of the mother for more provision than what was provided for under the mother's will); and
- there were allegations that the son, in his role as executor, had no intention on behalf of the estate in pursuing an investigation of the veracity of the gift and loan back arrangement.

In the subsequent decision of *Re Permewan No. 2*,[28] the court had to determine how the costs of the case should be borne. This was in the context that the son and his lawyers had conceded that the promissory notes (which had been prepared to evidence both the initial gift and the subsequent loan under the arrangement) had not been validly delivered – impliedly in part because the documentation was dated before the date the trustee company of the trust was registered – and thus the arrangement failed.

To reach its decision on costs, the court explained its views on the legitimacy of the arrangements, assuming that the promissory notes had been effective, with a focus on two key aspects, namely, whether the gift and loan back was void due to either:

- public policy; or
- being a sham.

The court concluded, prior to considering the above points, that the mother did not have $3m in cash to pay to the trust if the promissory notes were called on. Rather, she would have had to liquidate her assets and, even if she did so, the obligation to pay CGT on the realisation of those assets would be likely to have left a shortfall.

Furthermore, the court held that the transactions were not a bona fide inter vivos gift as the mother had no intention of disposing of her property during her lifetime.

Instead, it was held that the documents which recorded the transactions were executed contemporaneously with the mother's will and were only ever intended by her to take effect on her death. That is, the trust was never intended to call on the promissory notes or attempt to enforce the loan while she was alive. The court stated that, if that had occurred, the mother would have been placed in the position of having to sell her assets (and pay the CGT) to meet her obligations – and the court believed she never intended to do so. The court concluded that the evidence of both the lawyers and accountants for the mother supported this.

The court also concluded that it was "almost certain" that the transactions would have been unenforceable as being contrary to public policy, because:

- the transactions were illusory in that, contrary to reality, they were designed to make it appear that the mother had departed with her property. That conduct amounted to dealing with her property in a testamentary fashion;
- the sole purpose of the conduct was to ensure that there was so little, if anything, left in the estate on death (meaning any challenge against the estate would have no prospect of success); and thus
- the effect of enforcing the transactions would have been to defeat or circumvent the public policy on which the rules concerning challenges against estates are based and would thereby be generally regarded as injurious to the public interest.

The court also concluded that it was "almost certain" that the transactions were a sham, as:

- despite the promissory notes, there was never any intention for the mother or the trust (which she controlled) to pay the amounts of the gift or loan (and trigger the CGT costs); rather
- the transactions were only ever intended by her to take effect on death.

The conclusions in *Permewan No. 2* in relation to both the public policy and sham aspects are on one view only relevant to the question of costs in that particular case. That said, the comments made by the court are a radical departure from cases such as *Atia* (which was not considered in *Permewan No. 2*) where, on an ostensibly similar factual matrix, the concept of a gift and loan back arrangement being void as a sham was expressly rejected. This was on the basis that, where the implementation documentation evidences a genuine agreement reached between the parties, the suggestion of a sham is untenable. That is, where the documents are, on their face, effective, it is not for the court to speculate about the reasons for the transactions being entered into.

Furthermore, a transaction is not a sham merely because it is carried out with a particular purpose or object. If what is done is genuinely done, it should not be deemed to be "undone" merely because there was an ulterior purpose in doing it, such as managing CGT costs or protecting assets from creditors (see *Donnelly v Edelsten*[29] being another, arguably very relevant, case not considered in *Permewan No. 2*).

Similarly, these earlier cases did not entertain any arguments in relation to public policy being a relevant consideration when determining the effectiveness of a gift and loan back arrangement – arguably, at least in part, because, if there was in fact a public policy concern with arranging personal affairs to minimise the risk of a challenge against an estate, the notional estate regime (as exists in New South Wales) would be law in other states.

While the comments in *Permewan No. 2* concerning gift and loan back arrangements are not binding on any other court, they create significant uncertainty for advisers in this area, given the decision completely ignores other leading decisions in the area that each reached contrary conclusions.

At a minimum, *Permewan No. 2* is a reminder for advisers in this area that they must ensure that all legal documentation is validly implemented. Furthermore, advisers must ensure that the relevant asset owner is aware of and, if necessary, willing to incur the CGT consequences of disposing of the assets the subject of the gift and loan back arrangement.

Superannuation and estate planning

The "notional estate" rules that apply in NSW provide that, in certain circumstances, assets or estates that have a connection to NSW, that are not owned personally by a deceased, can still be subject to attack when the estate itself is challenged.

The potential range of assets at risk under the notional estate regime is highlighted by the decision in *Benz v Armstrong*.[30]

In a situation where the personal assets of the deceased, that would have passed to children from his first marriage under the will, were negligible, the application of the notional estate provisions instead created a pool of available assets in the region of $18m.

While the second wife of the deceased (who would have otherwise received all of the wealth) retained more than half of the assets, four adult children from the first marriage received amounts in the region of $1m (two children) and $2m (two children, noting that one child appears to have secured their payment by calling in a credit loan owed by a family trust (controlled by the deceased) to that child, that was held to be repayable on demand).

The allocations to the adult children were despite the fact that the court concluded that all of the children had a relatively privileged childhood, including attending private schools and receiving a university education. Further, none of the children had particularly dire financial or medical issues.

The court confirmed its view that the deceased's testamentary intention was that his children receive an inheritance from him.

Furthermore, given the deceased had a moral obligation to his children, it was extraordinary to think that (in the absence of some far more serious fracture in the relationship with his children) the deceased would have intended his children to obtain nothing at all from his very large estate, particularly when the second wife had already obtained substantial wealth, both through the relationship and under the will.

Specifically, in relation to the notional estate regime, the court confirmed that:

- all parties appear to have accepted that the family trust fell within the description of "a paradigm case for the intended application of the notional estate provisions". However, given (following the repayment of the credit loan) there would likely be a deficit in the trust, this aspect was not considered further;
- in relation to the deceased's superannuation entitlements (that were in the region of $13m and were subject to a valid binding death benefit nomination (BDBN) within three years of the date of death), the court also concluded that these should form part of the notional estate – even though the death benefit payment would have been received tax-free by the surviving spouse, and instead would be taxable on reallocation to adult children;[31]
- the court acknowledged that, in the case of *Carr v Douglass*[32] (*Carr*), it was held that the failure to renew a BDBN could trigger the notional estate rules as at the date of failure (not at the date of death) because it denied the estate the benefit of the deceased's interest in the superannuation fund. However, the relevant date being the date of failure (as opposed to the date of death) meant that, under the rules, the necessary intention to defeat a notional estate claim also needed to be proved;
- the court also quoted the decision in *Wardy v Salier*[33] that the purpose of the notional estate provisions is to extend the powers of the court in NSW to the full range of benefits and advantages controlled by willmakers, and therefore, insofar as any question of construction presents a choice, an approach that promotes this purpose is preferred;
- thus, here the deceased's failure to revoke his BDBN in the 12 months prior to death (the time period within which the intentions of the deceased are irrelevant[34]) and give a replacement BDBN (in favour of his legal personal representative, to ensure that the entitlements passed into the estate for distribution under the will) was a transaction within the meaning of the notional estate rules, and would also have been caught had there been a failure to make any BDBN at all;[35]
- ultimately, the court concluded that the omission to revoke a BDBN was analogous to an omission to sever a joint tenancy (another situation that is subject to claw-back under the notional estate rules) in light of the fact that the deceased's BDBN could have been revoked at any time prior to death. Therefore, it was not until the moment of death that the failure took effect;
- while this conclusion was acknowledged to perhaps be inconsistent with the reasoning in *Carr*, a distinction was drawn between the omission to renew a BDBN (which was said to take effect when the BDBN lapses) and the failure to revoke or change a BDBN (which subsists up until the date of death); and, furthermore,
- the reasoning in *Carr* was questioned, given other cases where the absence of a valid BDBN meant that the transaction took effect on the resolution of the trustee to distribute the death benefits following the death of the superannuation member. In other words, it was held unnecessary to establish that the failure to revoke was with the intention (wholly or partly) of denying or limiting provision out of the estate within the meaning of the notional estate regime.

