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Charities and not-for-profits

The Tax Institute

Considering tax challenges for NFPs at state and federal level

Tax and estate planning in 2022: the year ahead

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THE TAX INSTITUTE

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Tax News – at a glance

by TaxCounsel Pty Ltd

December – what happened in tax?

The following points highlight important federal tax developments that occurred during December 2021. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 406 (at the item number indicated).

Allocation of professional firm profits

The Commissioner has issued a practical compliance guideline that sets out the ATO's compliance approach to the allocation of profits or income from professional firms in the assessable income of the individual professional practitioner (PCG 2021/4). **See item 1.**

R&D tax offsets: at risk rule

The Commissioner has released a final ruling in relation to the research and development (R&D) regime provisions that prevent an R&D entity from notionally deducting expenditure that is not "at risk" (TR 2021/5). **See item 2.**

JobKeeper payments: R&D expenditure

The Commissioner has released a final determination that sets out how the "at risk" rule applies to JobKeeper payments received by an R&D entity under the *Coronavirus Economic Response Package (Payments and Benefits) Rules 2020* (TD 2021/9). **See item 3.**

Temporary full expensing

A final law companion ruling released by the Commissioner on 22 December 2021 considers the provisions for temporary full expensing of depreciating assets that were introduced by the *Treasury Laws Amendment (A Tax Plan for the COVID-19 Economic Recovery) Act 2020* and the *Treasury Laws Amendment (2020 Measures No.6) Act 2020* (LCR 2021/3). **See item 4.**

Worldwide freezing order

The High Court has by majority allowed an appeal by a Deputy Commissioner of Taxation from a decision of the Full Federal Court which had set aside a worldwide freezing order that had been made by a single judge of the Federal Court under r 7.32 of the *Federal Court Rules 2011* (*DCT v Huang* [2021] HCA 43). **See item 5.**

Employee option plan and incentive scheme cancellation payments

The Full Federal Court (Kenny, Davies and Thawley JJ), dismissing an appeal from a decision of Colvin J at first instance, has unanimously held that an amount of just over $15m paid by the taxpayer company to employees in the 2014 income year in consideration for the cancellation of employee entitlements under an employee option plan and an employee incentive scheme was not deductible as a general deduction (under s 8-1 of the *Income Tax Assessment Act 1997* (Cth) because the positive limbs of the section were not met and the amount was of a capital nature (*Clough Ltd v FCT* [2021] FCAFC 197). **See item 6.**

Harman and the Commissioner

The Federal Court (Davies J) has rejected an application by an entity that was not a party to litigation in which the Commissioner was involved, but had provided documents in response to a subpoena for an order that the Commissioner was bound by the so-called Harman principle to use the documents for the purposes of the litigation only (*La Mancha Africa SARL v FCT* [2021] FCA 1564). **See item 7.**

FBT: car parking benefits

The Full Federal Court (Logan, Thawley and Downes JJ) has unanimously allowed the Commissioner's appeal from a decision of Griffiths J and held that two airlines (collectively, Virgin) were liable to FBT in relation to car parking facilities provided by Virgin to flight crew and cabin crew employees and that were located near airport terminals in Sydney, Brisbane and Perth (*FCT v Virgin Australia Regional Airlines Pty Ltd* [2021] FCAFC 209). **See item 8.**

Reimbursement agreements: s 100A

In a recent decision, the Federal Court (Logan J) has allowed appeals against assessments made by the Commissioner and, in doing so, considered a number of important issues (*Guardian AIT Pty Ltd ATF Australian Investment Trust v FCT* [2021] FCA 1619). The assessments were issued on the basis that there was a "reimbursement agreement" that fell within s 100A of the *Income Tax Assessment Act 1936* (Cth). **See item 9.**

President's Report

An interview with our President, Jerome Tse, CTA

Get to know President Jerome Tse, as he brings our focus to diversity and modernisation in 2022.

You've been an active member of The Tax Institute for years. What does the Institute mean to you?

Early in my involvement with the Institute, I served as part of an education committee and one thing that was made abundantly clear through that experience was that The Tax Institute's vision is not just for our members. We are here to support the tax profession. We are here to educate the community. That sense of inclusive growth is central to my approach to our work.

As someone who has been a part of The Tax Institute in my early career and now in mid-career, I know that professional development extends outside the technical realm as well. As a member, you are given the opportunity to build networks of both peers and senior professionals, opening doors you may not have even known existed. It gives you a foundation to learn how to interact with colleagues 20 years your senior, or to develop the confidence to speak in front of 400 people, or the clarity to write a succinct, impactful paper. Creating those opportunities for growth is fundamental to our purpose.

What is your vision for leadership in 2022?

Openness and inclusivity are, I think, at the core of where we need to be and where we are going. We are continuing a legacy of strong vision and direction put forward by past Presidents, including immediate past President Peter Godber who was a steadying influence during an incredibly challenging period for our organisation.

The Tax Institute's long-term vision, developed under Tracey Rens' leadership, is still fit for purpose. However, our organisation is not a "finished product" and we should always strive to do and be better. I aim to extend our vision, to find increasing relevance and purpose in new areas by being open to new ideas and perspectives. Crucially, I want to be open to diverse voices from members who can become engineers of their own solutions by ensuring they are represented in our committees.

What are a few of your key priorities and goals for the Institute in 2022?

The Institute has gone through a significant amount of structural change in the last couple years, partly in response to COVID-19, but more importantly, as an active strategy to modernise our engagement with members. Investment in technology has been a major element of this strategy. We are launching a new website with improved search capabilities in 2022, which will ensure that our resources are easily available to members. Our micro-credential learning offering, also launching in 2022, is a significant technological investment that we are confident will serve the needs of our members and the wider tax community.

As part of our long-term vision, Giles and I are also committed to raising the bar on diversity and inclusion within The Tax Institute and in the broader tax community in 2022. We are finalising our diversity and inclusion policy, and it is my sincere hope that we will embed a culture of inclusiveness across all facets of Institute life. This means embracing all forms of difference, including nationality, ethnicity, religion, culture, language, sexual orientation, gender identity, disability, age and family status.

It is my hope that our members will play an active role in our work towards this goal. Each small step in this direction is a success and the more people working towards it, the stronger we will be.

At the last Annual General Meeting, the board approved the option of appointing an independent Chair. What advantages will flow from this change?

Members of our current board are skilled, experienced individuals. We are also all tax specialists and approach things from that viewpoint. Serving on a board is more than just financials and tax. An independent Chair has the skills and perspective to lead us through the governance aspects of a large organisation, and to ensure that our members, our member value proposition and our members' funds continue to be protected and invested wisely and in accordance with our objects and vision.

While the Chair will lead from a governance perspective, the President will still be front and centre, leading member engagements and advocacy. In fact, the change means future Presidents will have more time to devote to representing members' interests, which is, I think, where our efforts will provide the most value back to members.

When you look back on your time as President, what legacy do you hope to have left for our members, our organisation and for the tax profession?

The Institute will always continue its work of educating the tax profession and being a leading voice on all matters tax. I would be proud to leave my mark on that story by affording a new generation of tax professionals from all walks of life the same incredible opportunities the Institute has afforded me over my career.

A diverse membership, a membership that is involved and active in shaping their own experience, a membership that is empowered to bring different perspectives and ideas to the table — that is what I would hope to leave the Institute with.

CEO's Report

by Giles Hurst

Working towards our long-term vision

In 2022, the Institute is committed to helping members grow and thrive.

Setting a New Year's resolution is not a new tradition. The earliest known example of a resolution made at the beginning of the year dates back to Scotland in 1671, and by 1802, writers in magazines were poking fun at another longstanding tradition — breaking those New Year's resolutions.

At the Institute this year, we haven't set New Year's resolutions. Instead, you'll be glad to hear that we are continuing to work towards a long-term vision for our community to grow and thrive. Our goals are a little bigger than a year-long commitment, and we've been working towards them surely and steadily for some time now.

It's exciting to welcome Jerome Tse to the role of Institute President, and Marg Marshall as Vice President. They are by no means new faces in our organisation, both having served on committees and councils and having been active and valued members for many years. I look forward to what their leadership will mean for future opportunities and support for our members throughout the year.

As you will have read in the interview with Jerome this month, in 2022, we have committed to making a concerted effort towards increased diversity within our ranks. We've always prided ourselves on being a welcoming bunch, but with a formal diversity and inclusion policy in place, it is our hope to extend our services, support and resources more effectively to every corner of the tax profession.

A diverse and active membership also enriches our organisation. With an ongoing commitment to tax reform and improving the system for everyone, it's important that everyone is represented in our advocacy efforts. Different perspectives, new ideas and unique experiences make us stronger as an organisation and a community.

In 2022, we will be working hard to put ourselves in the best possible position to continue supporting members. This will come in many different forms, including our long-awaited website update which is a major component of our vision to make your access to resources easier, quicker and more intuitive than it has been in the past.

It also includes launching our micro-credential offering which is a sensational foray into modern learning. Our members are busy people who need the flexibility to upskill and study on their own timetable and according to their own requirements. We are keenly aware of this need and micro-credential learning is key to addressing it. We are so proud to be bringing it to you in 2022.

We will also have a strong focus on ensuring that both our in-house Tax Policy and Advocacy team and our volunteer committees and councils are being utilised to their full potential. Our organisation has a wealth of expertise and knowledge at its fingertips and we are committed to channelling that into more resources, events and advocacy for you.

A note on your wellbeing

Finally, to address the elephant in the room: COVID-19 continues to have a significant impact on all of our lives, both personally and professionally. I know that, for many of us, the Christmas season was disrupted by the Omicron surge and, as we move into the third year of the pandemic, there is a new set of challenges for us to adapt to.

At the end of last year, I encouraged all of you to take the time to look after yourself and your loved ones, to have a break, and to put your wellbeing first. I urge you to carry that attention to physical and mental health into the New Year with you.

COVID-19 was not part of anyone's long-term plan, us included. However, it has raised an important conversation about our priorities, how we work, and how we live. While your work is undoubtedly important, sometimes it must take a backseat to even more important matters, like health, happiness and family.

I wish you all a wonderful year ahead. We have much to look forward to.

Associate Tax Counsel's Report

by Abhishek Shekhawat, ATI

On the horizon in 2022

In this month's column, we turn our mind to upcoming developments and changes to the tax system that will impact taxpayers and tax practitioners across Australia.

2022 brings with it a number of significant changes that will impact the way tax professionals operate.

Below are some of the major changes, reviews and legislative measures.

Single Touch Payroll Phase 2

Phase 2 of Single Touch Payroll (STP) commenced from 1 January 2022. The changes to STP include:

- the disaggregation of gross amounts;
- reporting certain employee details through STP, including their TFN declaration, employment basis, and details of when they leave their employment; and
- the option to include child support garnishees and deductions, reducing the need to give separate remittance advices to the Child Support Registrar.

The changes need to be reported from 1 January 2022, unless the employer's digital service provider has a deferral. The ATO has released detailed guidelines to assist employers transition to Phase 2 of STP reporting.

Allocation of professional firm profits

In late December 2021, the ATO released PCG 2021/4, which commences from 1 July 2022 and sets out the ATO's compliance approach to risk-assessing how professional firms allocate profits to their practitioners.

The new compliance approach requires firms to consider the commercial rationale of their profit allocation and potential deemed "high-risk" features before undertaking a risk analysis that provides the firm's rating. PCG 2021/4 will apply to all professional firms (including financial services practices, medical practices and consulting firms).

Members can access a detailed overview of PCG 2021/4 and can look forward to a range of guidance from The Tax Institute to assist them, including factsheets, webinars and tools to help calculate the risk rating.

Section 100A reimbursement agreements

At the time of writing this article, the ATO has foreshadowed the release of its long-awaited draft public ruling concerning the purpose and ordinary dealing exclusions in s 100A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36). We will continue to monitor developments in this area. The draft ruling will set out the Commissioner's preliminary views on the exclusions from a "reimbursement agreement" for:

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

The draft ruling is expected to be released alongside a draft taxation determination which will set out the Commissioner's proposed view on when an unpaid present entitlement (UPE) (or similar amount held on sub-trust) of a private company beneficiary will be "any other form of financial accommodation" for the purposes of Div 7A ITAA36. The draft determination is expected to apply prospectively to UPEs created on or after 1 July 2022.

Inspector-General of Taxation and Taxation Ombudsman reviews

The Inspector-General of Taxation and Taxation Ombudsman is currently undertaking three reviews on the powers and processes of the ATO. These are:

- an investigation into the objection process, focusing on the timeliness of objections, the independence of the decision-maker, and initiatives to minimise disputes;
- an investigation into the ATO's general powers of administration, with a focus on case studies and complaints to highlight the areas to be examined; and
- an investigation into the exercise of the Commissioner's remedial powers, focusing on the clarity over the underlying processes and considerations when exercising the powers.

The Tax Institute is working with our members and national technical committees to develop submissions that highlight member experiences and suggest methods to improve the processes in these areas.

Residency

In addition to the ATO's decision impact statement on the *Addy* case, there is likely to be a significant overhaul to the residency rules for all taxpayers. Following the announcement in the Federal Budget 2021-22, the individual tax residency rules will be updated with a new framework as recommended by the Board of Taxation (BoT) in its 2019 report. The new framework is currently proposed to consist of a primary bright line test based on physical presence and a secondary test based on objective factors.

Further, the government has also announced changes to the corporate tax residency rules that seek to adopt the BoT's 2020 report and provide that companies incorporated overseas will be Australian tax residents if they have a "significant economic connection to Australia", and to potentially extend the corporate tax residency rules to trusts and corporate limited partnerships.

As mentioned above, these are just some of the major developments in 2022. For a detailed overview of many of the current key tax and superannuation measures, see The Tax Institute's State of Tax Policy December 2021.

Tax News – the details

by TaxCounsel Pty Ltd

December – what happened in tax?

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

The Commissioner's perspective

1. Allocation of professional firm profits

The Commissioner has issued a practical compliance guideline that sets out the ATO's compliance approach to the allocation of profits or income from professional firms in the assessable income of the individual professional practitioner (IPP) (PCG 2021/4).

PCG 2021/4 focuses on whether there is a risk that income earned by an IPP is not appropriately taxed to the IPP. The approach assists the ATO to differentiate risk in order to tailor its engagement. It uses two "gateways" and a risk assessment framework of objective factors to rate IPP arrangements as low (green), moderate (amber) or high (red) risk. Analysis of the facts and circumstances of individual arrangements in the high and moderate risk zones would then be undertaken to determine investment of compliance resources where appropriate.

Historically, most professional firms were partnerships of natural persons. Professional firms are now structured in a variety of ways, reflecting the economic and legal choices made by owners of those firms. PCG 2021/4 uses the term "professional firm" to refer to all business structures providing professional services. In some cases, these structures may be used in ways that give rise to different tax consequences and resulting tax compliance risks.

The ATO is concerned about arrangements involving taxpayers who redirect their income to an associated entity from a business or activity which includes their professional services where it has the effect of significantly reducing their tax liability.

The use of companies, trusts and other business structures does not of itself give rise to avoidance concerns. Further, the profit generated by the business may not be wholly generated by the individual and there may also be good non-tax reasons as to why the IPP receives significantly less of the business' profits than would otherwise be the case. However, the use of those structures can provide the IPP with an opportunity to redirect income from them. When the business involves the provision of services, the ATO will be concerned with arrangements where the compensation received by the individual is artificially low while associated entities benefit (or the individual ultimately benefits) and commercial reasons do not justify the arrangement.

The ATO's concern increases the more the actual return to the IPP is linked to the individual performance of the IPP during the year in question (as contrasted to a given share of the overall profit of the professional firm, a share which may increase over time as the partner's contribution to the partnership accumulates) but is not reflected in the actual direct compensation to the individual. At an extreme, the overall remuneration arrangements of an IPP may reflect that the role is more akin to a highly-paid employee (with bonus entitlements or remuneration at risk) rather than a partner in a professional firm. In this case, the ATO's concern is that the partnership structure may be used to provide artificial tax advantages.

The Commissioner's view is that the profit or income of a professional firm may comprise different components, reflecting a mixture of income from the efforts, labour and application of skills of the firm's IPPs (that is, personal exertion) and income generated by the business structure.

The ATO is aware that, in some cases, professional firm income has been treated as being derived from a business structure, even though the source of that income remains (to a significant extent) the provision of professional services by one or more individuals. In that context, the ATO may look to apply the general anti-avoidance provisions (Pt IVA of the *Income Tax Assessment Act 1936* (Cth) (ITAA36)) where income is redirected away from the individuals, despite the existence of a business structure.

PCG 2021/4 explains the ATO's risk-based approach to IPPs and how their professional firms allocate profits. The application of Pt IVA requires consideration of the matters identified in s 177D(2) ITAA36. A consideration of Pt IVA would go beyond the gateways, including, for example, an IPP's profit allocation arrangement. It is only after having passed the gateways in PCG 2021/4 that an IPP (or the firm more generally) can assess their risk rating under the guideline. The Commissioner will use the "risk assessment factors" in PCG 2021/4 to determine whether compliance resources will be allocated to structures or transactions after gateways have been satisfied.

The gateways

The two gateways that must be passed for PCG 2021/4 to apply are:

- there is a sound commercial rationale for entering into and operating the arrangement or structure; and
- certain "high-risk features" are absent.

Where an IPP's circumstances pass both of these gateways, the risk assessment framework explained in the guideline may be used by the IPP and the ATO to understand whether further attention may be given to the arrangement.

Overall, schemes which are designed to ensure that the IPP is not directly rewarded for the services they provide to the business, or receives a reward which is substantially less than the value of those services, are considered high risk by the ATO. Where an IPP attempts to alienate amounts of income flowing from their personal exertion (as opposed to income generated by the business structure), the Commissioner will consider applying the general anti-avoidance provisions or other integrity rules.

PCG 2021/4 does not replace, alter or affect the operation of the law in any way and does not relieve an entity of its legal obligation to comply with all relevant tax laws or create any safe harbour administrative concessions.

PCG 2021/4 replaces the web material published in 2015 (*Assessing the risk: allocation of profits within professional firms*) which was suspended in December 2017.

Date of effect and transitional

PCG 2021/4 applies from 1 July 2022. Its use and application will be reviewed from and during the 2022-23 income year. If an existing arrangement complies with the suspended guidelines, those guidelines can continue to be relied on for the period 1 July 2017 to 30 June 2022 if the arrangement:

– is commercially driven; and
– does not exhibit any of the high-risk factors outlined in the no high-risk features gateway.

If an arrangement was low risk under the suspended guidelines but has a higher risk rating under PCG 2021/4, the suspended guidelines can continue to be applied until 30 June 2024.

2. R&D tax offsets: at risk rule

The Commissioner has released a final ruling in relation to the research and development (R&D) regime provisions that prevent an R&D entity from notionally deducting expenditure that is not "at risk" (TR 2021/5).

In particular, TR 2021/5 considers the tests for determining whether an entity's expenditure is "at risk" under s 355-405 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) (the "at risk" rule) and is intended to provide certainty to taxpayers about whether the "at risk" rule is satisfied, for instance, where R&D activities are carried out in the context of commercial contracts for the supply of products or services.

TR 2021/5 does not consider other exclusions or conditions relating to notional deductions for expenditure on R&D activity. Therefore, a statement in the ruling that the "at risk" rule applies or does not apply does not imply that the expenditure would otherwise be notionally deductible under Div 355 ITAA97.

3. JobKeeper payments: R&D expenditure

The Commissioner has released a final determination that sets out how the "at risk" rule applies to JobKeeper payments received by an R&D entity under the *Coronavirus Economic Response Package (Payments and Benefits) Rules 2020* (the CERP Rules) (TD 2021/9).

TD 2021/9 does not consider other applications of the "at risk" rule, including to economic response measures taken by state or territory governments to COVID-19. TR 2021/5 (see above) considers the tests for determining whether an entity's expenditure is "at risk" more generally.

If an entity received a JobKeeper payment:

– for its paid employees (under Div 2 of the CERP Rules), the entity triggers the "at risk" rule and cannot notionally deduct the portion of its wage expenditure incurred on R&D activities that has attracted the JobKeeper payment; or
– based on business participation (under Div 3 of the CERP Rules), the entity does not trigger the "at risk" rule and is therefore not prevented from notionally deducting expenditure for having received a JobKeeper payment.

If an entity received a JobKeeper payment for an eligible employee who is wholly engaged in R&D activities during a fortnight, the entity cannot notionally deduct so much of its wage expenditure paid to that employee as is equal to the JobKeeper payment rate. If an eligible employee who is partially engaged in R&D activities during a fortnight, the entity's notional deduction is partially reduced by that portion of the JobKeeper payment as is in proportion with the time the employee spends on R&D activities during that fortnight.

Expenditure an entity incurred on R&D activities that cannot be notionally deducted does not give rise to a tax offset under s 355-100 ITAA97. Therefore, for the portion of JobKeeper payments the entity received that triggered the "at risk" rule, no extra income tax is payable under the R&D clawback rules.

4. Temporary full expensing

A final law companion ruling released by the Commissioner on 22 December 2021 considers the provisions for temporary full expensing of depreciating assets that were introduced by the *Treasury Laws Amendment (A Tax Plan for the COVID-19 Economic Recovery) Act 2020* and the *Treasury Laws Amendment (2020 Measures No. 6) Act 2020* (LCR 2021/3).

Temporary full expensing (TFE) means the immediate write-off of the cost of depreciating assets and relevant additional expenditure in accordance with the rules in:

– Subdiv 40-BB of the *Income Tax (Transitional Provisions) Act 1997* (Cth), applicable to business entities generally; and
– s 328-181 of that Act which modifies the operation of rules in Subdiv 328-D ITAA97, applicable to small business entities choosing simplified depreciation.

Before TFE was introduced, instant asset write-off (IAWO) and backing business investment (BBI) measures were enacted during 2020 to enhance immediate write-off and provide accelerated depreciation for eligible assets respectively. For the assets to which it applies, TFE effectively enlarges the scope of the IAWO by not stipulating a maximum cost of assets and by extending eligibility to large business entities.

LCR 2021/3:

– outlines the operation of TFE;
– provides views on interpretative issues;
– explains the interaction of TFE with IAWO and BBI; and
– explains and illustrates how TFE applies to small business entities.

Recent case decisions

5. Worldwide freezing order

The High Court has by majority allowed an appeal by a Deputy Commissioner of Taxation from a decision of the Full Federal Court which had set aside a worldwide freezing order that had been made by a single judge of the Federal Court under r 7.32 of the *Federal Court Rules 2011* (Cth) (*DCT v Huang*).[1]

The appeal concerned the Federal Court's power to make an order restraining a person from disposing of, dealing with, or diminishing the value of, assets, including assets located in or outside Australia (a "worldwide freezing order") conferred by r 7.32 of the *Federal Court Rules 2011*. Rule 7.32(1) provides that the purpose of the order must be "preventing the frustration or inhibition of the Court's process" and the order must serve that purpose "by seeking to meet a danger that a judgment or prospective judgment of the Court will be wholly or partly unsatisfied".

The respondent, a Mr Huang, who had been a tax resident of Australia for a number of years, left Australia in December 2018 for the People's Republic of China (the PRC) while the ATO was conducting an audit into his income tax affairs. Subsequently, the Commissioner of Taxation issued to Mr Huang assessments for tax liabilities and a shortfall penalty totalling almost $141m. On application by the Deputy Commissioner, the primary judge (Jagot J) made a worldwide freezing order against Mr Huang until further order. On appeal, the Full Federal Court set aside the worldwide freezing order on the basis that there was presently no realistic possibility of enforcement of any judgment obtained by the Deputy Commissioner against Mr Huang's assets in the PRC or Hong Kong.

On further appeal by the Deputy Commissioner with special leave, the High Court by majority (Gageler, Keane, Gordon and Gleeson JJ, Edelman J dissenting) has held that the power in r 7.32 is not constrained by a precondition that it may only be exercised if there is proof of a realistic possibility of enforcement of a judgment debt against the person's assets in each foreign jurisdiction to which the proposed order relates. Provisions granting powers to a court are not to be read down by making implications or imposing limitations which are not found in the express words.

The power conferred by r 7.32 is broad and flexible. It is the court's authority to make orders against a person who is subject to the court's jurisdiction that is relevant to the power to make a freezing order, rather than the location of the person's assets. Requiring proof of a realistic possibility of enforcement in each jurisdiction would render the power to make a freezing order largely impotent to protect the Federal Court's process from frustration by defendants who are able to secrete assets or move them almost instantaneously across international borders.

Further, such a precondition would be effectively inconsistent with the power to make a worldwide freezing order as it would necessitate identification of the defendant's foreign assets as well as potential means of enforcement in a relevant foreign jurisdiction. However, the likely utility of a freezing order is undoubtedly relevant to the exercise of the court's discretion to grant a worldwide freezing order.

6. Employee option plan and incentive scheme cancellation payments

The Full Federal Court (Kenny, Davies and Thawley JJ), dismissing an appeal from a decision of Colvin J at first instance, has unanimously held that an amount of just over $15m paid by the taxpayer company to employees in the 2014 income year in consideration for the cancellation of employee entitlements under an employee option plan and an employee incentive scheme was not deductible as a general deduction (under s 8-1 ITAA97) because the positive limbs of the section were not met and the amount was of a capital nature (*Clough Ltd v FCT*[2]).

The facts

The taxpayer company provided engineering, project management and construction services. Central to the success of the business was the retention and incentivising of key employees. These outcomes were sought to be achieved in part by providing attractive entitlements to employees under an employee option plan (option plan) and an employee incentive scheme (incentive scheme).

Under the option plan, the taxpayer company could offer (and had given) options to employees which entitled the employee, on exercise of the option, to subscribe for and be allotted one share (credited as fully paid) at the specified exercise price. The board could declare that options would vest immediately if, in its opinion, a "change of control event" occurred, despite the fact that a condition of vesting (such as achieving a particular performance criterion) had not been met.

Under the incentive scheme, the taxpayer company could issue (and had issued) "performance rights", which entitled the employee, three years after the date of grant of the right, either to acquire one share or receive in cash the market price of one share (at the election of the taxpayer company). A performance right vested automatically after three years and also vested before three years if a "change of control event" occurred.

A "change of control event" within the meaning of the option plan and incentive scheme included the taxpayer company entering into a scheme of arrangement, as in fact occurred.

In 2011, approximately 60% of the shares in the taxpayer company were owned by Murray & Roberts Ltd, a subsidiary of Murray & Roberts Holdings Ltd, the head company of the Murray & Roberts Group. Murray & Roberts was a South African engineering, contracting and construction services company operating in the underground mining market and in selected emerging markets in the natural resources and infrastructure sectors in Southern Africa, the Middle East, Southeast Asia, Australasia and North and South America.

In 2012 and 2013, there were negotiations concerning potential terms on which Murray & Roberts might acquire the minority shareholding in the taxpayer company. The treatment of options and rights granted to employees under the option plan and the incentive scheme was a key concern to both the taxpayer company and to Murray & Roberts. Both accepted that there was an obligation on the part of the taxpayer company to make payments to the employees holding options and rights if the change in control were to occur.

On 28 August 2013, two entities in the Murray & Roberts Group and the taxpayer company entered into a scheme implementation agreement (SIA), under which a Murray & Roberts entity would acquire the remaining shares in the taxpayer company pursuant to a scheme of arrangement.

Schedule 7 of the SIA set out certain "incentive acquisition principles". Clause 6 required the parties to ensure that options and rights were dealt with in accordance with those principles. Schedule 7 required the taxpayer to make an offer to cancel the options and performance rights and to use its best endeavours to ensure that each person receiving an offer accepted the offer. Schedule 7 also dealt with what was to occur if the offers were not accepted.

In September and October 2013, the taxpayer company made offers to all employees holding options or rights in accordance with the SIA. The offers were conditional on the SIA becoming effective. The employees either accepted the offer to cancel or exercised vested options and, in the latter case, thereby became shareholders who could participate in the scheme of arrangement if implemented.

The scheme of arrangement was implemented on 11 December 2013. On the same day, a subsidiary of the taxpayer company made payments totalling $15,050,487 to employees in consideration of the cancellation of their respective options and rights. The taxpayer company was delisted on 12 December 2013. At issue was whether these payments were allowable as deductions under the general deduction provision (s 8-1 ITAA97). At first instance, Colvin J held that the amounts were not so allowable and the Full Federal Court has now affirmed that decision.

Full Court decision

Thawley J (with whose judgment Kenny J and Davies J each agreed) said that questions of characterisation are ones about which minds often differ. The difficulty that the case presented was that the payments were made both to facilitate a change in control of the taxpayer company and also to honour legal or commercial obligations to employees arising out of the fact that the taxpayer company had granted options and rights to its employees in the course of running its business and for the purpose of rewarding and incentivising those employees. However, in a practical business sense, the payments were better characterised as payments made pursuant to an agreement to secure a change in control rather than as meeting employee entitlements on a change of control. The payments were made to effect a reorganisation of the capital structure of the taxpayer company through a takeover by Murray & Roberts and the delisting of the taxpayer from the ASX.

Further, the bringing to an end of the various rights of the employees under the employee schemes was necessary to secure the reorganisation of the company's capital structure for the enduring advantage of the business. There was no doubt that the payments would not have been made unless the employees had entitlements under the employee schemes and that those schemes had been designed to incentivise and reward those employees. The rights were granted to the employees in gaining or producing assessable income. However, the occasion of the outgoings lay in the takeover and the object behind making the payments was the bringing to an end of the employees' rights, at the one time, to facilitate the takeover by Murray & Roberts and the delisting of the taxpayer company.

Accordingly, the payments were not deductible; the payments did not fall within the positive limbs of s 8-1 and were payments on capital account. It may be noted that Colvin J at first instance did not consider the "capital" issue.

Canadian decisions

Of some interest is the fact that, before the Full Federal Court, the Commissioner referred to two decisions of the Canadian Federal Court of Appeal in which payments similar to those made in the *Clough Ltd* case were held to be on capital account. After referring to the facts of, and the decisions in, these decisions, including quotations from the judgments, Thawley J said:

> "Of course, these two Canadian decisions concern different legislation. However, it is the distinction between income and capital which is critical. Here, that distinction does not relevantly turn on specific statutory language. It may be accepted that differences emerge in the common law of different countries and, even where principles remain broadly the same, differences emerge in expression and emphasis. None of this automatically denies the persuasive or instructive value of the reasoning and decisions of other common law jurisdictions — see: *Paciocco v ANZ Banking Group Limited* (2016) 258 CLR 525 at [10] (French CJ)."

Blackhole expenditure

Thawley J said that the findings made showed that the concession made by the Commissioner before the hearing commenced at first instance that the amount claimed was deductible over five years under s 40-880 ITAA97, was properly made. Some aspects of the operation of this provision are considered in the Tax Tips column of this issue of the journal (see page 413).

7. Harman and the Commissioner

The Federal Court (Davies J) has rejected an application by an entity that was not a party to litigation in which the Commissioner was involved, but had provided documents in response to a subpoena for an order that the Commissioner was bound by the so-called Harman principle to use the documents for the purposes of the litigation only (*La Mancha Africa SARL v FCT*[3]).