In the context of this case, it seems clear that only the removal of funds from superannuation, or a BDBN that is non-lapsing and "double entrenched" in the trust deed (ie unable to ever be changed) – and, in each instance, implemented at least three years before the date of death (the relevant time period for claw-back where the deceased has the intention of defeating claims[36]) – will be outside the NSW notional estate regime.

Non-lapsing BDBNs

For many years, there was a level of debate about whether self-managed superannuation funds (SMSFs) were permitted to offer BDBNs and if so, whether any such BDBN would automatically lapse after three years.

According to reg 6.17A(7) of the *Superannuation Industry (Supervision) Regulations 1994* (Cth) (SISR94), a BDBN regulated by that provision lapses:

- at the end of the period of three years after the day it was first signed, or last confirmed or amended, by the member; or
- if the governing rules of the fund fix a shorter period – at the end of that period.

A similar level of confusion arguably existed in relation to the form of a BDBN, for example, if witnesses are needed, how many should there be? This confusion existed despite the fact that the ATO answered the question succinctly in 2008,[37] where the Commissioner confirmed the view that s 59 of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA93) and reg 6.17A SISR94 do not apply to SMSFs.

That is, the governing rules of an SMSF may permit members to make death benefit nominations that are binding on the trustee, whether or not in circumstances that accord with the rules in reg 6.17A SISR94 (including, as one example, if witnesses are needed and, if so, how many are needed).

The decision in *Hill v Zuda Pty Ltd*,[38] as relevantly confirmed by the High Court in *Hill v Zuda Pty Ltd*,[39] provides judicial support for the longstanding approach of the ATO. In this case, the court also specifically confirmed the interpretation that s 59 SISA93 and reg 6.17A SISR94 do not apply to SMSFs, and cross-referenced the decisions in *Munro v Munro*[40] and *Cantor Management Services Pty Ltd v Booth*[41] as further support for this conclusion.

This meant that the failure of the BDBN to comply with reg 6.17A (in that it was made more than three years before the death of the member and was not witnessed by two witnesses) was irrelevant to the question of whether it was binding on the trustee of the SMSF.

Similarly, the position in relation to non-lapsing BDBNs for non-SMSFs (eg retail, industry, corporate and small APRA funds) has also been the subject of longstanding debate.

The approach that appears generally accepted for non-SMSFs and BDBNs can be summarised as follows, noting that APRA has specifically confirmed in *Prudential Practice Guide SPG 280 – Payment standards* that non-lapsing BDBNs are possible:

- "standard" BDBNs are lapsing and will comply with s 59(1A) SISA93. This means that they will also be regulated by, and need to comply with, reg 6.17A(7) SISR94;[42]
- it is possible, however, for non-lapsing BDBNs to be created under s 59(1)(a) SISA93. This section is not caught by reg 6.17A(7) SISR94 and therefore any BDBN made pursuant to this section does not automatically lapse;
- arguably, the key aspects of ensuring that the non-lapsing BDBN is in fact valid are that the trust deed for the fund must permit the approach and that the trustee of the fund must consent to the BDBN and the form it can be made in[43] (for example, including the number of witnesses); and
- in contrast, standard lapsing BDBNs do not require the consent of the trustee.

Conclusion

For tax and estate planning advisers, the complexities from the interaction between revenue-related legislation and decided cases across key areas such as tax, trusts, superannuation, wills and estates have become increasingly problematic.

As observed previously, significant and ongoing changes appear to be the "new normal" for all advisers specialising in holistic tax and estate planning as we head into 2023.

Matthew Burgess, CTA
Director
View Legal

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17 [1972] VR 248.

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19 [1968] 2 NSWR 697.

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21 [1985] 1 WLR 102.

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34 S 80(2)(b) of the *Succession Act 2006* (NSW).

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37 SMSFD 2008/3.

38 [2021] WASCA 59.

39 [2022] HCA 21.

40 [2015] QSC 61.

41 [2017] SASCFC 122.

42 Which mandates a number of specific requirements in relation to issues such as the information that the trustee must provide the member, the avatar of the recipient, the manner in which the BDBN is witnessed, and the fact that the maximum length of time the BDBN can remain valid is three years.

43 S 59(1A) SISA93.

Case note: E Group Security appeal

by Amanda Guruge, CTA, Associate Lawyer, and Bruce Collins, CTA, Principal Solicitor, Tax Controversy Partners

The security industry commonly uses contractors to provide services to its clients. In the series of *E Group Security* cases, the courts considered whether payments to service providers met the definition of an "employment agency contract", and therefore whether the taxpayer had a payroll tax liability. At first instance, Ward J focused on ss 38 to 40 of the *Payroll Tax Act 2007* (NSW) which provided the statutory basis for employment agency contracts. Ward J focused on the *UNSW Global* test which looked at the "intended scope of the employment agency contract" to determine liability. On appeal, Bell CJ, Gleeson and Leeming JJA stated that there were "no compelling reasons to depart from the *UNSW Global* test". The court suggested legislative change would be required to address the Chief Commissioner's continued invitations to alter the meaning of the current legislation, as this would be applicable across all jurisdictions, not just in New South Wales.

On 6 July 2022, the Court of Appeal of the New South Wales Supreme Court made an important decision in *Chief Commissioner of State Revenue v E Group Security Pty Ltd*.[1] This was an appeal from the original decision of the NSW Supreme Court.[2]

The original case considered whether the taxpayer had a payroll tax liability for payments made to service providers – specifically, for security guard services. The case focused on an age-old argument that taxpayers continue to have with the state and territory revenue agencies: whether the relationship between the taxpayer and the service providers met the "employment agency contract" requirement in the payroll tax legislation.

The appeal case focused on whether the precedent set in *UNSW Global Pty Ltd v Chief Commissioner of State Revenue*[3] (*UNSW Global*) was the appropriate test to apply, or whether the decision in *Bonner v Chief Commissioner of State Revenue*[4] should instead be applied.

Facts of the case

E Group Security was the main operating entity that provided security services to clients. The security services provided included typical security guard services (eg patrolling buildings, maintaining static security posts, boom gate or access control, and crowd control) and other non-stereotypical services (eg concierge, loading dock control, and weighbridge services).[5]

There was a re-branding in 2018 that caused some initial confusion, where one of the wholly-owned subsidiary entities was referred to as the "Employer – EGroup Payroll Company".[6]

E Group Security was the entity in the group that would enter into contracts with end-user clients. It was also the entity that would enter into contracts with third-party contractors for the supply of subcontractor security guards.[7] One exception to this arrangement was in 2017, when contracts with clients and third-party contractors were entered into by a wholly owned subsidiary, Vital Security Group Pty Ltd.[8]

E Group Security had more than 600 clients, over a variety of industries, grouped into the following categories: NSW Government clients; community non-profit establishments; sports organisations and events; superannuation funds, strata plans, landlords, property owners and trusts; one food industry client; builders and construction clients; retailers; hotels and pubs; and one-off and short-term clients.

Assessments

On 31 August 2018, the NSW Revenue Chief Commissioner assessed E Group Security for payroll tax liability for the 2015 income year. On 3 September 2018, E Group Security received further payroll tax assessments for the 2016 to 2018 income years. These assessments were made following an earlier audit, where it was concluded that E Group Security was already compliant with its payroll tax obligations.