In proceedings in the Federal Court between La Mancha Africa SARL (La Mancha) and the Commissioner, Ernest Henry Mining Pty Ltd (Ernest Henry Mining) produced documents to the court pursuant to a subpoena issued to it at the request of La Mancha. La Mancha agreed to confidentiality orders and gave undertakings in relation to its use of the subpoenaed documents and had been granted leave to inspect, uplift and copy the subpoenaed documents on that basis.

Ernest Henry Mining sought additional orders and undertakings by the Commissioner, the effect of which would be to limit the Commissioner's use of the subpoenaed documents for the purposes of the proceedings on foot only. That limitation was sought "for the avoidance of doubt", it being contended by Ernest Henry Mining that the obligation of law commonly referred to as the Harman undertaking (or obligation) constrained the Commissioner to use the subpoenaed documents only for the purposes of the proceedings on foot, absent obtaining a release from the court.

The Commissioner, on the other hand, contended that the Harman undertaking did not operate to constrain his lawful exercise of his statutory functions and powers.

Davies J held that the Harman undertaking would not restrict the Commissioner's use of the subpoenaed documents in the proceedings on foot only.

The Harman undertaking is an obligation imposed by law on parties to a proceeding who receive documents or information from the other side or third parties pursuant to the court's processes, such as through the subpoena process, and binds the parties not to make use of such documents and information other than in the litigation unless it is received into evidence. The Commissioner's case was that the Harman undertaking did not operate to prevent him from using documents and information which come into his possession through the curial processes in the lawful exercise of his statutory powers and duties under the taxation laws.

Davies J said that it was important to bear in mind the nature of the Harman undertaking. The content of the Harman undertaking is such that it recognises and is shaped by inconsistent legal obligations. The imposition of the obligation not to use documents or information compulsorily produced in a proceeding other than for the purposes of that proceeding is necessarily abrogated by a duty or compulsion imposed by law or statute to use the information for other purposes. Hence, the Harman undertaking must yield to inconsistent statutory provisions and to the requirements of curial process in other litigation.

Her Honour said that there is a wealth of appellate authority to the effect that the Commissioner's duty under s 166 ITAA36 requires him to act on the information which he has in his possession for the purpose of determining and fixing the amount of the tax liability that the law operates to impose on the taxpayer. Furthermore, s 166 not only permits, but also requires the Commissioner to act on the information which he has in his possession.

8. FBT: car parking benefits

The Full Federal Court (Logan, Thawley and Downes JJ) has unanimously allowed the Commissioner's appeal from a decision of Griffiths J and held that two airlines (collectively, Virgin) were liable to FBT in relation to car parking facilities provided by Virgin to flight crew and cabin crew (collectively, flight and cabin crew) employees and that were located near airport terminals in Sydney, Brisbane and Perth (*FCT v Virgin Australia Regional Airlines Pty Ltd*[4]).

During the relevant years, Virgin operated passenger airline services in Australia. In order to operate commercial flights, flight and cabin crew were required on board each aircraft. The Commissioner's assessments were made on the basis that the flight and cabin crew employees' "primary place of employment" was each employee's "home base" airport terminal in Sydney, Brisbane or Perth.

Virgin entered into contracts with commercial car park operators of car parks at Sydney, Brisbane and Perth airports to provide Virgin with car parking spaces. Virgin provided those car parking facilities to its flight and cabin crew by giving them access cards to the car park at the airport nearest to the location where the crew members lived (their home base airport).

As Virgin contracted directly with the operators of the relevant car parking facilities where their employees (that is, the flight and cabin crew) parked their cars, it was not an "expense payment benefit" pursuant to s 20 of the *Fringe Benefits Tax Assessment Act 1986* (Cth) (FBTAA86) and thus not an "eligible car parking expense payment benefit". Virgin's provision of car parking facilities to its employees would therefore be exempt unless s 39A FBTAA86 (in Div 10A) applied.

In the circumstances, the issues that arose under s 39A were whether the employee had a "primary place of employment" and, if so, whether the employee's car was parked "at, or in the vicinity of, that primary place of employment".

At first instance, Griffiths J accepted Virgin's contention that the duties performed by flight and cabin crew at terminals were appropriately described as ancillary to the principal duties which were performed on board the aircraft.

The Full Court, however, held that, taking into account all of the relevant facts in relation to each of the relevant days, the employee's "home base" airport was the "primary place of employment" within the meaning of para (c) of the definition of that phrase in s 136(1) FBTAA86, read with s 136(2). It was the primary place of employment on each day of the employment of the flight and cabin crew, even on days where the employee did not attend the "home base" at all, for example, on one or more days of a "tour of duty" where the employee had no occasion to attend, or perform duties at, their "home base". The "home base" was still the central place relevant to such matters as the employee's rosters, rest periods, allowances and car parking entitlements. The "home base" was the central place from where a "tour of duty" might typically be expected to begin and end. It was relevant to the inquiry required under para (c), but not determinative, that on any particular day an employee carried out central duties on aircraft away from the "home base".

9. Reimbursement agreements: s 100A

In a recent decision, the Federal Court (Logan J) has allowed appeals against assessments made by the Commissioner and, in doing so, considered a number of important issues (*Guardian AIT Pty Ltd ATF Australian Investment Trust v FCT*[5]). The assessments were issued on the basis that there was a "reimbursement agreement" that fell within s 100A ITAA36.

On 14 November 1999, Guardian AIT Pty Ltd (Guardian), of which a Mr Springer was the sole shareholder, became the trustee of the Australian Investment Trust (the AIT), a discretionary trust that was established on 25 June 1998. Mr Springer was the "principal" of the AIT and this office conferred on him the power to appoint a person to be a beneficiary of the trust.

On 27 June 2012, Mr Springer incorporated a company (AIT Corporate Services Pty Ltd (AITCS)) and appointed it to be a beneficiary of the AIT. The sole shareholder of AITCS was Guardian in its capacity as trustee. On 28 June 2012, Guardian appointed the balance of the income of the AIT for the 2012 income year ($2,640,209) to AITCS. This distribution was not paid to AITCS, creating an unpaid present entitlement (2012 UPE). On 17 April 2013, AITCS drew on its entitlement to the income of the AIT to discharge its liability to income tax for the 2012 income year of $792,062.

On 1 May 2013, AITCS declared a fully-franked dividend in the amount of $1,848,145 payable to the AIT. That dividend was paid by reducing the balance of the 2012 UPE of AITCS to the income of the AIT from $1,848,145 to nil.

On 23 June 2013, Guardian resolved that the amount of net income of the AIT for the 2013 income year attributable to franked dividends be set aside and held on trust absolutely for Mr Springer.

A similar procedure was adopted in relation to each of the 2013 and 2014 income years. In March 2016, AITCS and the AIT entered into a loan agreement (that complied with s 109N ITAA36) in the amount of the balance of the 2014 UPE. This loan was repaid in the 2016 income year.

On 17 November 2017, the Commissioner assessed the AIT as being liable to income tax under s 99A(4A) ITAA36 on the basis that s 100A ITAA36 applied, together with assessments to administrative penalties.

For the purposes of these income tax assessments, and the appeals before the court, the Commissioner's position was that, on or before 27 June 2012, Guardian (as trustee) and Mr Springer reached an understanding that, in the then current income year and future income years:

- AITCS would be incorporated for the purposes of being made presently entitled to the income of the AIT;
- Guardian as trustee would benefit from the amount to which AITCS was made presently entitled; and
- Mr Springer would ultimately benefit from the amount to which AITCS was made presently entitled.

The Commissioner termed this "the 2012 understanding". The Commissioner's contention was that the 2012 understanding was a reimbursement agreement for the purposes of s 100A ITAA36.

Further, or in the alternative, a separate position adopted by the Commissioner for the purposes of the assessments was that, on or before 23 June 2013, Guardian (as trustee) and Mr Springer reached an understanding (the 2013 understanding) that, in the then current income year and future income years:

- Guardian as trustee would benefit from the amount to which AITCS was made presently entitled; and
- Mr Springer would ultimately benefit from the amount to which AITCS was made presently entitled.

The Commissioner's alternative contention was that the 2013 understanding was a reimbursement agreement for the purposes of s 100A ITAA36.

As an alternative to the assessments raised in reliance on s 100A ITAA36, the Commissioner issued assessments and assessments of administrative penalty to Mr Springer on the basis that Pt IVA ITAA36 was applicable.

Logan J allowed the appeals against the assessments raised by the Commissioner on the basis that s 100A ITAA36 applied, and also the assessments raised in reliance of Pt IVA ITAA36. The following notes some points of interest that arise out of his Honour's consideration of s 100A ITAA36.

Timing of agreement

Logan J said that a textual approach supported the submission made on behalf of Guardian that, for s 100A to have application, the reimbursement agreement concerned must precede "the payment of money or the transfer of property to, or the provision of services or other benefits" and the present entitlement of the beneficiary.

His Honour said that, on the findings of fact which he had made, what the Commissioner termed "the 2012 understanding" did not exist at all. A "reimbursement agreement" need not be legally enforceable and may be attended with great informality. But accepting this breadth of meaning, it must be possible to conclude that something answering the description of "reimbursement agreement" in s 100A(7) ITAA36 existed before the present entitlement.

There was no support for this in the contemporaneous evidence as to events in June 2012 on or prior to the resolution on 28 June 2012 which created the present entitlement of AITCS, not even a foundation for reasonable inference. A hypothetical contingency open in law but never considered was not sufficient to yield that. It was only many months later that even the possibility of the declaring of a dividend by AITCS emerged. The requisite temporal sequence was lacking. There was no "relevant connection".

Ordinary family or commercial dealing

Logan J said that, read in context, the adjective "ordinary" in the expression "ordinary family or commercial dealing" had particular work to do. It was used in contradistinction to "extraordinary". It referred to a dealing which contained no element of artificiality. This was confirmed by reference to the relevant explanatory memorandum, where there is a reference to addressing the mischief of specially introduced beneficiaries having a fiscally advantageous status.

In this particular case, and for the reasons given, the incorporation of AITCS, its appointment as a member of the eligible beneficiary class, and the resolution to make a distribution to it of trust income were each nothing more than an ordinary family or commercial dealing.

Logan J further said that, even if there were an "agreement" as defined, s 100A could still have no application because that agreement did not provide 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". The agreement made in June 2012 provided only for the payment of money to a beneficiary, AITCS. It went no further. It could not therefore be a "reimbursement agreement".

Given the way the definition of "agreement" is cast, a conclusion that an agreement, arrangement or understanding was entered into in the course of ordinary family or commercial dealing necessarily also meant that there was, in the 2012 income year, no "agreement" as defined, to which s 100A(8) could have application.

It is not known whether the Commissioner will appeal to the Full Federal Court from the decision of Logan J.

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References

1 [2021] HCA 43.
2 [2021] FCAFC 197.
3 [2021] FCA 1564.
4 [2021] FCAFC 209.
5 [2021] FCA 1619.

Tax Tips

by TaxCounsel Pty Ltd

Blackhole expenditure: some points

The *Clough* case highlights the potential for s 40-880 ITAA97 to provide relief in relation to so-called blackhole expenditure that is not otherwise taken into account for income tax purposes.

Background

The present s 40-880 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) (business-related costs) was enacted by the *Tax Laws Amendment (2006 Measures No. 1) Act 2006*. In broad terms, the section provides for taxation deductions for business capital expenditure that is not recognised in some way elsewhere in the tax law.[1] The expenditure may be incurred in relation to an existing, past or prospective business.

The section has been recently highlighted by the decision of the Full Federal Court in *Clough Ltd v FCT*.[2] In that decision, the Full Federal Court unanimously dismissed an appeal by the taxpayer company against a decision of Colvin J[3] that an amount of just over $15m paid by the taxpayer company to employees in consideration for the cancellation of employee entitlements under an employee option plan and an employee incentive scheme was not deductible as a general deduction (under s 8-1 ITAA97) because the positive limbs of the section were not met and the amount was of a capital nature.

Before the hearing at first instance in that case, the Commissioner had conceded that the amount claimed was deductible over five years under s 40-880 ITAA97. Thawley J (speaking for the Full Federal Court) said that the findings made showed that the Commissioner's concession was properly made.

This article briefly considers some of the more significant aspects of s 40-880 ITAA97. The section has been amended several times since its enactment but this article reflects the way that the section applies in relation to expenditure incurred now.

The object of the deduction

The explanatory memorandum to the amending Bill that proposed the enactment of s 40-880 ITAA97 explained that taxpayers may incur business expenditures that fall outside the scope of the various deduction provisions of the income tax law. For example, expenditure may not be deductible under the general deduction provision (8-1 ITAA97) because it is capital expenditure, but is not included in the cost base of a CGT asset or in the cost of a depreciating asset, or there is no other specific capital allowance provision in the income tax law that allows a deduction for the expenditure. Expenditure could also be incurred before a business commences, or after it ceases, which may mean that a taxpayer has difficulty in demonstrating the required nexus with the business to enable a deduction under the other provisions of the tax law.

Section 40-880 ITAA97 itself explains (in subs (1)) that the object of the section is to make certain business capital expenditure deductible over five years, or immediately in the case of some start-up expenses for small businesses, if:

- the expenditure is not otherwise taken into account;
- a deduction is not denied by some other provision; and
- the business is, was or is proposed to be carried on for a taxable purpose.

The Commissioner has issued a public ruling (TR 2011/6) which considers the operation of s 40-880 ITAA97 and to which reference may be made.

Operation of s 40-880

Diagram 1 sets out in broad terms the way that the s 40-880 deduction provision operates.

What can be deducted?

The main rule that governs the deductibility of expenditure under s 40-880 ITAA97 is provided for in subs (2) which reads as follows:

> "(2) You can deduct, in equal proportions over a period of 5 income years starting in the year in which you incur it, capital expenditure you incur:
>
> (a) in relation to your business; or
>
> (b) in relation to a business that used to be carried on; or
>
> (c) in relation to a business proposed to be carried on; or
>
> (d) to liquidate or deregister a company of which you were a member, to wind up a partnership of which you were a partner or to wind up a trust of which you were a beneficiary, that carried on a business."

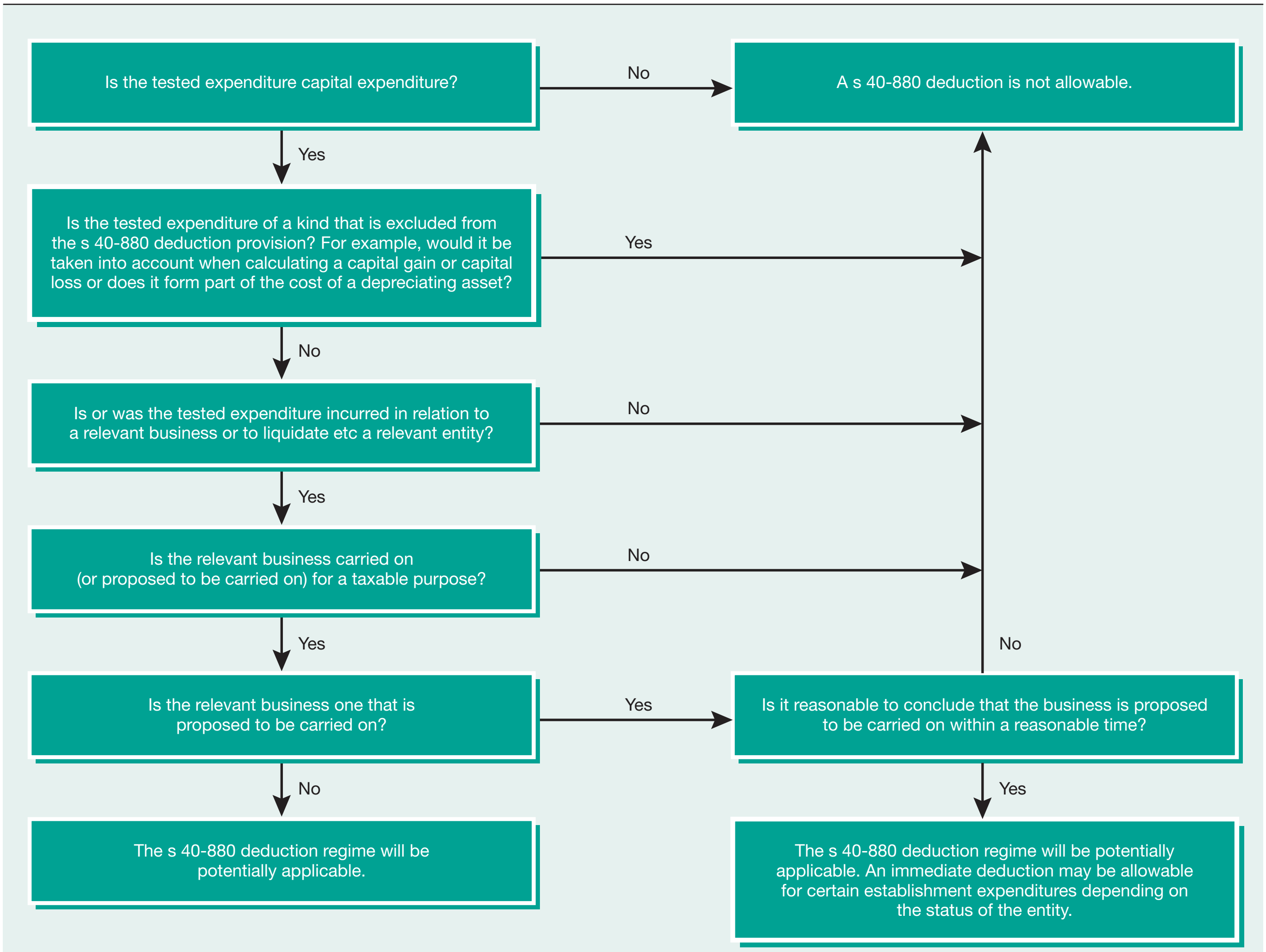
"Business"

It is pointed out in TR 2011/6 that the reference in s 40-880(2)(a) to "your business" is a reference to the taxpayer's overall business rather than a particular undertaking or enterprise within the overall business. Similarly, where the taxpayer is the head company of a consolidated group, "your business" refers to the overall business of the head company.

In contrast, s 40-880(2)(b) and (c), which concern a former business and a proposed business, could refer to an overall business or a business activity which is an element or aspect of the taxpayer's overall business. This is also the case with the head company of a consolidated group.

Whether a business is (or was) being carried on will be a question of fact in each case. But it is a requirement in

Diagram 1. How the deduction provision works



all cases that the business (depending on the particular circumstances) was, is or is proposed to be carried on for a taxable purpose (s 40-880(3) ITAA97). The concept of a taxable purpose is defined in s 40-25(7) ITAA97. By virtue of that definition, a taxable purpose is the purpose of producing assessable income.[4] In turn, something is done for the purpose of producing assessable income if it is done: (1) for the purpose of gaining or producing assessable income; or (2) in carrying on a business for the purpose of gaining or producing assessable income.[5]

Business proposed to be carried on

In the case of a business that is proposed to be carried on (see s 40-880(2)(c) above), it must, having regard to any relevant circumstances, be reasonable to conclude that it is proposed to carry on the business within a reasonable time (s 40-880(7) ITAA97).

In relation to

It is stated in TR 2011/6 that the expression “in relation to” that is used in s 40-880(2)(a) to (c) (quoted above) denotes the proximity required between the expenditure on the one hand and the former, current or proposed business on the other.

In *First Provincial Building Society Ltd v FCT*,[6] Hill J (Black CJ and Carr J agreeing) said that the words “in relation to”:

> “… are words of wide import. They are capable of referring to any relationship between two subject matters, in the present case the receipt of the bounty or subsidy, on the one hand, and the carrying on of the business, on the other … As McHugh J points out,[7] the degree of connection will be ‘a matter of judgment on the facts of each case’. If the relationship were a merely remote one, para (g)[8] would have no operation. What is necessary, at the least, in the present context is that there be a real connection. But the existence of the alternative first limb of the paragraph makes it clear that the relationship need not be direct, it may also be indirect.”

In the context of s 40-880 ITAA97, TR 2011/6 states that, for capital expenditure to be “in relation to” a business, there must be a sufficient and relevant connection between the expenditure and the business. The closeness of the association or connection must objectively support the conclusion that the capital expenditure is a business expense of the particular business.

Other points made in TR 2011/6 are:

- whether capital expenditure is truly business expenditure is determined by the facts. If the facts show that the expenditure satisfies the ends of the relevant business, it will have the character of business expenditure;
- capital expenditure that has the essential character of business expenditure also includes expenditure on activities that prepare for the commencement of the business; and
- business-related capital expenditure does not include expenditure relating to non-business activities such as passive investment. Occupation as an employee is generally a non-business activity (although earning income under a contract of employment can, in limited circumstances, form part of a business).

Capital expenditure

For expenditure to qualify for deducibility under s 40-880 ITAA97, it must be "capital expenditure". That, it would seem, would require an analysis along the lines that is necessary for determining whether a loss or an outgoing is capital or of a capital nature for the purposes of the general deduction provision (s 8-1 ITAA97).[9]

Timing of deductions

As provided for by s 40-880(2) ITAA97 (quoted above), a deduction is allowable in equal proportions over a period of five income years, starting in the year in which the taxpayer incurred it.

An immediate deduction, however, is allowable for certain expenditure that is incurred by an entity that is a small business entity (or would be a small business entity if the aggregated turnover threshold for small business entity status were $50m and not $10m) where the expenditure is incurred in relation to a business that is proposed to be carried on (s 40-880(2A) and (2B)).

Presumably, for the purpose of determining whether, and if so, when, capital expenditure is incurred, the principles that have been developed by the courts in relation to the general deduction provision (s 8-1 ITAA97) would be relevant.[10]

Apportionment

It is pointed out in TR 2011/6 that other provisions of s 40-880 ITAA97 (in particular, s 40-880(3), (4) and (5)) use the expression "to the extent that", indicating that an apportionment may be required when applying those subsections. In contrast, s 40-880(2) does not contain that expression. However, the ruling states that, in the Commissioner's view, the absence of the expression "to the extent that" in s 40-880(2) does not prevent an apportionment of expenditure on a single thing or service which serves more than one purpose or object. This is equally so whether the thing or service serves distinct and separate purposes or objects, or whether the thing or service serves two or more purposes or objects indifferently. The basis for any apportionment must be fair and reasonable.

What if the business is sold or ceases?

The test to determine whether expenditure is deductible under s 40-880 ITAA97 is a once only up-front test established as at the time when the expenditure is incurred. This means that, once eligibility is established, the deduction is able to be written-off over the five income years even if the relevant business later ceases or is disposed of or, in the case of a prospective business, the business does not commence.

Example (adapted from the relevant explanatory memorandum)

Eleanor and Olivia own a small but successful coffee shop and are seeking to expand their business. They incur qualifying expenditure during the 2020 income year for the purpose of establishing another coffee shop in a newly constructed shopping mall. Eleanor and Olivia deduct 20% of the expenditure for the 2020 income year. In the following income year, 2021, Eleanor and Olivia are forced to sell the new coffee shop due to unforeseen personal circumstances. They are able to continue to claim the remaining 80% of the expenditure in equal proportions for each of the 2021 to 2024 income years.

This example from the explanatory memorandum, it is suggested, does not go far enough to illustrate how the section would operate if, for example, the unforeseen personal circumstances meant that both coffee shops had to be disposed of so that no business at all was then carried on. This would mean that the partnership would cease to exist. But would Eleanor and Olivia be entitled to continuing deductions in their individual returns? Difficulties could also arise if, after a partnership incurred relevant expenditure, a new partner was admitted to the partnership so that there is a different association of persons. It is suggested that it would be helpful if the Commissioner were to provide his views on these issues.

For individual taxpayers, the non-commercial loss provision will also apply so that a deduction otherwise available may be deferred (see below).

Exclusions from deductibility

Subsection (5) of s 40-880 is an important provision which operates to deny deductions under the section in a range of circumstances. The effect of the subsection is that a deduction is not allowable under s 40-880 ITAA97 for an amount of expenditure that is incurred to the extent that:

a. the expenditure forms part of the cost of a depreciating asset that the taxpayer holds, used to hold or will hold;
b. the taxpayer can deduct an amount for it under a provision of the ITAA97 or the ITAA36 other than s 40-880 itself;
c. the expenditure forms part of the cost of land;[11]
d. the expenditure is in relation to a lease or other legal or equitable right;[12]
e. the expenditure would (apart from s 40-880 ITAA97) be taken into account when working out a profit that is included in the taxpayer's assessable income (for example, under s 6-5 ITAA97) or a loss that the taxpayer can deduct (for example, under s 8-1 or 25-40 ITAA97);
f. the expenditure could (apart from s 40-880 ITAA97) be taken into account when working out the amount

of a capital gain or capital loss from a CGT event.[13] It is pointed out in TR 2011/6 that this exclusion does not require that the capital expenditure be actually taken into account when working out a capital gain or capital loss, or that the capital gain or capital loss worked out be actually taken into account when working out the net capital gain included in the taxpayer's assessable income — that is a separate process. If the words were interpreted otherwise, expenditure which should receive CGT treatment could inappropriately become a revenue deduction;

g. a provision of the ITAA97 or the ITAA36 (other than s 40-880) would expressly make the expenditure non-deductible if it were not of a capital nature;
h. a provision of the ITAA97 or the ITAA36 (other than s 40-880) expressly prevents the expenditure from being taken into account as described in (a) to (f) above for a reason other than the expenditure being of a capital nature;
i. the expenditure is expenditure of a private or domestic nature; or
j. the expenditure is incurred in relation to gaining or producing exempt income or non-assessable non-exempt income.

In relation to the exceptions provided for in (d) and (f) above, s 40-880(6) provides that the exceptions do not apply to expenditure incurred to preserve (but not enhance) the value of goodwill if the expenditure incurred is in relation to a legal or equitable right and the value to the taxpayer of the right is solely attributable to the effect that the right has on goodwill. In *FCT v Sharpcan Pty Ltd*,[14] the High Court explained that the purpose of s 40-880(6) is to confine deductibility under s 40-880(2) for expenditure in relation to goodwill to expenditure in relation to goodwill that could not otherwise be brought to account under the ITAA97.

If a market value substitution rule operates to exclude an amount of expenditure from the cost of a depreciating asset or the cost base or reduced cost base of a CGT asset, the excluded amount is not deductible under s 40-880 (s 40-880(8) ITAA97).

Market value is also applied for the purposes of s 40-880 ITAA97 where there is a non-arm's length arrangement under which the amount of expenditure incurred is more than, or an amount received is less than, market value (s 40-885 ITAA97).

Further, the general position is that no deduction is allowable under s 40-880 for an amount of expenditure incurred:

- by way of returning an amount that has been received; or
- to the extent that, for another entity, the amount is a return on or of an equity interest or a debt interest (s 40-880(9) ITAA97).

Other provisions that may affect deduction

Non-commercial losses

If the taxpayer is an individual taxpayer (operating either alone or in partnership), the non-commercial loss provisions in Div 35 ITAA97 may apply to defer deductions for expenditure they incur in relation to a business they carry on or propose to carry on.

Where the taxpayer has incurred business capital expenditure in relation to a former business and the activity does not satisfy the commerciality tests or the Commissioner does not exercise his discretion not to apply the rule in s 35-10(2) ITAA97, the s 40-880 deduction will be denied rather than deferred (s 35-10(2A) ITAA97).

Personal services income

Under the personal services income rules, an individual carrying on a business which generates personal services income, but does not meet the "personal services business tests" and does not have a "personal services business determination" from the Commissioner, will not be regarded as conducting a personal services business. By virtue of s 85-10 ITAA97, they will be prevented from deducting any amount, including under s 40-880 ITAA97, that an employee could not deduct in relation to their personal services income.

However, a taxpayer that is a "personal services entity" (a company, partnership or trust) which carries on business and is in receipt of personal services income may be entitled to a deduction under s 40-880 ITAA97, even though it does not meet any of the "personal services business tests" and has not received a "personal services business determination".

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References

1 Section 40-880 ITAA97 applies in relation to expenditure incurred on or after 1 July 2005. It replaced a provision that provided a five-year write-off for seven specific types of business capital expenditure, including costs to establish a business structure and costs to cease carrying on a business.

2 [2021] FCAFC 197. For further details of the Full Federal Court's decision in this case, see item 6 in the Tax News column of this issue of the journal (page 408).

3 *Clough Ltd v FCT* [2021] FCA 108.

4 The definition extends to the purpose of exploration or prospecting, mining site rehabilitation and environmental protection activities.

5 S 995-1 ITAA97.

6 [1995] FCA 1101 at [64].

7 In *O'Grady v Northern Queensland Co Ltd* [1990] HCA 16.

8 Former s 26(g) the *Income Tax Assessment Act 1936* (Cth) (ITAA36) (see now s 15-10 ITAA97).

9 The recent decision of the Full Federal Court in *Clough Ltd v FCT* provides an example.

10 This is the view expressed by the Commissioner in TR 2011/6 at para 12.

11 It is pointed out in TR 2011/6 that this will be a relatively uncommon situation. In most instances, the cost would be excluded by (f).

12 This exclusion was considered by Thawley J in *Origin Energy Ltd v FCT (No. 2)* [2020] FCA 409.

13 This exclusion was considered by Thawley J in *Origin Energy Ltd v FCT (No. 2)* [2020] FCA 409. See also TD 2014/14.

14 [2019] HCA 36.

Higher Education

A positive approach to new challenges

The winner of our Emerging Tax Star Award and Gordon Cooper Memorial Scholarship in 2021 reveals the qualities and skills that make a successful tax practitioner.

Helena Papapostolou, Senior Associate, Greenwoods & Herbert Smith Freehills, NSW

Please provide a brief background of your tax career.

As a Senior Associate at Greenwoods & Herbert Smith Freehills, I specialise in providing high-value indirect tax advice to clients in various industry sectors. This is mostly in relation to corporate and M&A transactions, real estate transactions and investment, complex due diligence and post-implementation steps. I hold a Bachelor of Commerce and a Bachelor of Laws from the University of New South Wales, where I have also completed a Master of Laws.

How does it feel to be the Emerging Tax Star Award winner?

It is an overwhelming surprise, honour and privilege to be recognised among my esteemed peers for this prestigious award. The award means more to me than just a title. It represents my continuing development through sharing ideas, engaging with peers and ongoing learning.

What factors would you attribute your success to?

I have been fortunate that my professional development has been under the guidance of exceptional mentors and peers from whom I have had the opportunity to collaborate and learn. I have been committed to continuing my learning and development through tertiary study, mentoring, and interpreting COVID-related tax changes which have exposed me to different commercial issues and diversity of thought.

As the recipient of this award, how would you use this to influence others?

This award presents a significant platform to use my knowledge and achievements to motivate and inspire others to become actively involved in the tax community. I hope to encourage junior practitioners to engage in new challenges and share their perspectives on complex issues. Collective thought is an invaluable element of this process and I hope to inspire the involvement and sharing of insights by my peers.

This recognition also presents a platform for my professional and personal development. My goal is to be an exceptional practitioner, peer and leader, the best that I can be in my area of practice. Applying the same enthusiasm and diligence in my work to learn and be actively involved, I hope to make the most of what this award offers an emerging tax practitioner and leader.