The assessments related to payroll tax in respect of wages paid to subcontractors providing security services.

Issues at first instance

The main issue in dispute was whether the arrangements between E Group Security and the client (who received the services) constituted an "employment agency contract", as defined in s 37 of the *Payroll Tax Act 2007* (NSW):

> "(1) For the purposes of this Act, an **'employment agency contract'** is a contract, whether formal or informal and whether express or implied, under which a person (an **'employment agent'**) procures the services of another person (a **'service provider'**) for a client of the employment agent.
>
> (2) However, a contract is not an employment agency contract for the purposes of this Act if it is, or results in the creation of, a contract of employment between the service provider and the client.

(3) In this section –

'contract' includes agreement, arrangement and undertaking."

A secondary issue was whether interest charged on any payroll tax owing should be remitted in whole or in part. (Given the court's decision on the payroll tax liability questions, it was unnecessary to address this secondary issue.)

E Group Security contentions

E Group Security did not dispute that the services it was providing met the statutory definition of "client" and "procures" for the purposes of s 37. However, it did dispute that the services were procured "for" its clients. This was a specific reference to White J's statement in *UNSW Global*.[9]

An alternative argument made was:[10]

> "… E Group Security says, first, that , when those arrangements are correctly understood, the wholly-owned subsidiaries do not 'procure' the services of security guards for the plaintiff (as the wholly-owned subsidiaries are not involved in any contractual relationship with the third-party subcontractors and simply perform a payroll function for E Group Security – the contractual relationship by which the services are procedures being said to be between the plaintiff and the third-party subcontractors); and, second, that E Group Security is not a 'client' of its wholly-owned subsidiaries in the relevant sense."

What did the Supreme Court decide at first instance?

Ward J focused on ss 38 to 40 of the *Payroll Tax Act 2007* which provided the statutory basis for employment agency contract arrangements.

Ward J referenced and then cited White J's statements in *UNSW Global*:[11]

> "Relevantly, in *UNSW Global* at [62], White J, as his Honour then was, construed the word 'for' in s 37(1) such that a contract is only an employment agency contract if the asserted employment agent procures the services of another person 'in and for the conduct of the business of' the asserted employment agent's client. His Honour considered that this construction gave effect to the intended scope of the employment agency contract provisions, which (at [63]–[64]) his Honour said:
>
> > 63. … were intended to apply to cases where the employment agent provided individuals who would comprise, or who would be added to, the workforce of the client for the conduct of the client's business …
> >
> > 64. One of the hallmarks of an independent contractor is that he or she carries on his or her own business. But sometimes that is done, or is said to be done, by the individual, in substance, working for the client in the same way as would an employee of the client. Where the services of the individual are provided through the intermediary, that is, the employment agent, to help the client conduct its business in the same way, or much the same way, as it would do through an employee, then the arrangement is within the intended scope of the section."

Ward J stated that other more recent decisions had followed the same test set as in *UNSW Global*.

Ward J concluded that there were no "employment agency contracts" in the arrangements between E Group Security and its clients. Ward J stated:[12]

> "Furthermore, let it be assumed that client participation in determining the parameters of an SOP (whether by way of suggesting or request) did occur from time to time (or can be said to have occurred by way of the setting or monitoring of performance to stipulated KPIs), I do not accept that this would necessarily amount to sufficient control or direction to warrant a conclusion that the security guards were integrated into the clients' workforce. There seems no doubt at a practical level that E Group Security personnel were required to perform their tasks at the client's premises subject to the direction and instruction of their E Group Security supervisors. In that regard, I accept the evidence of those responsible for supervision of the security operations at various of the clients' sites to the effect that, on the ground so to speak, the security guards were directed to comply with E Group Security's instructions and to report back to E Group Security. Responding to a request from a client (or answering a query from a customer of the client) does not change that)."

Ward J also referenced the Chief Commissioner's "complaint" that the contractual documents were incomplete. Ward J referenced E Group Security's evidence which included "that for a large number of clients … the arrangements were not in writing and were conducted by telephone calls".[13]

E Group Security focused on its obligations under the *Security Industry Act 1997* (NSW). During the course of the matter, evidence from third parties (client representatives and previous E Group Security personnel) corroborated the consistent picture that E Group Security "takes its security licensing obligations very seriously and that E Group Security maintains control over the supervision of the security guards it provides to clients".[14]

Ward J listed the following factors to be relevant when making the decision as to whether the subcontractor services were provided "in and for" the client's business:

- location: this was generally the client's premises, occasionally a roving location;
- regularity: in the commercial sector, the services were regular, but more ad hoc in the health and events sector and for short-term/one-off clients;
- level of interaction with client's customers: this varied but generally there was some interaction;
- level of direction or instruction: there was some direction or instruction reserved to the client under the contractual

documentation, but it did not extend to the control over or giving of binding instructions as to security decisions that are required to be made under the legislation by a security licence holder;

- access to and use of client staff facilities: this was limited or non-existent in most cases (except for one client, where security was required in staff areas, and other people, such as police officers, had access to the area); and
- significance of services being provided: there was a necessity and significance for clients of the security services, and clients may or may not have been in a position to obtain or hold a licence to perform those services themselves.

The decision went on to specify circumstances that were relevant to specific industries. For example, for club and pub clients, Ward J stated:[15]

> "… as to the Club and Pub Clients and the like; … I see the E Group Security personnel as not sufficiently integrated into the client's workforce. In general, the evidence is that the security guards use public facilities, that they take instruction from E Group Security, and that they wear distinguishing clothing. While they provide an integral function for the clients, they are not an addition in the sense of being integrated into the workforce."

Commissioner's contentions during the appeal

The Chief Commissioner contented that "the *UNSW Global* construction imposed an unwarranted gloss upon the definition of employment agency contract, thereby departing from and narrowing the statutory text, contrary to ordinary principles of statutory construction".[16]

The Chief Commissioner focused on the legislative history of s 37. He cited the original wording in the 1985 amending legislation:[17]

> "… the worker does not become the employee of either the agent or the client but does carry out duties of a similar nature to those of an employee."

The amending Act was repealed two years later and, in 1998, the current version was added. He argued that the word "for" emphasised in *UNSW Global* went against the intention of the legislation.

What did the Court of Appeal decide?

Bell CJ, Gleeson and Leeming JJA stated in their decision that there was "no compelling reason to depart from the *UNSW Global* test". The court stated:[18]

> "Even so, if the construction in *UNSW Global* were palpably wrong, this Court would overturn it. However, there is no suggestion that the construction in *UNSW Global* was unsatisfactory or inefficient or in any way took the Chief Commissioner by surprise. Indeed, White J recorded at [26] that it was the *Chief Commissioner* who propounded the test which he adopted as correct:
>
> 'the Chief Commissioner stated that he assumed that the "commonly understood" description of a "labour hire firm/agent" is an entity that procures persons to provide their labour "in, and for the purpose of, the ordinary conduct of the clients' businesses". In his contentions the Chief Commissioner agreed that EOS consultants typically did not perform services "in and for the purpose of, the ordinary conduct of the clients' businesses" and were required to undertake only limited reporting, advisory and consultation tasks.'"

Further in support, the court stated:[19]

> "The construction in *UNSW Global* accords with the purpose of the Act, by taking relationships which fall short of traditional employer/employee relationships and deeming them to be such. There is nothing to suggest however that Division 8 should entirely outflank its role as an add-on to common law notions of employment. This is not impermissibly to gloss the section. It is to recognise that the preposition 'for' is protean and is capable of bearing a very wide range of meanings depending upon context, and the presently relevant context is its appearance in provisions which create a legal fiction – a deemed relationship of employer and employee – in a *Payroll Tax Act*."