What role has education played in your career journey?

Education has been an essential tool for me to develop my commercial understanding, pursue new areas of practice that interest me and, notably, to navigate the current market conditions. As an industry, we have been challenged to be agile enough to adapt to new circumstances in a time of uncertainty. I feel that education has equipped me to traverse these challenges by being current with relevant training on technical issues and professional standards. I then apply this knowledge, innovation and initiative to best advise clients and uphold the highest professional standards.

Why do you want to undertake the Chartered Tax Adviser Program?

I am enthusiastic to continue my industry-specific education with The Tax Institute. Having the opportunity to learn from the most influential figures in the tax profession and accessing resources unrivalled in quality, I am certain the program will provide me with important industry insights and a sound technical foundation to continue to develop into the best practitioner that I can be.

What advice do you have for other tax professionals wanting a successful tax career?

The last 18 to 20 months have been particularly challenging but also, from a development point of view, rewarding. The impact of COVID-19 on businesses and communities has pushed me to reconsider business operations and see new opportunities. I would encourage practitioners to engage with, and have a strong presence in, the tax community to continue to inspire diversity of thought and share invaluable insights in areas that define tax professionals and trusted advisers — technical expertise, leadership, excellence, innovation and teaming.

Charities and not-for-profits

by The Tax Institute

This chapter of the *Case for Change* paper considers challenges faced by not-for-profits (NFPs) in tax treatment and administration at the state and federal levels. It points to the inconsistency in definitions, the different legislative (both tax and non-tax) regimes that charities are faced with: will income tax exemption be available; which government agencies must they apply to first; will GST concessions apply; can FBT concessions be offered to employees (and should they); what payroll tax, land tax or stamp duty concession might be available; and how much change is required to the same reports and financial statements for the different reporting regimes? It is posited, and many commissioned reports have similarly concluded, that the complexity of the regulatory environment for NFPs is disproportionate to the level of compliance and willingness to comply shown by the sector.

Overview

The charities and not-for-profit (NFP) sector in Australia is large, diverse and provides many services to the community. There is a broad range of federal and state tax concessions currently afforded to various types of NFPs. The principle of concessional tax treatment for NFP entities is widely supported by the general public, policymakers and commentators. Concessions for NFPs underpin good tax policy. Income tax exemption specifically was supported in both the Henry review[1] and the Productivity Commission Report.[2] It is clear that 'charitable giving is the lifeblood of civil society'[3] and that such organisations 'make a highly valued contribution to community wellbeing'.[4] Supporting NFPs through tax concessions helps to sustain the sector, and facilitates NFP entities in successfully undertaking their philanthropic activities, which ultimately should benefit the broader community.[5]

But this is not the only justification for tax concessions for charities and NFPs. Entities pursuing charitable purposes have been exempt from taxation since the first income tax legislation was introduced in England. One reason for this, that must not be overlooked in formulating tax policy, is that charities have only purposes, and are legally prohibited from distributing surpluses for private gain — any surplus must be applied to furthering the charity's purpose. The Australian income tax law rests on a basis that the primary aim is to tax profits and gains made by individuals. If individuals are the appropriate unit upon which to impose income taxes, then there is simply no appropriate individual, in a charity, who has income to tax.

Similarly, where income and profits generated are simply applied to further an entity's charitable purpose, it can be difficult to identify any amount that should be properly subject to tax. Where a charity performs work which would otherwise need to be performed by or funded by government, adding a tax or compliance burden can also result in increased costs to government.

There have been a number of inquiries and reviews into the NFP sector which have considered the size, scale and breadth of the sector's contribution to different aspects of society, including, importantly, its significant presence as an employer in Australia.[6] This chapter of the *Case for Change* paper considers challenges faced by NFP entities in tax treatment and administration at the state and federal levels.

The complexity of the regulatory environment in which NFPs operate is disproportionately high when factored against the risk and need for regulation. Further, there is a willingness and desire to comply within the sector that is difficult to achieve given the complex over-regulation. The NFP sector relies heavily on goodwill, volunteers and the pro bono contributions of professional services. The overarching objective of the reforms recommended in the context of the NFP sector is a reduction in the administrative burden. Simplification of the taxation environment for NFPs is critical to support such organisations to fulfil their objectives without undue administrative complexity.

Harmonisation of cross-jurisdictional administration of charities and NFPs

One significant factor which exacerbates compliance costs in the NFP sector is the multiplicity of regulation at the different levels of government. Charities and other NFPs are subject to a large number of different reporting thresholds with multiple regulatory bodies, dependent on their precise legal structure and geographical areas of operation.[7] For a charity that is incorporated and operating in all states and territories, depending on its particular activities (for example, fundraising), the organisation could be required to deal with over 20 different government departments and agencies. This does not take into account additional agencies involved in respect of local government concessions.

The lack of consistency leads to unnecessary complexity and a heightened risk of organisations inadvertently failing to meet their reporting obligations. It also results in an increased compliance burden which diverts funds from the community focus of the organisations in question. This complexity is exacerbated by a lack of clarity amongst NFPs as to a precise definition of revenue or turnover in an NFP context, with receipts from donors and government grants being treated differently depending on the reporting purposes.

These issue have been recognised in several reviews of the NFP regulatory framework, which has been characterised as unnecessarily complex, inconsistent and opaque.[8] Great strides were made with the introduction of the ACNC and the codification of the definition of 'charity' through the *Charities Act 2013* (Cth), though a lack of harmonisation of definitions and regulations across the state and federal levels continues (see discussion below).

To reduce the administrative burden that NFP entities (particularly charities) face in this regard, The Tax Institute recommends the standardisation and harmonisation of the state and federal administration of NFPs. This should involve harmonisation of the definition of 'charity', and consistency in the eligibility criteria for endorsement, registration and exemptions.

A common definition of 'charity'

The most pressing issue for the NFP sector is the burden caused by the lack of harmonisation between state and federal requirements for tax concessions. An entity registered as a charity by the ACNC, endorsed as income tax exempt, and entitled to GST concessions and an FBT rebate, may nevertheless fail to meet the definition of 'charity' as applied by the various state revenue offices. For example, Western Australia's charitable exemption from duties ostensibly restricts the eligibility of certain fourth limb charities to 'industrial associations' and 'professional associations'.[9] Particularly since the *Charities Act 2013* was not intended to depart from the common law definition of 'charity', this inconsistency is unnecessary and unworkable.

Charities which are registered with the ACNC should be deemed to be eligible for the state concessions in all jurisdictions. Serious consideration should be given to addressing this inconsistency and to creating uniformity. Harmonisation in this regard would alleviate the need for NFPs to obtain advice pertaining to their eligibility on a state-by-state basis. This has the additional benefit of freeing up professional service providers to instead provide pro bono services on meaningful work undertaken by the NFPs and to better support those organisations in other ways. It would eliminate the administrative burden of applications to, and verifications by, state revenue offices. The flow-on effect is that NFPs would be able to operate more freely across Australia. This is ultimately beneficial to the wider community and the particular sectors in need to which NFPs provide support and charitable services.

Reforming the deductible gift recipient regime based on a clear policy intent

Deductible gift recipients (DGRs) are organisations which can receive donations that are tax deductible to the donor. Deductible gift recipient endorsement is determined by the ATO. A charity may be wholly or partly DGR endorsed, depending broadly on the extent to which it falls within a DGR category. With recent legislative changes, specifically listed entities are able to qualify as DGRs even if they are not registered charities.

Australia's DGR framework remains antiquated, unnecessarily complex and unwieldy. Reforms to the DGR framework were announced in 2017 but, as yet, the only legislated reform has been the requirement for all DGRs (other than specifically listed entities) to be registered as charities with the ACNC. This reform suggests that the policy behind DGR endorsement, rather than being to facilitate the movement of private funds to the charitable sector, is instead the same as the policy behind charity endorsement, being broadly to provide concessions where there is public benefit and social contribution.

If this is the case, it follows that the DGR framework should be reformed in light of that policy. The bold but logical conclusion would be that all charities should automatically be eligible for DGR endorsement. Noting the existing condition for an organisation to be registered as a charity (as distinct from an NFP organisation which may not necessarily be a charity), if the issue is that charities with particular purposes or objectives should not be able to obtain DGR status, then it is submitted that this is actually a question of the meaning of a charity.

Short of such a solution, the proposed reforms of removing public fund requirements should be progressed with priority. In addition, in an era of informed donors seeking specific impact for their donation, consideration should be given to modernising and clarifying the gift rules. This would have the added benefit of generally streamlining the cumbersome DGR framework.

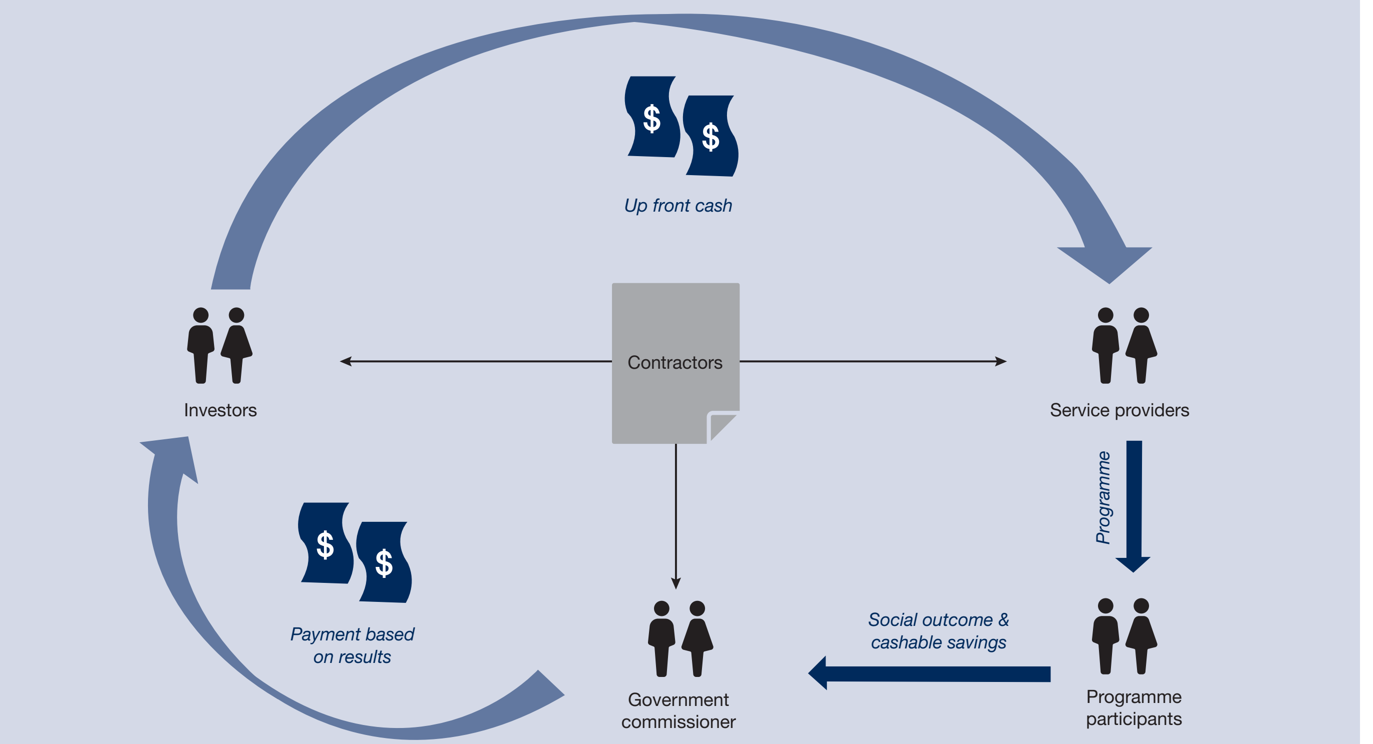
Facilitating the growth and development of social projects and programs

Across the NFP sector, there is the continual challenge of fund raising for projects and philanthropic initiatives. Increased access to funding that is linked to accountability for the outcomes delivered would stimulate projects that deliver efficient and effective community benefits. These kinds of opportunities exist and are leveraged in other jurisdictions. For example, social impact bonds (SIBs) are used in foreign jurisdictions, such as the UK, and smaller scale examples do exist at the state level in Australia, though are, as yet, far less common.[10] Federal support allowing for tax concessions for investors has the potential to deliver profound, efficient and effective community benefits. Consideration should be given to the policy design of a federal social impact regime to encourage access to funding and the delivery of outcomes in this sector.

The reference to the word 'bonds' in social impact bonds is a misnomer as SIBs are distinct from bonds in the ordinary sense. Social impact bonds bring together the public, private and voluntary sectors to address social inequities such as homelessness, youth unemployment, matters of public health and education. An SIB is essentially a mechanism which assists an organisation to deliver particular outcomes and makes funding conditional on the achievement of particular results or targets.

While there are a number of ways in which an SIB may operate, a basic example is set out in Figure 1. Social investors seeking both social and financial returns provide upfront capital to charities or other social enterprises to fund the projects undertaken through an SIB. The charity or social enterprise will be tasked with delivering a particular service or objective which improves the social outcomes for a particular sector of society (for example, the alleviation of homelessness). The SIB agreement will outline measurable outcomes (for example, establishment of a particular number of shelters, or registration of a certain number of homeless or at-risk persons in the program). Such outcomes are usually established by the commissioner of the SIB, which is generally a local government authority. Where the outcomes

Figure 1. A social impact bond



Source: HMRC, *A guide to social impact bonds*. Available at www.gov.uk/guidance/social-impact-bonds.

are achieved, the social investors receive a return on their investment.

Under one model for tax concessions for SIBs, investors might be entitled to an upfront deduction for the amount invested in an SIB and taxed at standard rates on any returns that are ultimately derived. An alternative model could be to allow investors to forego an upfront deduction in favour of future tax concessions on income only once the pre-determined and measurable benefits to the community have been achieved (a federal community benefit bond)[11] There are two key ways in which a tax concession could be applied to support such a scheme. An exemption could apply to treat any income returned from a taxpayer's investment in a federal community benefit bond as tax exempt (see Figure 2). Alternatively, a tax offset could apply with a similar operation to the former infrastructure bonds tax offset and carry a flat tax credit/offset.

Options for reform

- Harmonise definitions and regulations used across the states and territories with those used at the federal level to reduce administrative complexity and compliance costs.
- Provide all registered charities and NFPs with DGR endorsement.
- Introduce concessional treatment for social ventures to provide greater support to NFPs to achieve social outcomes.

Conclusion

Given the nature and structure of charities and the reliance on passionate but often non-tax expert volunteers, it is suggested that charities are not well placed to address the complexity that they face. Indeed, even the seasoned tax practitioner, confronted with a client who seeks help on the charities they are involved in, will often struggle with the multiple registration and reporting requirements and the array of different concessions that may be open. Multiple reports over decades have called for reform and it is an indictment on all governments that so little has been done and so much more needs to be.

The Tax Institute

Important note: This article does not necessarily reflect any changes in the law since June 2021.

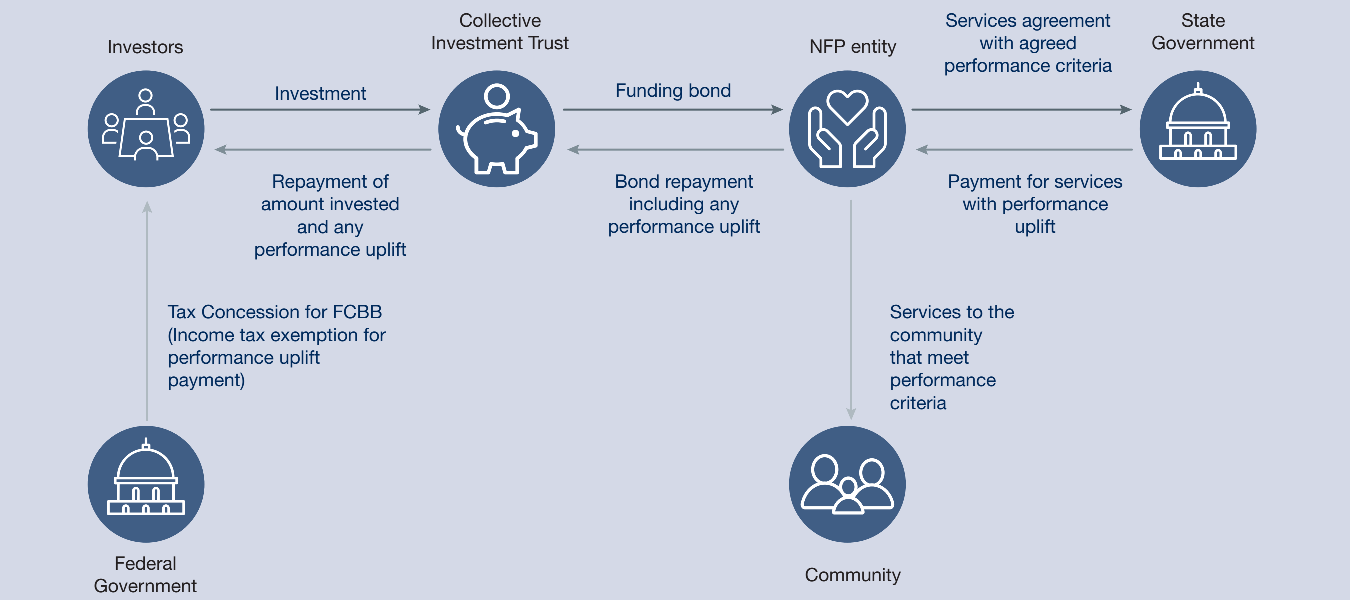
References

1 Australia's Future Tax System Review Panel (Dr Ken Henry, Chair), *Australia's future tax system: report to the Treasurer* (Henry review), 23 December 2009, p. 88. Available at https://treasury.gov.au/review/the-australias-future-tax-system-review/final-report.

2 Productivity Commission, *Contribution of the not-for-profit sector*, research report, January 2010. Available at www.pc.gov.au/inquiries/completed/not-for-profit/report.

3 J Malone and R Young, "The responsibility of charity: what constitutes a charity for income tax purposes?", The Tax Institute 6 (Malone, Charities), 26 February 2015, p. 1. Available at www.taxinstitute.com.au/tiseminarpaper/the-responsibilities-of-charity-what-constitutes-a-charity-for-income-tax-purposes-paper.

Figure 2. Illustration of a federal community benefit bond scheme



Source: PwC submission in response to the *Re:think tax discussion paper*, 1 June 2015.

4 Henry review, Part 2, p. 205.

5 Henry review, Part 2, p. 206. See also Malone, Charities, p. 4.

6 See, for example, *Contribution of the not-for-profit sector*, Productivity Commission research report, January 2010; ACNC, *Australian charities report*, September 2014; and, more recently, *Strengthening for purpose: Australian charities and not-for-profits Commission — Legislative review 2018*, report and recommendations, May 2018.

7 Treasury, *Increasing financial reporting thresholds for ACNC-registered charities*, consultation paper, February 2021. Available at https://treasury.gov.au/sites/default/files/2021-02/c2021-141336.pdf.

8 Henry review, Part 2, pp. 207-208.

9 Ss 95 and 96A to 96C of the *Duties Act 2008* (WA).

10 See UK: www.gov.uk/guidance/social-impact-bonds; and see Australia: www.socialventures.com.au.

11 PwC submission in response to the *Re:think tax discussion paper*, 1 June 2015.

Correction notice

In our cover article “Small and family business concessions” by The Tax Institute (published in the December 2021/January 2022 issue of *Taxation in Australia*), there were errors in the thresholds published for a small proprietary company (referred to on page 357), the ones referable apply to FY2019 and prior. For financial years commencing on or after 1 July 2019, these were doubled in terms of gross revenue, total assets and the number of employees to $50 million, $25 million and 100 or more employees, respectively. A corrected version of the article can be found here.

Tax and estate planning in 2022: the year ahead

by Matthew Burgess, CTA, Director, View Legal

Appropriate tax and estate planning strategies will remain critical in 2022 in light of ongoing changes to the taxation regime, expected further amendments to fund COVID-19 government spending, and the massive intergenerational wealth transfer of Australia's "baby boomer" population. Historically, tax and estate planning related areas have largely been outliers from radical rule overhauls. Since 2018, this historical position appears to have permanently shifted with a range of announcements. Subsequent years have seen significant evolution in a number of areas, including trust vesting, trust splitting, testamentary trusts, excepted trust income and family trusts. At 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.

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:

- the ability to structure testamentary trusts (TTs) to minimise the risk that assets will be attacked on the relationship breakdown of a beneficiary;
- the latest guidance from the High Court in relation to the deeming rules that can apply to assets otherwise registered as owned as a joint tenancy;
- the use of enduring powers of attorney to manage superannuation death benefit nominations; and
- the impact of lost trust deeds of an inter vivos discretionary trust.

Twelve months on, this article examines the following key tax structuring and estate planning related developments in 2021, namely:

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

A specific tax detriment following the 2018 Federal Budget attack on TTs

The announcement in the 2018 Federal Budget[2] that "the concessional tax rates available for minors receiving income from testamentary trusts will be limited to income derived from assets that are transferred from the deceased estate or the proceeds of the disposal or investment of those assets" was, for many, a surprise.

Thus, as flagged in previous articles,[3] advisers in the estate planning industry should likely continue to be concerned about what the government means by suggesting that the mischief to be addressed is that "some taxpayers are able to inappropriately obtain the benefit of [a] lower tax rate by injecting assets unrelated to the deceased estate into the testamentary trust".

With the unexplained retrospective effect from 1 July 2019, the new rules (which are set out in s 102AG(2AA) of the *Income Tax Assessment Act 1936* (ITAA36))[4] have already caused significant concern.

Pursuant to Div 6AA ITAA36,[5] excepted trust income (ETI) is the amount which is assessable income of a trust estate that resulted from a will, codicil, or court order varying a will or codicil.

A key question in relation to the rules is the way in which the restrictions operate with regard to ETI in the context of a husband and wife preparing wills incorporating TTs. In particular, are there any tax consequences that flow from preparing (say) the husband's and wife's wills to reflect that, in the event that the husband predeceases the wife (for example), the wife's will provides that her assets will be gifted into the TT previously set up under the husband's will.

Focusing solely on the ETI position, the new rules unfortunately make it clear that, in this situation, the income earned on the wife's assets gifted to the husband's TT will not give rise to ETI. The reason for this is that the legislation mandates that the property must be "transferred to the trustee of the trust estate to benefit the beneficiary *from the estate of the deceased person* concerned" (emphasis added).

An extract from the submission on the draft legislation on this point (which was at the time, and apparently continues to have been, ignored) that our firm made is as follows:

> "The draft legislation is focused on 'the deceased person concerned', and it is unclear why this restriction is relevant.
>
> For example, for most couples who both implement testamentary trusts, it will be the case that they will die at different times and there will often be a desire to transfer assets between testamentary trusts.
>
> It is clearly the case that the excepted trust income rules should continue to apply in situations where a couple both implement testamentary trusts.

> To argue otherwise would again see the proposed amendments extend significantly beyond the stated intent of the announced measure and impact taxpayers in a range of circumstances where there is no inappropriate tax benefit received by a beneficiary."

Unfortunately, for all advisers in this space, there is now a further complication that needs to be managed that potentially increases the tax-related administration aspects of deceased estates. That said, despite the changes (and issues like those outlined above), TTs are likely to remain a key tax planning strategy for many advisers and their clients.

Tax equalisation clauses in estate planning exercises

Many specialist tax and estate planning advisers argue that the tax equalisation provisions in wills are rarely appropriate.

The case of *Todd v Todd*[6] (*Todd*) further reinforces a number of the issues in this regard. Relevantly, a key clause in the will provided that the assets be "divided between [the beneficiaries] in such a manner so as to ensure that as at the finalisation of the administration of my estate all of my said children have received an equal value of bequests under this my will".

In question was whether the accumulated (latent) capital gains tax liability attached to each of the key assets should be taken into account when determining the value of the individual bequests or, alternatively, should they be ignored.

The will itself was unclear on the approach to take and the court confirmed that the cases were similarly confused, and indeed possibly in conflict. The court did however confirm the general principles outlined below.

Whether the incidence of CGT should be taken into account when valuing a particular asset varies according to the circumstances of the case, including the method of valuation applied to the particular asset, the likelihood or otherwise of that asset being realised in the foreseeable future, the circumstances of its acquisition, and the evidence of the parties as to their intentions in relation to that asset.

If the court orders the sale of an asset, or is satisfied that a sale of it is inevitable or would probably occur in the near future, or if the asset is one which was acquired solely as an investment and with a view to its ultimate sale for profit, then, generally, allowance should be made for any CGT payable on such a sale when determining the value of that asset for the purpose of the proceedings.

If none of the circumstances referred to above apply to a particular asset but the court is satisfied that there is a significant risk that the asset will have to be sold in the short- to mid-term, the court:

- should not make an allowance for the CGT payable on such a sale when determining the value of the asset;
- may take the risk into account as a relevant factor; or
- should attribute weight to that factor, varied according to the degree of the risk and the length of the period within which the sale may occur.

There may be special circumstances in a particular case which, despite the absence of any certainty or even likelihood of a sale of an asset in the foreseeable future, make it appropriate to take the incidence of CGT into account when valuing that asset. In such a case, it may be appropriate to take the CGT into account at its full rate, or at some discounted rate, having regard to the degree of risk of a sale occurring and/or the length of time which is likely to elapse before that occurs. Arguably, this last point is a practical example of "the vibe" principle, popularised in the movie, *The Castle*.

In *Todd*, the court held that there was nothing to support an argument that "value" should notionally bring potential future CGT liabilities to account. Furthermore, the will evidenced no intention that the process of ascertaining the equal value of bequests required the taking into account of the future potential taxation liability.

It was also held to be incorrect to say that a property bequeathed to a person in the highest bracket of income tax payable for a given year would have a higher value had it been bequeathed to a person who had nil taxable income. This is because such a proposition ignores the fact that CGT liability in respect of a property only arises when (and if) that property is disposed of, and only then will the resultant tax payable (if any) be able to be determined.

Practically, there are a myriad of reasons why tax equalisation clauses are rarely appropriate, for example:

- often a client will only want to take into account the tax position in relation to a particular asset (for example, superannuation). This can lead to significant imbalances in relation to other assets in the estate — most typically, a family home which, like superannuation, can often be received tax-free by a beneficiary;
- while there are embedded tax attributes in relation to certain assets, there can also be embedded tax attributes with the recipient, for example, if a beneficiary is a non-resident at the date they receive the asset, this can trigger a completely different tax outcome as compared to a beneficiary who is an Australian resident. Often these issues will change radically between the date of drafting the will and the date of death;
- where assets are to pass via a TT, this can cause a wide range of potential tax differentials, many of which may be unknown for a significant period of time;
- similarly, to the extent that there are assets held in related entities (for example, family trusts or private companies), there may be a wide range of potential tax ramifications which again may be unknown for a significant period of time;
- the calculations in relation to the net position of each beneficiary can potentially be limitless, for example, additional payments made to one beneficiary to compensate for the fact that they received assets that may have a latent tax liability may cause a further tax liability, which then would trigger a further payment, which of itself would cause a further tax liability; and
- most clauses in this area are also crafted with reference to precise tax provisions at a particular moment in time — there is a material risk that those tax rules will have changed by the time the will actually comes into effect.

The decision in *Craven v Bradley*[7] (*Craven*) further highlights the difficulties that can arise in this area, particularly where adjustments are required for estimated CGT consequences. The will in this case gifted two properties to two of three sons of the will-maker, with clauses then designed to provide for distribution of the remaining estate in a manner to achieve "equalisation" between the three sons, having taken into account the different values of the properties specifically gifted.

The relevant clauses designed to achieve the equality were along the following lines:

- If the remaining balance of my estate is more than three times the value of property X, then I give property X to my son A free of all duties and encumbrances, and after all costs associated with its transfer have been met from my estate, and the value of property X is included in the gift to my son A.
- If the remaining balance of my estate is less than three times of the value of property X, then I give property X to my son A free of all duties and encumbrances, provided he pays to my estate the difference between the value of property X and one-third of the balance of my estate as aforesaid.
- The value of property X should be determined by a registered valuer and on terms that would be granted to an arm's length purchaser from my estate.

In relation to one of the properties, the value of the property for the purposes of the will was to be calculated after deducting "an amount equal to the capital gains tax liability my estate would pay if the property were sold at the date of my death". The court accepted that this proviso was due to the will-maker's awareness of the tax-related differences between the two properties, that is, one property was the will-maker's main residence and thus likely to be exempt from CGT at the date of death.

The court also noted that, for the property that was the main residence, the will did not set any specific point in time for the valuation to be conducted.

The key questions in dispute, and the decision of the court, were as follows:

- whether CGT should be calculated by reference to the will-maker's taxable income or to the estate's taxable income at the date of the will-maker's death: the court held that the estate was the relevant taxpayer and assumed a simplified understanding of how the CGT provisions operated in this regard; and
- how and at what date should the value of the main residence be ascertained (eg the date of the will-maker's death, the point in time when the son paid into the estate the difference between the value of that property and one-third of the remaining balance of the estate, or the date the property was transferred to the son). In relation to this question, there is a statutory presumption in most states, other than Western Australia and the ACT (rebuttable by the provisions of a will), that the relevant date is the date of the will-maker's death: the court held that the statutory presumption was not rebutted and therefore the date of death was the relevant date.

A summary of the key points made by the court is set out below.

The interpretation of a will is analogous to the interpretation of a contract. This brings with it a consideration of the purpose of the will, or the purpose of its particular provisions, as well as the facts known or assumed by the will-maker at the time the will was executed, applying common sense and ignoring evidence of subjective intention.[8]

No will is made in a vacuum.[9] The will-maker's intentions are not necessarily to be discovered by looking at the literal meaning of the words alone if this leads to the frustration of their intentions. If, in light of the surrounding circumstances, the literal interpretation gives rise to a capricious result which the will-maker can never have intended, the literal interpretation should be rejected in favour of a sensible one which accords with their intention.[10]

If the law has consistently given a particular meaning to some word or phrase, that is the meaning which the word or phrase must, prima facie, be given when interpreting a particular will.[11]

It is open to the court, when construing a will, to insert missing words which are clearly necessary to give effect to the will-maker's intention.[12]

If, in the context of the will read as a whole and of the surrounding circumstances, the ordinary meaning of the words in the will do not make sense, extrinsic evidence is admissible under the "armchair principle". In effect, this means that the court is able to consider evidence of the circumstances surrounding the will-maker at the time of executing the will.[13]

A court is, however, not entitled to rewrite a will merely because it suspects that the will-maker did not mean what is said in the will.[14] Thus, in the case mentioned above of *Todd*,[15] the court may determine that there is nothing in a will to support an argument that it evidences an intention that the process of ascertaining the "equal value" of bequests requires the taking into account future potential taxation liabilities.

It may be that any required equalisation is only approximate, as was the case in *Craven* where (for example) the son who did not receive a property would have to pay the costs of that investment if he wanted to obtain a property. These costs would include substantial stamp duty, whereas the other two sons received their properties free of that cost (as roll-overs are available on death under the stamp duty legislation).