Future of payroll tax legislation

This decision not only impacts the security industry, but also other industries that heavily rely on subcontractor labour to provide the ultimate service to their clients, for example, the cleaning, road transport and construction industries.

At the end of the decision, Bell CJ, Gleeson and Leeming JJA made statements about the significance of harmonised payroll tax legislation across Australia.

Since 2007, Victoria, New South Wales, Tasmania, South Australia, the Australian Capital Territory and the Northern Territory have implemented harmonised legislation. Queensland amended its existing legislation in 2007 to align with the key provisions. And in 2012, Western Australia enacted similarly aligned provisions. As a result, all Australian states and territories now have very similar payroll tax legislation, reflecting the same concepts across each jurisdiction. With harmonised legislation, it became easier for employers who act in multiple locations.

The court suggested that legislative change would need to be made to give effect to the Commissioner's arguments:[20]

> "… The consequence is that for practical purposes, the Chief Commissioner is inviting this Court to alter the legal meaning of legislation which is in force not merely in New South Wales, but throughout the country.
>
> Still further, the effect of this Court accepting the Chief Commissioner's invitation is that the change in the legal meaning of the law will have retrospective effect. It is far from improbable that there will be pending disputes and pending litigation which will be affected. As well, a number of harmonised rulings have been issued which

> turn on the operation of the employment agency contract provisions (including PTA027, PTA028 and PTA029, each of which is in force in every State save for Western Australia).
>
> It is in those circumstances far better for the law to be changed, if indeed it is to be changed, by legislation, and with clearly stated transitional provisions."

Overall, in the absence of any such legislative change being implemented in the harmonised payroll tax laws, this important case confirms that the *UNSW Global* test still represents the most applicable approach for such potential employment agency contract cases. The authors suggest that this has obvious impacts on how state and territory revenue agencies should now be treating current and future cases in relevant industries that rely heavily on subcontractor labour.

Amanda Guruge, CTA
Associate Lawyer
Tax Controversy Partners

Bruce Collins, CTA
Principal Solicitor
Tax Controversy Partners

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A Matter of Trusts

by Will Monotti, Sladen Legal

Lost trust deeds

Recent decisions of the Victorian Supreme Court have confirmed that the consequences for trustees are potentially disastrous if trust documentation is mislaid and cannot be located.

The trustee of a trust has a duty to keep proper accounts and records of the trust.[1] This includes an obligation to keep track of all documents which detail the terms of the trust, including the initial deed as well as subsequent deeds of variation or amendment. Technology has simplified this process to an extent, allowing for electronic copies of documents to be stored and accessed quickly. However, and in particular where the trust was set up decades ago before the advent of "scanning to .pdf", lawyers, advisers and their clients often find themselves searching for copies of old deeds, without which the terms of the trust may be uncertain.

The Victorian Supreme Court has recently handed down three decisions, each with subtly different fact scenarios, that related to missing trust documents.

Mantovani: where only the schedule page survives

In *Mantovani v Vanta Pty Ltd (No. 2)*,[2] it was common ground between the parties that the deed of the Mantovani Family Trust was lost. The only document that could be located in relation to the trust was the schedule page to a deed, which provided a date of 27 July 1976. The schedule page also listed the name of the trust, its settlor, trustee, settled sum, appointer, and beneficiaries.

Various properties were transferred from Teresa Mantovani to Vanta Pty Ltd (Vanta), the purported trustee of the trust, in the 1970s and 1980s.

One of Teresa's children, Giovanni, lived in a property that was owned by Teresa and had done so for several decades. Giovanni was not a director of Vanta, and was not named as a beneficiary of the trust in the schedule page that had been located.

A dispute arose between Giovanni and two of Teresa's other children, who were the directors of Vanta, after Teresa's death. The executors of the estate wished to sell the property that Giovanni lived in to enable them to cover estate debts. In response, Giovanni brought the matter to the Supreme Court, seeking a declaration that the trust had failed for uncertainty, and that the properties held by Vanta be held on resulting trust for the estate of Teresa.

At para 53 of the judgment, McMillan J set out the following six-step test to determine the consequences of the loss of the trust deed for the trust:

"(a) **Question 1:** Is the Deed lost?

(b) If yes to question 1 – **Question 2**: Can secondary evidence be relied upon to prove the existence and contents of the Deed?

(c) If no to question 2 – **Question 3**: Can the presumption of regularity be relied upon to save the Family Trust?

(d) If no to questions 2 and 3 – **Question 4**: Does the Family Trust fail for uncertainty?

(e) If yes to question 4 – **Question 5**: Should a declaration be made that Vanta holds the trust property on resulting trust for Teresa's estate?

(f) If yes to question 5 – **Question 6**: Should an order for the taking of accounts and payment of monies owed to Teresa's estate be made?"

It was common ground that the deed had been lost – extensive searches had been undertaken by all parties, to no avail, and so the answer to question 1 was "yes".

Although the schedule page confirmed the existence of a trust deed, it did not clarify the contents of that deed. Important matters such as the nature of the trust (ie whether it was fixed or discretionary), the basis for which trust distributions could be made, the vesting procedure, the existence of any additional beneficiaries, or the means by which the trustee could manage trust assets were not able to be discerned from the schedule page alone.[3] Additional documentation, such as recent financial statements and tax returns for the trust, were not sufficient to assist in enlightening the court as to the trust's terms.[4] Hence, the answer to question 2 was "no".

The answer to question 3 was also "no", as precedent provided that the presumption of regularity was to be "expressly rejected in cases where the substantive content of a deed of trust was in issue", and was limited in application to matters relating to adherence to formal requirements and due execution.[5]

McMillan J held that, in relation to question 4, the trustee had administered the trust for many years, apparently without any knowledge of its terms. This "guesswork" amounted to a breach of trust. Further, the loss of the deed rendered the trustee incapable of determining how it *could* act in future in that capacity, meaning that there was no basis on which the trust could continue to operate. The court therefore held that the trust failed for uncertainty.[6]

In regard to question 5, McMillan J noted that, aside from the settlor's purported gift of the settled sum, it was Teresa who had gifted all of the property into the trust, and her Honour described Teresa as "the provider of the trust property". Consequently, it was determined that it was "Teresa in whom the equitable interest vests and in whose favour the resulting trust has arisen".[7] Teresa's (futile) attempts to give away some of the properties purportedly held in the trust by her will were also relevant in McMillan J finding that a resulting trust existed in favour of her estate.[8] McMillan J also ordered (pursuant to question 6) that Vanta provide accounts for the period commencing six years before the institution of proceedings to Teresa's estate.[9]

Barry McMahon Nominees: the importance of exhaustive searching

The decision in *Application by Barry McMahon Nominees Pty Ltd*[10] concerned the BL & KM McMahon Family Trust. The plaintiff, being the trustee of the trust, deposed that the original deed could not be located, although one of the parties to it deposed that it was signed on or around December 1975. A 1997 deed of variation was located, which recited various provisions allegedly in the original deed, including a power of variation.

The plaintiff wished to execute a deed to, effectively, adopt new provisions of the trust. The purpose of this was to deal with some properties that were said to be assets of the trust. The trustee wished to distribute one of the properties to a beneficiary in specie, and to develop and sell the others and distribute the proceeds to beneficiaries thereafter.

The court declined to make orders in relation to whether this new deed could be executed. McMillan J noted that there was "a dearth of evidence about the circumstances surrounding the creation and execution of the trust deed" presented to the court.[11] McMillan J was not satisfied that the plaintiff had made exhaustive enquiries when attempting to locate the deed, and considered that further enquiries should have been made regarding the law firm that drafted the 1997 deed of variation, and regarding a law firm that one of the parties to the original deed had customarily used in the 1970s. Further, evidence was not submitted to confirm whether one of the directors of the trustee company at the time had signed the original deed. The plaintiff was thus permitted to file further evidence and further written submissions for the court to consider before any direction was given.