In light of the significant range of difficulties outlined above, generally it is preferable to simply set out directions in the memorandum of directions to the trustees of the estate to ensure that they seek specialist advice at the point of administering the will to ensure that the optimal legitimate tax outcome is achieved for the estate (and therefore the underlying beneficiaries) as a whole.

Family law and tax equalisation

Somewhat in contrast to the preferred position in relation to tax equalisation under an estate plan, the impact of tax generally in family law property settlements is arguably compulsory. The recent decision in *Lacey & Lacey*[16] provides a useful reminder of some of the key issues in this regard, as summarised below.

Where, as was the case in *Lacey*, a spouse is the sole director and shareholder of a company and there is no doubt that the company is the alter ego of the spouse, the property of the company can be considered as the property of the spouse. This means that the court can make an order in relation to the property of the company without having to rely on the powers under s 90AE(2)(b) of the *Family Law Act 1975* (Cth), which relate to orders imposed on third parties and in part mandate that the court must take into account the tax effects of the order on the parties, and on the third party.[17]

In *Lacey*, due to the tax consequences of the proposed orders (both CGT on forced asset sales and Div 7A ITAA36), the overall proportional share of the parties' assets assessed by the trial judge would not be achieved in a just and equitable manner if tax was ignored, making the initial trial decision unsustainable.

In relation to the proposed receipt of cash from the company by the former wife, the court held that this would probably be deemed as a dividend in her hands and trigger a tax liability under Div 7A because the husband was the sole shareholder in the company and, as his former spouse, the wife would be characterised as an "associated entity".

The court held that the parties (and their advisers) were at least partially responsible for leading the primary judge into the error of ignoring the tax consequences because neither of them presented any evidence on the issue. That said, because the error was legal rather than factual, the tax consequences justified the granting of, and could be argued in, the appeal.

While the Family Law Act allows the imposition of conditions limiting the scope of any rehearing,[18] in this case, the rehearing was to be unconfined because around three years had passed since the initial trial. In other words, a complete retrial of the entire proceedings was ordered.

Ultimately, any family court order or property settlement should also specifically include tax-related indemnities, a point that also seemed to have been missed in the initial trial.

Tax consequences of changes of trusteeship

The starting point for any change of trusteeship is always the terms of the trust deed. In this regard, the "read the deed" mantra is regularly highlighted.

Assuming the trust deed creates the relevant power, and the change of trustee documentation follows the procedure mandated by the trust instrument, there are two key revenue issues to be aware of, namely:

1. CGT; and
2. stamp duty provisions in the relevant jurisdiction (which are outside the scope of this article, other than to note that, while there are generally no stamp duty consequences for merely changing a trustee, the rules to gain access to the relevant exemption are different in each state and territory).

Arguably, the most commonly triggered CGT event is the disposal of a CGT asset (being CGT event A1).

A question that regularly arises, particularly in estate planning and asset protection exercises, is whether a change of trustee triggers CGT event A1.

Relevantly, the *Income Tax Assessment Act 1997* (Cth) (ITAA97)[19] provides as follows:

- CGT event A1 happens if you dispose of a CGT asset; and
- you dispose of a CGT asset if a change of ownership occurs from you to another entity, whether because of some act or event or by operation of law. However, a change of ownership does not occur:
  - if you stop being the legal owner of the asset but continue to be its beneficiary owner; or
  - merely because of a change of trustee.

Therefore, it is generally accepted that CGT event A1 does not occur as a result of a change in the trustee and the ATO acknowledges this position.[20] Similarly, there are numerous private binding rulings that confirm the same outcome.[21]

The case of *Advanced Holdings Pty Ltd as trustee for The Demian Trust v FCT*[22] highlights the risks in this area.

In summary, the key issues in relation to the purported change of trustee were as follows:

- the deed required that the principal first remove the trustee if the principal was wanting to appoint a new trustee;
- the documentation did not support an argument that the principal did in fact remove the incumbent trustee;
- furthermore, the documentation failed to effectively evidence the trustee itself resigning and also did not comply with the written notice of intention to resign mandated by the trust deed as needing to be given two months before any trustee resignation;
- while there was a "Notice of Removal of Trustee" signed by a director of the trustee company, as this was signed in the director's personal capacity and not as a director, it was held to be invalid;
- the "Notice of Removal of Trustee" document was also not a valid reliance on the principal powers as the notice was drafted on the assumption that the trustee had in fact already resigned;
- the signed "Deed of Retirement and Appointment of Trustee" also referred to the minutes of the previous trustee company being tabled at the meeting of the directors of the (purported) new trustee company, and yet no such minutes could be produced to the court;
- separately, the documentation that was available was further undermined by the fact that the accountants for the trust produced and backdated documents (leaving an email trail confirming their conduct) in an attempt to create the impression that the change of trustee had in fact occurred many years earlier; and
- there were also allegations (that the court decided it did not need to resolve) that the backdated documents had been further doctored from the actual documents signed in an attempt to create the desired tax outcome.

One of the consequences of the failed change of trusteeship was that the, purported, new trustee was unable to demonstrate that one of the assets it was owner of (being units in a unit trust) were in fact held on trust. This meant that the potentially concessional tax treatment on distributions from the unit trust were instead taxed in the company in its own right.

A number of key issues in this regard were explored in more detail in the appeal decision of *Advanced Holdings Pty Ltd as Trustee for The Demian Trust v FCT*.[23]

While the appeal case essentially confirmed the original decision, the following statements made in the appeal judgment are noteworthy in relation to the way in which trusts are managed (at least for tax purposes).

As a general rule, a court should give effect to the objective intention sought to be achieved where the words of an instrument allow that intention to be given effect. However, the court cannot give effect to any intention which is not expressed or plainly implied in the language of the document, as to do otherwise would be to engage impermissibly in "gratuitous, groundless, fanciful implication".[24]

To the extent of any ambiguity in the terms of a document, the court should construe the clause so that the operation of the trust is advanced.[25]

In this case, a claimed "implied removal" of a trustee lacked the essential words that pertained to what the court referred to as "a straightforward concept". This was held to be fundamental and prevented any favourable interpretation for the taxpayer. Any interpretation other than that demanded by the words of the document (ie an appointment, but no retirement, of trustee) meant that the court would have needed to cross a line from simple construction into rectification.

Statutory provisions, such as s 251A(6) of the *Corporations Act 2001* (Cth) which provides that a minute of a meeting properly recorded and signed is evidence of the proceeding to which it relates unless the contrary is proved, do not mean that such a minute is automatically conclusive evidence of happenings at a meeting unless the contrary is proved. Whether the contrary is proved must be judged on the whole of the evidence. If the evidence establishes that an event recorded in a minute did not occur, the fact of its recording in the minute has no effect.[26]

Thus, where there are other findings of fact firmly adverse to the quality of corporate management by a director, a court is not obliged to accept, at face value and for all purposes, the existence and efficacy of challenged underlying transactions referred to in a company minute.

The court acknowledged that this reality may present a sobering book-keeping reminder to directors of small companies. That said, it was also confirmed that the evidentiary rules established under the statutory provisions are not intended to circumvent the need to establish the efficacy of all of the underlying transactions recorded in a company's minutes in all cases.[27] In this case, the underlying transactions were squarely in issue and their efficacy open to being doubted.

Finally, given that it was found that the taxpayer was not only aware that his accountant had prepared backdated documents, but was also aware of his wilful and reckless inattention to the correctness of the relevant tax returns, the court confirmed that the penalties imposed (of 75% of the tax shortfall amount, further increased by 20%) were appropriate.[28]

This conclusion was reinforced by the finding that the taxpayer's advisers also took steps to prevent or obstruct the ATO.

"The court acknowledged that this reality may present a sobering book-keeping reminder to directors."

Impact of loan accounts

High-profile cases, such as *Clark v Inglis*[29] and *Fischer v Nemeske Pty Ltd*,[30] emphasise the interplay between beneficiary loan accounts, tax and estate planning.

The decision in *McCarthy v Saltwood Pty Ltd*[31] provides another reminder in this area.

In a factual matrix where the integrity of various loan accounts on the balance sheet of a "standard" family discretionary trust was at the heart of litigation commenced following the death of the ultimate controller of the trust, a number of relevant observations were made, as summarised below.

Within certain parameters, the provisions of the Corporations Act[32] (which, essentially state that books of accounts kept by a body corporate are admissible in evidence in any proceeding and are prima facie evidence of any matter stated) may be helpful.

Thus, cases such as *Livingspring Pty Ltd v Kliger Partners*[33] have confirmed that, while the books are prima facie evidence of the matters stated in them, the weight of that evidence is to be measured in accordance with the common sense of the tribunal of fact. This means that the evidence constituted by the company's books may be outweighed by other evidence (including evidence adduced by the proponent of the books, even if the opponent does not give evidence about them), or by some quality or characteristic of the books themselves, even if there is no other evidence.

For example, if a book has the appearance of a draft or (being electronic) has a file title indicating that it is a draft, that alone may be sufficient (all other things being equal) for the tribunal of fact to reject the book as evidence of the matter stated in it, particularly if the book contains inconsistencies or ambiguities or the matter otherwise demands explanation.

In this case, the court accepted that the usual practice was that, at the end of each financial year, the balance of beneficiary loan accounts was debited for funds utilised and credited with income distributed in accordance with the purported resolutions and that the accounts validly reflected this approach.

While there was evidence that any resolutions for distributions were made well after the end of the financial year (and were therefore unlikely to be valid for tax purposes), this did not mean that they were invalid under the deed, nor were the default distribution provisions under the deed enlivened.

The fact that the will-maker essentially appeared to act as sole director of the company, even though there were other directors, did not invalidate resolutions that the will-maker made on behalf of the company.

In particular, while there was no suggestion that the distributions were outside the ambit of the trustee's discretion, it was argued that the trustee had not lawfully made the relevant decision because of the lack of the requisite quorum (at least two directors were required under the constitution) and there were failures to provide directors with formal notices of meetings.

However, the absence of other directors was held not to have detracted from the inference that the will-maker was purporting to make these decisions on behalf of the company.

While s 1322 of the Corporations Act does provide that a proceeding may be invalidated because of procedural irregularity, this will only be where the court is of the opinion that the irregularity has caused or may cause substantial injustice that cannot be remedied by any order of the court. In this regard, the court confirmed that the irregularities in relation to the resolutions failed to cause substantial injustice for the following reasons:

- the other directors were well aware that the decisions in question were made by the will-maker;
- in consultation with the accountant on a yearly basis, the other directors were content with the arrangement of the will-maker essentially acting as a sole director;
- neither of the other directors requested access to the financial reports, or made any effort or request to attend the accountant with the will-maker, review any of the relevant material prior to preparation of the documents, or indeed played any role at all in respect of the financial affairs of the company and the trust, including in the preparation of the end-of-year financial accounts;
- rather, each director was content to simply sign off on the signing pages given to them without discussion;
- since each director was an adult, they had individual responsibilities as a director;
- it was held probable that each director would have had a reasonable understanding of when the meeting with the accountant was to take place and the relevant decision was to be taken, or at the very least, could have made enquiry about those events. There is no suggestion that either ever made such an enquiry.

Ultimately, therefore, there was no basis for a finding that the irregularities caused substantial injustice.

In the context that the deed permitted distributions "to or for the benefit of … General Beneficiaries living from time to time …", a purported distribution to the will-maker after they had passed away was held to be invalid.

As the discovery of this invalid distribution was well after the time at which the deed otherwise required distributions to be made, the amount needed to be allocated in accordance with the default provisions of the trust deed.

Trust rectification and tax planning

A significant number of tax and estate planning exercises that involve a trust see issues arise in relation to trust deeds that, with the aid of hindsight, were not drafted in the way intended. In some instances, there is a need to consider the ability to amend a trust deed by way of rectification.

A recent useful reminder in this regard is the decision in *Wilstead No. 5 Pty Ltd v Smyth.*[34] In this case, due to an apparent error in the drafting of the deed, at least one of the adult parents of infant children was excluded as a potential beneficiary of the trust.

The adult parents had however been receiving distributions from the trust for many years before the error was discovered. The deed also did not seem to have a valid default distribution provision on vesting, with the court observing that the clause was "difficult" to understand.

In accepting the evidence that the intention on establishing the trust had been to include the adult parents as the primary beneficiaries, the court confirmed a range of important points, as set out below.

To address the apparent error by way of arguing a presumed contrary contractual intention is only available where, on an objective construction, the deed results in an absurdity or inconsistency. Here, any potential absurdity or inconsistency arose only due to the subjective intention of the parties. Therefore, the only potential remedy was via rectification.

Rectification was permitted on the basis that the evidence provided clear and convincing proof that, at the time of execution of the trust deed, the trustee and the settlor had a common intention that the adult parents would be primary beneficiaries of the trust.

Furthermore, the inconsistency between the actual common intention and the terms of the trust deed was a result of the wording that the court was being asked to rectify.

While it was argued that the fact that distributions had been made to the adult parents on the assumption that they were primary beneficiaries supported the rectification application, the court confirmed that this did not in fact assist.

In particular, the distributions did not indicate an actual common intention at the time the trust deed was executed. Rather, the distributions were simply evidence that the parties acted on the basis of the actual common intention after that time (a point not relevant to the rectification application).

Pursuant to the Trusts Acts (and similar legislation) in most Australian states and territories (although not NSW), there is power for a court to make prospective variations to trust instruments. The NSW provisions are however more limited. This power can be extremely important where there is no, or a very narrow, power of variation in a trust instrument.

One of the leading cases in NSW in relation to court variations is *Re Dion Investments Pty Ltd*.[35]

In broad terms, the case involved a trust deed set-up in 1973, which the trustee was wanting to amend so as to be able to better manage the trust property. The relevant legislative provision in NSW gave the court the power to amend a trust instrument provided it was "expedient" for the management or administration of trust property.

In rejecting a request to amend the deed by inserting a comprehensive variation power (which in turn would have allowed the trustee to make such changes to the trust deed as it deemed appropriate from time to time), the court confirmed that:

- the legislative provisions in NSW did not allow the court to simply insert into the deed a comprehensive power of variation;
- only specific powers (in contrast to wide discretionary powers) with respect to a particular dealing will be granted under the NSW legislation;
- it was however permissible in NSW for the court to confer particular and limited powers in relation to certain issues, such as how to account for income and capital gains and related tax-driven provisions; and
- despite not originally crafting its variation request along the lines that the court said was permissible, the trustee was permitted to make further submissions in accordance with the court's recommendations for immediate approval.

Interestingly, in the subsequent decision of *Re Dion Investments Pty Ltd*[36] in relation to the same trust, the court authorised a further variation to ensure that the "foreign person" land tax surcharge could be avoided. This was in light of the fact that the trust deed did not give the trustee the ability to exclude foreign persons as beneficiaries. In particular, the relevant power of variation was limited to "trusts" (granted to persons who had all died and therefore had lapsed), not the "powers" — a distinction perhaps most famously explored in the decision of *Jenkins v Ellett*[37] (discussed in an article published in a previous issue of this journal[38]).

The court confirmed that the requirements in the legislation were all met, namely:

- there needs to be a "proposed dealing", being a "sale, lease, mortgage, surrender, release, or disposition, or any purchase, investment, acquisition, expenditure or transaction";
- the dealing must be, in the court's opinion, "expedient"; and
- the dealing must be incapable of being effected because of an absence of power.

Relevantly, the court confirmed that the existence of a tax advantage can form the basis of the "expediency" in the management and administration of the trust property requirement; here, the land tax saving was over $100,000.

This conclusion was reached notwithstanding that the order would adjust or even destroy the rights of some (potential) beneficiaries to the extent that they met the definition of a "foreign person".