Cleeve Group: when an unexecuted copy only of the deed exists

In *Re Cleeve Group Pty Ltd*,[12] the applicant, Cleeve Group Pty Ltd, sought advice from the court as to whether it could continue to act as trustee of the Cleeve Group Trust, when only an unexecuted copy of a trust deed, prepared on or around December 1999, could be located.

The deed in question was prepared by a law firm acting on instructions from an accounting firm advising the applicant. The law firm prepared the trust deed based on their firm's precedent document.

The applicant had, at all times since December 1999, acted as though it was the trustee of the trust. In that capacity, the applicant had opened a bank account, guaranteed a loan, made loans, entered into investments, made distributions, prepared financial accounts, and lodged tax returns in its purported capacity as trustee of the trust.[13]

Although no executed original or copy of the deed could be located, the court held that a deed had been executed based on the evidence submitted. This included:

- evidence of the lawyer responsible for executing the deed who deposed that it was "highly unlikely" that the documents had not been signed. She recalled executing a precedent trust deed in the form prepared by the law firm. She was also listed as the settlor in the deed and deposed that she had only ever acted as the settlor of a trust once in her career. She also recalled making payment of a settled sum;
- a bank account had been opened and a charge given by the applicant. It was noted that, ordinarily, a bank will not open an account for a trust until it is provided with a copy of an executed trust deed; and
- the bank had charged the trust for "Trust Deed Perusal", implying there was a trust deed that it had reviewed.[14]

As in the other cases discussed in this article, the court had to determine whether the deed had been lost, and, if so, what constituted the terms of the trust. Gorton J held that the trustee had made reasonable efforts to locate the deed, including making enquiries of law firms, accounting firms, banks and the ATO, and therefore it was appropriate to conclude that the executed deed had been lost.[15]

Gorton J held that the provisions of the unexecuted deed constituted the trust deed. His reasons for this included that:

- evidence was submitted showing that a draft of the deed was prepared by the law firm and sent to the accountants that retained the law firm, and then sent to an adviser of the family;
- the terms of the unexecuted deed suggested that the law firm was acting on specific instructions from the family;
- the law firm was paid for its work in preparing the deed;
- the lawyer who recalled executing the trust deed (who was also the listed settlor), recalled paying the settlement sum, and recalled being settlor only once in her career; and
- a guarantee and indemnity given by the trustee that was prepared by the bank listed the settlor as the one stated in the deed.[16]

Conclusion

These decisions confirm that, if trust documents are lost and cannot be subsequently located, the consequences for the trust itself can be as significant as the trust failing on the grounds of uncertainty. Record-keeping processes for trustees of privately managed trusts, such as discretionary trusts, self-managed superannuation funds and unit trusts, are thus critical. Even in the matter of *Cleeve Group*, where the outcome for the trustee was favourable, the expenses incurred in seeking the court's direction as to whether the unexecuted deed was valid could easily have been avoided had a signed copy of the deed been kept on the trust file.

If trust documents cannot be found, then, short of taking the matter to court, a trustee may be able to execute a deed of confirmation and/or rectification to confirm the terms of a missing or unexecuted trust document. However, there is no certainty that the court would accept that such a deed was effective if the trust was later the subject of a dispute, especially if the deed did not set out clear and convincing evidence of the terms of the trust that were to be confirmed and/or rectified. In the circumstances described in the *Mantovani* decision, for instance, where no trust terms could be located whatsoever, it is difficult to accept that any deed of confirmation would have been effective. All parties to the missing document would also need to be party to such a deed, which may be challenging if the lost document dates back several decades.

If there is a problem as to execution or adherence to formal requirements of a trust deed, it may be that the trustee or the settlor could execute a statutory declaration to clarify matters. Again, while this evidence may be of assistance, it would not provide the same certainty as a direction of the court and would not guarantee rectification of the issue.

Advisers to trustees should ensure that good practice management systems are in place to minimise the risk of trust failure if documents are mislaid.

Will Monotti
Senior Associate
Sladen Legal

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1 See *Byrnes v Kendle* [2011] HCA 26 at [42]–[43] per Gummow and Hayne JJ.

2 [2021] VSC 771.

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4 Ibid at [78].

5 Ibid at [84]; see also *Chase v Chase* [2020] NSWSC 1689.

6 [2021] VSC 771 at [102]–[106]

7 Ibid at [117].

8 Ibid at [116].

9 Ibid at [138].

10 [2021] VSC 351.

11 Ibid at [56].

12 [2022] VSC 342.

13 Ibid at [1].

14 Ibid at [27].

15 Ibid at [31]–[32].

16 *Re Cleeve Group Pty Ltd* [2022] VSC 342 at [39]–[48].

Superannuation

by Cassandra Hurley and
Daniel Butler, CTA, DBA Lawyers

Employee or contractor — payroll tax: part 3

Businesses must be aware of the wide net that is cast by the payroll tax legislation, as many contractors are likely to be caught unless an exception can be obtained.

Overview

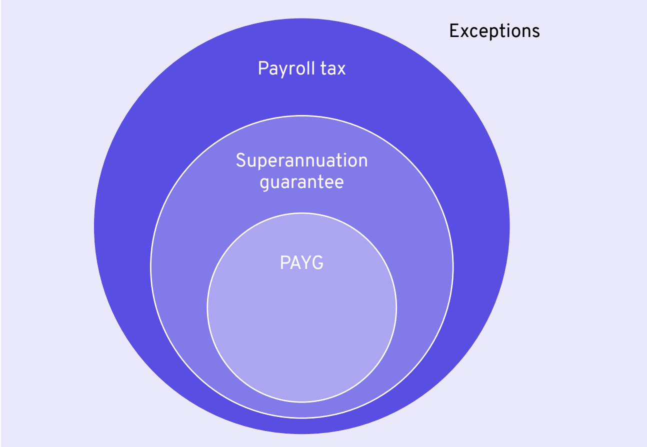
Payroll tax is a tax imposed by each state and territory in Australia where the employer's taxable wages (including any employer superannuation contributions and assessable "fringe" benefits) exceeds the relevant threshold for the period. Payroll tax is levied on wages paid by an employer to an employee and also covers certain payments to contractors. In particular, payroll tax can be imposed on payments to contractors under the "relevant contract" provisions.

As previously discussed in this series of articles on employees versus contractors, how the relationship between a worker and a business is documented and managed is key to such things as employee entitlements (eg annual and long service leave entitlements, unfair dismissal and other employee protections), PAYG and the superannuation guarantee (SG) regime. The state and territory payroll tax regimes expand the payroll tax net even wider under the "relevant contract" provisions than the PAYG and SG regimes (as shown in Diagram 1).

This article provides a top-level summary of the payroll tax regime and focuses on the "relevant contract" provisions. Fortunately, most Australian states and territories have harmonised many aspects of their payroll tax legislation. However, legislation in the appropriate jurisdiction should be checked to ensure that the relevant rules are complied with, especially as each state and territory has established its own payroll tax rates, thresholds and registration criteria. As this article provides an overview of payroll tax, unless express reference to a particular jurisdiction is made, the authors' comments refer to the Victorian payroll tax legislation.

The Payroll Tax Australia website (www.payrolltax.gov.au) provides links to legislation in each state and territory. As you would appreciate, significant penalties can be imposed for non-compliance, late lodgment and the like.

Diagram 1. The breadth of the net for the key taxes (the superannuation guarantee is a tax)



Payroll tax legislation

As a broad overview, payroll tax is levied on wages paid or payable by an employer to its employees. A liability to pay payroll tax is triggered when the total taxable wages of an employer exceeds a threshold amount.

If the threshold amount is exceeded, that employer is liable to pay payroll tax in the relevant state or territory. The threshold amount is the total taxable wages of an employer paid or payable across all states and territories. For example, in Victoria, the threshold is $700,000 compared to $2,000,000 in the ACT. Payroll tax is self-assessed by each employer. Note that related entities are grouped to determine the payroll tax liabilities of a group of employers.

If a worker meets the legal definition of an "employee", the employer will be liable to payroll tax on payments of taxable wages.

When determining whether an employer–employee relationship exists, the typical tests are applied. Where there is a comprehensive written contract, the courts focus on the rights and obligations under that agreement to determine whether the relationship is that of employer–employee or one of principal and contractor. If there is no comprehensive written contract, the court will apply a multi-factorial test to determine whether the person is an employee or a contractor. For guidance, please refer to the earlier articles in this series.[1]

Payments to contractors can be liable to payroll tax

As noted above, payroll tax extends beyond the typical employer–employee relationship to cover payments to contractors. Broadly, there are three key steps when determining whether there is a payroll tax liability in respect of a payment to a contractor:

1. determine whether the person is an employee (refer to the earlier articles in this series[1]);
2. determine whether the contract is a relevant contract; and
3. if the contract is a relevant contract, determine whether any exclusion applies.

What is a relevant contract?

Section 32 of the *Payroll Tax Act 2007* (Vic) provides:

> "(1) In this Division, a ***relevant contract*** in relation to a financial year is a contract under which a person (the ***designated person***) during that financial year, in the course of a business carried on by the designated person –
>
> (a) supplies to another person services for or in relation to the performance of work; or
>
> (b) has supplied to the designated person the services of persons for or in relation to the performance of work; or …"

Thus, a payment to a person is covered by the relevant contract provisions if s 32(1)(a) or (b) is satisfied. Relevantly, the Victorian State Revenue Office's website states:

> "Payments under these contracts are deemed to be wages (excluding GST). The principal who engages the contractor is deemed to be an employer who is liable for payroll tax on those wages.
>
> The contractor provisions apply regardless of whether the contractor provides services via a company, trust, partnership or as a sole trader.
>
> This covers most contractual arrangements between two persons each of whom supplies or receives such services in the course of a business."

The application of these provisions is best explained by analysing several recent cases where the "relevant contract" provisions have been applied in Victoria and New South Wales.

Section 35(1) of the *of* the *Payroll Tax Act 2007* (Vic) provides:

> "(1) … amounts paid or payable by an employer during a financial year for or in relation to the performance of work relating to a relevant contract … are taken to be wages paid or payable during that financial year."

This provision deems payments for relevant contracts to be wages for payroll tax purposes.

Victorian case summary: The Optical Superstore

"Tenancy agreements" were entered into between The Optical Superstore (TOS) and optometrists, with "rent" payable based on the time the optometrists provided their services at the relevant store. The optometrists provided services to the store owner (ie TOS), as well as to the patients. The State Revenue Office of Victoria (SRO) classified the "tenancy agreements" as "relevant contracts" and issued payroll tax reassessments.

At first instance, the Victorian Civil and Administrative Tribunal found that, in summary, the agreements between TOS and the optometrists were relevant contracts but that the amounts paid to them were not "paid for work relating to a relevant contract" because those amounts were paid to the optometrists from an express trust (ie the payments were held on trust by TOS for each optometrist, reflecting the fees collected for each optometrist).[2]

The SRO appealed to the Supreme Court which dismissed the appeal against the tribunal's decision that patient fees held on express trust could not constitute payments relating to a relevant contract.[3]

On the SRO's further leave application and appeal, the Victorian Court of Appeal allowed the appeal and held that the ordinary meaning of "payment" embraced a payment of money to a person beneficially entitled to that money. Thus, the payments to the optometrists were subject to payroll tax.[4]

The Optical Superstore's special leave application to the High Court of Australia was denied.

NSW case summary: Thomas and Naaz Pty Ltd

The NSW Civil and Administrative Tribunal in *Thomas and Naaz Pty Ltd v Chief Commissioner of State Revenue*[5] considered whether payments by a medical centre to doctors were subject to payroll tax under the NSW "relevant contract" provisions. The facts in this decision involved Naaz Pty Ltd (Naaz) operating three medical centres, with each doctor (or a related entity of each doctor) entering into a written agreement with Naaz that included, among other things, the following terms and conditions:

- Naaz provided consulting rooms and administrative services so that each doctor could provide services to patients;
- the doctors had obligations to comply with protocols, including a work roster and leave policy, and to promote the medical centre;
- the doctors had independence in the way they treated patients and they used some of their own medical equipment; and
- there was a restraint of trade if a doctor left the clinic.

In summary, Naaz provided the clinic from which the doctors could service patients and it retained 30% of every $1.00 of patient fees for providing the services. The 70% of patient fees paid by Naaz to the doctors was subject to payroll tax under the NSW "relevant contract" provisions (which are the same provisions as in Victoria).

The tribunal held that the agreements secured the services of the doctors for the benefit of Naaz and therefore the doctors were not only providing services to Naaz, but also to the patients. As the services were work-related, the tribunal was satisfied that the agreements between Naaz and each doctor were "relevant contracts" under s 32(1)(b) of the *Payroll Tax Act 2007* (NSW). The tribunal was also satisfied that the payments had a clear relationship with the performance of the work.

NSW payroll tax was therefore held to be properly levied on the payments made by a medical clinic to doctors under a service agreement where the doctors thought they were paying the medical clinic a service fee for services provided through the clinic by each doctor conducting their own professional practice.

Naaz was unsuccessful in its appeal against the decision to the appeal panel of the tribunal.[6] An appeal has since been lodged in the NSW Supreme Court. Thus, the final outcome of this case is still pending.

Summary of the above "relevant contract" cases

Many are surprised to learn about the breadth of the payroll tax provisions. There also appears to be increasing audit activity by state and territory revenue offices in relation to arrangements similar to those involved in the above cases. Thus, advisers need to be aware of similar arrangements where payroll tax exposure may arise and take proactive steps to ensure compliance. In relevant cases, a voluntary disclosure to minimise future penalties may also be required.

Exceptions to relevant contracts

Some exceptions where payroll tax is not relevant to a work relationship include the following:

- services ancillary to supply or use of goods test: the contract is primarily for the supply or use of goods, and the services provided by the contractor are ancillary to the supply of the goods;
- genuine contractor test: services that the recipient does not normally require and that are provided by a contractor who provides such services to the public generally;
- 180-day test: a contract for services of a kind ordinarily required by the principal for less than 180 days in a financial year;
- 90-day test: a contract for services by a person providing the same or similar services to a principal under the contract for no more than 90 days in a financial year;
- services of the same kind to the public test: the SRO is satisfied that the contractor ordinarily provides services of that kind to the public generally;
- two or more persons' test: the contractor engages two or more persons in a business carried on by the contractor to perform the work; and
- owner-driver exclusion: the contract is primarily for the transport of goods in a vehicle provided by the contractor, and the contractor's services are ancillary to the transport of goods.

Related issues

The breadth of the SG provisions in relation to contractors also requires monitoring in view of recent decisions such as *Dental Corporation Pty Ltd v Moffet*[7] which examined the breadth of s 12(3) of the *Superannuation Guarantee (Administration) Act 1992* (Cth). Further, the High Court in the recent case of *ZG Operations Australia Pty Ltd v Jamsek*[8] remitted the SG question relating to s 12(3) to the Full Court of the Federal Court for review. The SG matters are discussed in the earlier articles in this series,1 and this area of law needs to be monitored.

Conclusion

As noted above, businesses should be aware of the relevant payroll tax obligations that they have with their workforce, including each contractor. In particular, businesses must be aware of the wide net that is cast by the payroll tax legislation, as many contractors are likely to be caught unless an exception can be obtained.

In addition to payroll tax, businesses must be compliant with the range of other obligations and taxes arising from engaging labour, including PAYG, SG, WorkCover insurance and employee entitlements (covered in the earlier articles in this series[1]). Significant penalties, costs and reputational damage can arise from non-compliance.

Cassandra Hurley
Lawyer
DBA Lawyers

Daniel Butler, CTA
Director
DBA Lawyers

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7 [2020] FCAFC 118.

8 [2022] HCA 2.

Alternative Assets Insights

by Kirsten Arblaster, Trinh Hua,
Andrew Hirst, CTA, and
Richard Vann, CTA, PwC

Stapled structures and Pt IVA

The ATO has successfully challenged the use of a stapled structure under Pt IVA, raising a number of interesting questions.

Overview

On 16 September 2022, a single judge of the Federal Court (O'Callaghan J) handed down his judgment in *Minerva Financial Group Pty Ltd v FCT*.[1] The applicant, the Minerva Financial Group Pty Ltd, is a member of a group of companies and trusts known as "Liberty" or the "Liberty Group". The case related to the ATO's challenge under the general anti-avoidance provisions in Pt IVA of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) to the Liberty Group's structure.

While the ATO was largely successful, with the judge finding that Pt IVA applied to two of three identified schemes, it was the unusual features of the arrangement (including a discretion to distribute income to the corporate side of the structure), rather than the use of a stapled structure in general, that attracted the application of Pt IVA. It is as yet unknown if the taxpayer or the ATO will seek to appeal the decision.

In detail

Although the judgment runs to 161 pages in the Federal Court's version, the facts on which the case was ultimately decided can be summarised as follows. The Liberty group had a series of securitisation trusts that derived income from loan receivables. In 2007–08, the group was restructured into a corporate/trust structure, involving a corporate side and a trust side, with the ultimate owners of the group directly owning shares in the corporate side and units in the trust side. Two entities on the corporate side also held "special units" in the trust side of the group.

A number of the securitisation trusts were held under the trust side of the group – the intention being that new securitisation trusts would be on the trust side, while some of the existing securitisation trusts remained on the corporate side. In other words, over time, the interest flowing from the securitisation trusts reduced on the corporate side and increased on the trust side.

The ATO contended that Pt IVA applied to the structure as the existence of the trusts (and various other facts) allowed the underlying net "interest" income to flow through to the non-resident unitholders at a 10% tax rate, whereas a 30% rate would have applied if the securitisation trusts had continued to be held within the corporate group.

Prior to the ultimate initial public offering (IPO), the shares in the corporate side and the units in the trust side were not stapled (the group ultimately stapled prior to the IPO in 2020). Although not stapled, the position of the ATO and much of the analysis is based on there being a "stapled" structure. For ease of reference, the authors have referred to a stapled structure in the remainder of this analysis.

The ATO put forward three schemes under Pt IVA – as the second and third schemes are similar, the authors have simply referred to them as the second scheme. The first scheme related to the formation and existence of the stapled structure. The second scheme related to the existence of the "special units" and a series of loan arrangements that resulted in the corporate side gaining access to much of the cash for which present entitlements had been created for the non-resident unitholders and which were largely satisfied by various intragroup transactions.

The taxpayer won on the first scheme, with the judge holding that there were commercial factors driving the existence of the stapled structure, including, in particular, the ability for investors to derive higher gross cash returns (rather than a franked dividend) and the advice that the group had consistently received that a stapled structure would be a more effective and preferred structure to take to market as part of an IPO of the group. While the stapled structure was not listed until 2020 (on the third attempt), the consistent advice from the various investment banks assisting was that it was preferable to go to market with a stapled structure.

On the second scheme, the judge held in favour of the ATO. In this regard, although the judge found that the loan arrangements and the requirement for the corporate side of the group to access the cash were legitimate and commercial, he nevertheless held that Pt IVA applied. His decision was based on the taxpayer being unable to demonstrate commercial reasons (ie non-tax reasons) why the trustee decided to distribute virtually all of the income derived by the trust to the non-resident unitholders (rather than to all of the unitholders, including the corporate side pursuant to the "special units"). Under the stapled structure, the income flowed by default to the non-resident owners but with a discretion to make distributions on the special units.

Both the taxpayer and the ATO are unlikely to be happy with the judgment. The taxpayer will be unhappy because it lost the case based on an application of Pt IVA to the second scheme. The ATO is also likely to have misgivings about the judgment as it was almost certainly hoping for a Pt IVA "win" on stapled structures more generally – indeed, although the ATO was successful in applying Pt IVA to the second scheme, such cross-staple units (ie the special units) are very unusual, so the case is unlikely to assist the ATO in attacking stapled structures more generally. As such, it is likely that one or both parties will look to appeal the decision.

The problems of complex Pt IVA cases

The judge correctly considered the three schemes put forward separately, but the evidence and the parties' written and oral submissions tended to treat everything "in globo", making it necessary for the judge to untangle for each scheme the relevant findings on the facts and expert evidence and the relevant arguments to be considered. He also took the cautious course, often found in Pt IVA judgments, of considering each factor in s 177D(2) ITAA36 separately for each scheme. As a result, the judge's views on the facts, expert evidence and sorting out the arguments relevant to each scheme take up a large proportion of the judgment, while the reasoning on dominant purpose only takes up to 12 pages at the end under 24 headings (the ATO's three schemes with eight factors each), replete with cross-references to the earlier material. Most space is given to the first scheme. On each scheme, the judge finds most factors neutral and only one or two pointing in either direction.

The impression is that the critical factor in relation to the first scheme was the consistent intention to list with a stapled structure on commercial grounds of obtaining the highest value for the business, both on listing and subsequently. On the second (and third) scheme, the impression is that the change wrought by the stapled structure and the decisions in the exercise of discretion by the relevant trustee on the trust side to distribute only small amounts, if any, on the "special units" to the corporate side was driven by the lower interest withholding tax rate compared to the corporate tax rate. We comment on each further below.

The first scheme: the stapled structure

For the first scheme (ie the stapled structure), the judge placed much greater emphasis on the evidence provided by the taxpayer (in particular, its expert witness, a former Deutsche Bank investment banker) than that provided by the ATO. The ATO's expert witness got off to a bad start by having to admit that he had never been involved in or worked on an IPO – this admission leading the judge to quickly discount his evidence related to the benefits (or not) of having a stapled structure in order to implement a successful IPO. The judge in particular accepted that some classes of investors would favour a higher cash return than a lower cash return plus franking credits. The taxpayer's expert dealt comprehensively with the often-contested issue of the value of franking credits and the importance of cash flows for a variety of reasons to many of the institutional investors which make up the great bulk of investment in the ASX.

What is disappointing (but not surprising) is that there is no discussion about tax policy settings, either in the hearings or judgment. The ATO is clear that policy has nothing to do with the application of Pt IVA, only complexity and contrivance – this is most clearly evident in its *Consolidation reference manual* where the ATO does consider policy issues while making it clear that they are not relevant to the Pt IVA analysis.

The absence of policy is very conspicuous here as Australia has recently had a lengthy policy debate over the extent to which stapled structures facilitated tax avoidance, with 65 pages of legislation introduced in 2019 to deal with the problems. As a result, the tax system has been set up to allow certain types of passive income (eg rent and interest income) to flow through trusts in a way that allows non-residents to derive that income at a lower rate of tax than if such income was held via an Australian corporate group. This is part of the bedrock of stapled groups generally.

While the *Minerva Financial Group* case concerned income years pre-dating the legislation, the ATO objection decision which generated the appeal post-dated it. While, as noted above, the facts of the Liberty Group were unusual, the ATO's first scheme was a direct attack on the stapled structure, rather than its unusual features. It will be a significant concern if the ATO in future seeks to apply Pt IVA to stapled structures as a matter of general principle.

The second scheme: including the "special units"

As noted above, the conclusions of the judge on the second scheme are unlikely to impact stapled groups more generally. What is interesting about the second scheme is that the "scheme" that the ATO put forward was not simply the decision by the trustee to distribute the income to the non-resident unitholders (rather than distributing all or a significant part of the income to the corporate group). It also involved the structural arrangements that allowed the trustee to distribute income to the non-resident unitholders and the arrangements that were in place between the group members and the non-resident unitholders (through various loan arrangements) such that the cash that was available to be distributed to the unitholders was moved across to the corporate group – as the corporate group needed this cash in order to continue to run its activities.

The precise mechanics of these loan/cash arrangements are not entirely clear from the judgment. However, what does appear to be apparent is that: (1) distributions of the income were validly made to the unitholders (and 10% withholding tax was paid); (2) the cash was moved to the corporate group (it appears that no cash was received by the unitholders); and (3) there were various loan arrangements in place (flowing in various directions).

The judge did not find these other factors compelling – he had no difficulty in finding, having regard to the facts, that the loan arrangements served a commercial purpose. Ultimately, he decided on the second scheme having regard to the decision to distribute most of the income of the trusts (approximately 98% of the income was distributed to the non-residents). On this, he stated:[2]

> "… I agree with the Commissioner's submission that, viewed objectively, the exercise of the choice in each of the relevant years (the manner in which the second part of the second scheme was carried out) was driven by the tax benefit of directing that income away from [the corporate side] … I agree with the Commissioner's submission that, objectively, the manner in which the second scheme was entered into is indicative of a dominant purpose of obtaining that tax benefit."

This conclusion may have wide-ranging implications as it is not clear how the analysis and reasoning should apply to other trusts, including discretionary trusts. On one view of the world, there is a potential Pt IVA issue with any decision that a trustee makes to distribute income to A, rather than B, based on tax attributes. The position is clearly much more nuanced than this as a distribution to A, rather than B, has commercial consequences as well, ie the money or property actually flows to A rather than B. Accordingly, the decision may be interpreted narrowly as applying to a situation where the funds are effectively kept in-house (because the ultimate owners of both parts of the structure are the same entities). Furthermore, the discretion was narrowly confined here in the sense that there were only two possibilities (a 30% taxpayer or a 10% taxpayer) — most discretionary trust situations do not present this stark choice. Hence, it may be argued that a normal discretionary trust is not exposed.

Although such an interpretation/argument can be put forward (and probably will be put forward by the ATO), the position is certainly far from clear. Indeed, is the position here really that different from a family trust where there are two beneficiaries who are spouses, and the decision is made to distribute income to one spouse rather than another because of their tax attributes?

At a more general level, the fact that the result flowed simply because there were non-residents with a different tax profile was rejected in a recent UK tribunal decision in *Burlington Loan Management DAC v HMRC*[3] in the context of the main purpose test in the UK–Ireland tax treaty. This test was the predecessor of the principal purpose test (PPT) in the multilateral instrument and now in the Australian multinational anti-avoidance law and diverted profits tax.

In the *Burlington Loan Management* case, the fact that a Cayman company, without treaty protection from the UK domestic withholding tax rate of 20% for interest payments, sold a debt for 92% of its face value to an Irish company (which benefited from a zero tax rate in the UK–Ireland tax treaty) was not enough to deny treaty benefits. The tribunal found there are a range of tax-favoured investors in the market and the reality is that the tax status of the buyer affects the amount that they are willing to pay. Otherwise, the tribunal found that there would be considerable disruption of the international capital markets. Given that the PPT is a lower threshold than the dominant purpose test applicable to the general operation of Pt IVA under s 177D, one would expect the UK tribunal to reach a similar result for widely held stapled structures for a dominant purpose test.

The expert evidence for the taxpayer in the Liberty Group accepted by the judge made a similar point. The only difference is that, in the years in question, the Liberty Group was closely held, although its owners were consistently seeking to turn it into a widely held group through an IPO. It is not clear why this should make a difference.

The takeaway

Minerva Financial Group Pty Ltd v FCT raises a number of interesting questions regarding the use of stapled structures and discretionary trusts, and is likely to go on appeal. Following a lengthy debate over the use of stapled structures and significant tax law reforms in 2019, it is clear that the ATO is not yet through with stapled structures.

Kirsten Arblaster
Partner, Melbourne Tax Market Leader
PwC

Trinh Hua
Partner, Sydney Tax Markets Leader
PwC

Andrew Hirst, CTA
Partner, Corporate Tax
PwC

Richard Vann, CTA
Specialist, Corporate Tax
PwC

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Events Calendar

Upcoming month

NOVEMBER
10–11
Thu–Fri

WA | Online

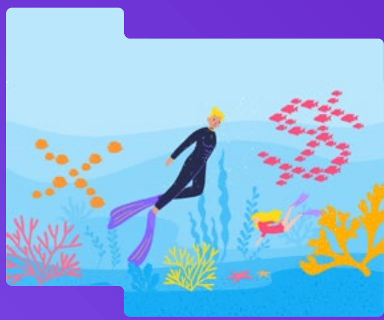
National Resources Tax Conference

10 CPD hours

NOVEMBER
16–18
Wed–Fri

QLD

Noosa Tax Convention



12 CPD hours

NOVEMBER
24–25
Thu–Fri

WA

Rottnest Tax Retreat

10 CPD hours

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

Cumulative Index

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Authors

Giving back to the profession

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

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Bill Keays, CTA

National Office

CEO: Giles Hurst

Level 37, 100 Miller Street
North Sydney, NSW 2060

T 02 8223 0000
E ceo@taxinstitute.com.au

State Offices

New South Wales and ACT
Chair: Glen Hutchings, FTI

Level 37, 100 Miller Street
North Sydney, NSW 2060

T 02 8223 0031
E nsw@taxinstitute.com.au

Victoria
Chair: Fiona Knight, CTA

c/o Level 37, 100 Miller Street
North Sydney, NSW 2060

T 03 9603 2000
E vic@taxinstitute.com.au

Queensland
Chair: John Ioannou, CTA

Level 11, Emirates Building
167 Eagle Street
Brisbane, QLD 4000

T 07 3225 5200
E qld@taxinstitute.com.au

Western Australia
Chair: Bill Keays, CTA

Level 32, Central Park
152 St Georges Terrace
Perth, WA 6000

T 08 6165 6600
E wa@taxinstitute.com.au

South Australia and Northern Territory
Chair: Nick Wilkins, CTA

The Tax Institute, WOTSO Adelaide
217/219 Flinders Street
Adelaide, SA 5000

T 08 8463 9444
E sa@taxinstitute.com.au

Tasmania
Chair: Ian Heywood, CTA

The Tax Institute, WOTSO Adelaide
217/219 Flinders Street
Adelaide, SA 5000

T 1800 620 222
E tas@taxinstitute.com.au

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General Manager – Commercial Transformation & Special Projects
James Paterson

Content Delivery Manager, Knowledge & Learning
Carla Reddy

Managing Editor
Deborah Powell

Graphic Designers
Mei Lam; Nicole Welch; Claus Huttenrauch

Typesetter
Midland Typesetters, Australia

Advertising
Business Relationship Manager
Brian Martin 08 6165 6600

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