The same outcome was granted in the case of *Re Cecil Investments Pty Ltd*[39] (*Re Cecil*) where the trust deed permitted only a variation to the "powers", not "trusts". This case also confirmed that previous attempted variations to the trust deed were invalid as they breached the limitation set out in the power of variation against anything that purported to change beneficiaries who were takers-in-default of appointment.

A comprehensive power of variation is arguably one of the most important aspects of any trust deed.

It is important to keep in mind that the legislation is worded differently in each state and territory. In particular, in Queensland, Western Australia and Victoria, there are more widely drawn provisions than the NSW law considered in *Re Dion*. Similarly, the South Australia legislation also offers wider provisions in comparison to NSW. Reference should therefore always be had to the specific wording of the legislation in the relevant jurisdiction.

Re Cecil is also useful as it confirms that there have been a number of examples as to where tax savings or advantages form a basis of expediency in the management and administration of trust property — one of the key tests that generally needs to be satisfied.

In particular, the decision lists the following examples:

- "… the powers conferred on the Court … should not be withheld merely because their exercise is sought to enable the avoidance of a revenue impost …";[40]
- "As well, the minimisation of the capital gains tax and stamp duty on the trust property provides a separate basis upon which the conferring of the power is expedient";[41]
- "modernisation of the trust deed … with consequential tax benefits, is expedient in the management or administration of the property vested in the trustee…";[42]
- the scope of the court's powers includes preserving trust property and making it financially productive "…which included planning to minimise the impact of tax and duty on the trust property…";[43] and
- "… there are numerous decisions of this Court to the effect that the tax effective administration of a trust is a matter to which regard may properly be had in considering whether or not to exercise discretion".[44]

Conclusion

In modern estate planning, significant complexities from the interaction between the legislation relating to tax, trusts, family law and loan arrangements have become increasingly ubiquitous.

Significant and ongoing changes appear to be the "new normal" for all advisers specialising in holistic estate planning as we head into calendar year 2022.

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Commissioner of Taxation's access powers

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The authors consider the Commissioner of Taxation's use of his formal access powers to obtain information and documents from taxpayers contained in ss 353-10 and 353-25 of Sch 1 to the *Taxation Administration Act 1953* (Cth). They discuss their recent experiences of the Commissioner's approach to gathering information and documents using these powers and the inefficiencies that arise for taxpayers and the Commissioner in the observed use of the Commissioner's formal access powers, including from requests that at times can be broad, duplicated, vague and/or ambiguous — and which the authors consider capable of remedy and worth some reflective thought on the Commissioner's part. The authors also consider the Commissioner's recent approach to legal professional privilege claims, including the topical issue of privilege claims made in relation to the communications of multidisciplinary practices, along with other recent developments relating to legal professional privilege. Finally, the authors discuss the Commissioner's approach to the accountants' concession and how that approach could be improved.

Introduction

The Commissioner of Taxation has broad powers to obtain information and documents for the purposes of his administration of Australia's tax laws. The Commissioner is entitled to (and does) use these access powers to undertake a broad survey of, and/or "fish" for, information and documents which may be relevant to his tax administration role.

The authors' recent experience in advising multinational corporate clients regarding the Commissioner's use of his access powers has shown that:

- the Commissioner appears more inclined than ever to use his formal access powers to obtain information and documents rather than seeking the information and documents through informal means;
- when he does use his formal access powers, he tends to make very broad requests and to duplicate requests (by issuing multiple notices to the one entity and/or notices to multiple entities containing the same information and document requests), presumably to ensure that he has closed off every possible avenue of enquiry;
- the Commissioner appears more inclined than ever to question and, potentially test, legal professional privilege claims, particularly in circumstances where the claims relate to the tax advice and/or services of multidisciplinary practices (MDPs) comprised of both accounting and legal professionals (and this also aligns with the Commissioner's stated concerns that some taxpayers and advisers may be *abusing* privilege); and
- the Commissioner continues to interpret the scope of application of the accountants' concession narrowly and is more inclined than ever to seek to lift the concession, including prospectively and where assessment decisions have already been made.

Some additional information on each of these matters is provided below.

Use of Commissioner's formal access powers as opposed to informal information requests

Recent experience is that the Commissioner is more inclined than ever to use his formal access powers to obtain information and documents from taxpayers. The Commissioner's rationale for doing so appears to be that use of the formal powers is the only way in which he can obtain assurance that he is provided with all of the facts necessary for him to make fully informed decisions.

Broad requests

In the context of the Commissioner's enquiries of large multinational organisations, what the authors have seen is:

- formal notices issued containing large amounts of information and document requests which are very broadly framed and which, in a litigation setting, would likely be described as constituting "general discovery of documents";
- formal notices issued containing requests which are vague and ambiguous in their terms, requiring the recipients of the notices to interpret the scope of the requests; and
- the Commissioner being unprepared to consult with taxpayers to clarify the scope and terms of requests in formal notices, instead placing the onus on the taxpayers to use their professional judgment to interpret the requests.

Duplicate/multiple requests

The authors have also seen formal notices being "duplicated", with the taxpayer receiving the exact same requests in both a s 353-10 notice (ie seeking information within the knowledge of, and documents in the custody or under the control of, the taxpayer) and a s 353-25 notice (ie seeking information within the knowledge of, and documents in the custody or under the control of, the taxpayer's foreign affiliates) and, on occasion, the formal notices being "duplicated" across multiple entities within the taxpayer group (if the Commissioner is unsure where custody or control of documents may reside).

While the Commissioner's perspective of wanting to ensure that he has obtained all of the facts may be understandable, the approaches referred to above mean that taxpayers are obliged to commit substantial resources to the task of responding to the Commissioner's notices. The Commissioner's current approaches to information and document gathering may demonstrate that there has been no improvement in the level of trust between the Commissioner and taxpayers in relation to tax audit activity. However, a focus on how the Commissioner's information and document gathering could be streamlined, without compromising the level of assurance that there has been discovery of all of the facts, would be welcome.

In that regard, matters worth some reflective thought on the Commissioner's part include:

- information and document requests which are vague and ambiguous can be extremely counterproductive:
  - for taxpayers because the task of responding to information and document requests in formal notices can be enormous and only made bigger if the task involves interpreting the scope of vague and ambiguous requests, with the taxpayer's natural (and understandable) inclination being to err on the side of adopting a broad interpretation of the vague and ambiguous requests; and
  - for the Commissioner because vague and ambiguous requests are likely to lead to the taxpayer producing a great deal of information and documents which may fit the strict terms of the requests in the notice but which are in fact irrelevant to, and a distraction from, the Commissioner's enquiries;
- following on from the point above, in order to avoid vague and ambiguous requests, it would be worthwhile if the Commissioner formally reinstituted past practices (in the authors' experience, now essentially lapsed) of ATO officers engaging with taxpayers on the terms of information and document requests prior to the formal notices being issued; and
- duplicating formal notices can be extremely counterproductive:
  - for taxpayers because it adds significant time and cost to the task of complying with the notices; and
  - for the Commissioner because inevitably a taxpayer's attention and resources must be directed first to responding to any s 353-10 notices (non-compliance with which is an offence), with responses to any s 353-25 notices actioned second. This is the case even where the same information and documents provided in response to the s 353-10 notice could be provided as part of what would be a larger response to the s 353-25 notice.

The Commissioner's approach to legal professional privilege claims

The legal professional privilege immunity against the compulsion to produce documents otherwise required to be produced at law is an important part of the fabric of Australian society because it facilitates the conduct of candid and confidential discussions between legal advisers and their clients concerning the clients' business and/or personal affairs. In a tax setting, the legal professional privilege immunity promotes candid and confidential discussions between a taxpayer and their legal adviser concerning the taxpayer's tax affairs, and often comes into focus when the Commissioner seeks documents from the taxpayer during the conduct of an ATO tax audit.

Generally, in his public statements regarding legal professional privilege, the Commissioner will acknowledge the importance of the legal professional privilege immunity and say that he is not interested in obtaining a taxpayer's legal advice, but rather only the facts.

Over the last several years, the Commissioner has taken active steps to test and/or to resist privilege claims made by clients of lawyers and has enjoyed varying degrees of success in the process. Those steps include:

- resisting privilege claims asserted over communications made through a third party and legal advice provided by or sought from a foreign lawyer. The Commissioner's resistance to the privilege claims resulted in litigation culminating in the Federal Court decision in *Song v FCT*.[1] The Commissioner appears to have tried to explore the efficacy of the application in practice of a range of agreed principles concerning legal professional privilege which had been formulated by the courts over a number of years. Issues considered included:
  - whether the applicant in the case had established that the communications in question were undertaken for the dominant purpose of giving or obtaining legal advice;
  - for communications made through a third party, whether the third party was an agent of the applicant for the purposes of communicating with the lawyer to obtain or receive the legal advice; and
  - for the legal advice sought from or provided by a foreign lawyer, whether the applicant had established that the person from whom the advice was sought or provided was a qualified lawyer, and whether the advice was sought from or provided by the person in that capacity.

  The Commissioner was largely unsuccessful in his challenge, with the court (Davies J) finding that, of the 23 primary documents which it examined, 19 were wholly privileged and one attracted privilege in part. The approach of the court in *Song* to considering the privilege claims in question is a general demonstration of the observations made by the court in *AWB Ltd v Cole (No. 5)*[2] that the advice which attracts legal professional privilege is of broad, though not unlimited, compass. In *Song*, Davies J provided useful guidance on what evidence needs to be adduced to confirm the validity of privilege claims. Her Honour tested whether the contents of each document asserted by the applicant to contain wholly privileged communications accorded with the evidence of the applicant regarding those communications. Her Honour also provided guidance on what inferences can reasonably be drawn as to the status of individuals and the nature of their advice based on their employment, and on what inferences can reasonably be drawn as to the nature of legal advice based on documents — both key considerations when determining whether a privilege claim can be made and maintained;

- refusing to return privileged documents. Having received copies of documents containing privileged material (referred to as the "Paradise Papers") which had originally been obtained from a Bermudan law firm by a third party using illegal means, the Commissioner refused to return them. That refusal became the subject of the High Court decision in *Glencore International AG v FCT*.[3] The High Court held that the holder of privilege over documents which are in the possession of the Commissioner and in the public domain cannot recover the documents by bringing legal action based on a claim of legal professional privilege. In doing so, the court explained that legal professional privilege is an immunity from the exercise of powers that would otherwise compel the disclosure of privileged communications; it is not a legal right capable of being enforced (ie that may found a cause of action).

  Recent experience suggests that the Commissioner considers that he is entitled to retain and rely on any privileged documents which he receives, no matter what the circumstances in which the documents came into the Commissioner's possession. More particularly, the Commissioner considers that he can use and not return privileged documents which are not in the public domain and which have been inadvertently disclosed to the Commissioner. Generally, the Commissioner will say that he is under an obligation to use such documents for the purposes of the exercise of his powers of assessment (on the authority of *Donoghue v FCT*[4]). A likely (and unfortunate) consequence of the Commissioner's approach of not returning privileged documents inadvertently disclosed to him is that taxpayers will require more time to respond to ATO information and document requests as heightened care will need to be taken to ensure that all available privilege claims are identified and made at the outset, it being quite apparent that the Commissioner will not return privileged material provided in error. This will be a particular issue for large-scale ATO document requests;

- challenging legal professional privilege claims made in relation to MDP advice and services. In line with the ATO belief that some taxpayers and their advisers in MDPs might not be making sustainable legal professional privilege claims, the Commissioner brought proceedings in the Federal Court in *FCT v PricewaterhouseCoopers*.[5] The matter concerned how the legal professional privilege immunity applies in practice in circumstances where an MDP (in this case, PricewaterhouseCoopers (PwC)) employs both qualified legal practitioners and qualified accountants to provide tax advice and services to its clients (in this case, entities within the JBS SA meat processing group (JBS)). The matter was heard by a single judge of the Federal Court, Moshinsky J, in the first and second weeks of September 2021. Based on the submissions made by the Commissioner's Counsel during the hearing, it appears that the Commissioner is resisting the privilege claims in this case on three bases, being that:

  - the retainer or engagement structure between PwC and JBS was inconsistent with there being a lawyer/client relationship;
  - the work performed by PwC under the retainer was not work performed pursuant to a lawyer/client relationship; and
  - alternatively, the documents themselves were not privileged because the communications in them failed the dominant purpose test (ie were not made for the dominant purpose of giving or requesting legal advice or services).

  Moshinsky J reserved judgment in the case; and

- testing privilege claims over documents seized on execution of search warrants. The Commissioner commenced a Federal Court proceeding in October 2017, *FCT v Brandi*,[6] in a challenge to privilege claims. The case management conferences in the matter disclosed that documents had been provided to an independent court-appointed referee for inquiry and to report on the legal professional privilege status of the documents (an understandable, practical course of action for the court to take when faced with needing to rule on a challenge to the privileged status of a large body of documents). However, prior to a hearing in relation to the disputed documents reported on by the referee, the case was discontinued by consent on 24 August 2021.

JWS is also involved in a matter concerning aspects of the making and maintenance of legal professional privilege claims which is currently before the courts and so will not be discussed in this article.

Additionally, the Commissioner has uploaded to the ATO website a draft "Legal professional privilege (LPP) Protocol", dated September 2021 (the draft protocol). The consultation period for the draft protocol ended in October 2021, however, at the date of publication of this article, the draft protocol had not yet been finalised. The draft protocol sets out the Commissioner's recommended approach by taxpayers for identifying and making legal professional privilege claims. Essentially, the Commissioner's draft protocol sets out his views on when and how taxpayers ought to make privilege claims, including the types and amounts of information which the Commissioner says he needs to receive in order to be able to determine whether to accept or challenge privilege claims. Such views are not based on or supported by any particular legal principle or requirement.

One concern with the draft protocol is that some of the actions which the Commissioner suggests taxpayers take may result in the Commissioner being provided with privileged communications, and information in relation to such communications, which may also give rise to questions regarding the extent of any waiver of privilege. A further concern is that it would be highly impractical (both time-consuming and costly) to comply with the suggested approaches in the draft protocol regarding privileged communications made in the course of any significant transaction or other commercial undertaking.

The suggested approaches in the draft protocol to gathering information in relation to the privileged communications would need to be implemented contemporaneously with the transaction or undertaking. The impracticality of applying the Commissioner's draft protocol in relation to, and contemporaneously with, any significant transaction or other commercial undertaking in preparation for possible subsequent ATO scrutiny is underlined by the fact that, ordinarily, there would be uncertainty regarding each of the fact, scope and timing of any such ATO review.

> *"… a focus on how the Commissioner's information and document gathering could be streamlined … would be welcome."*

The Commissioner's approach to the accountants' concession

The accountants' concession is not a legal right. It is an administrative concession on the Commissioner's part and so, unlike legal professional privilege, does not have the status of a legal immunity against the compulsion to produce documents sought by the Commissioner. However, as with legal professional privilege, the accountants' concession ought to be an important part of the fabric of the Australian tax system in facilitating the conduct of candid and confidential discussions between taxpayers and their external professional accounting advisers concerning the taxpayers' income tax affairs.

When the Commissioner originally introduced the accountants' concession, it was on the basis that the concession ought to afford the same scope of protection to (albeit not the same status as) certain communications between taxpayers and their external professional accounting advisers in relation to the provision of Australian income tax advice as was afforded to communications between taxpayers and their legal advisers in relation to legal advice and requests for legal advice. As such, because at that time the test that needed to be applied to determine whether a communication was privileged was a sole purpose test (in line with case law authority such as *Grant v Downs*),[7] similarly, the test to be applied to determine whether the accountants' concession was available in any given case was framed as a sole purpose test. Of course, subsequently, the High Court of Australia in *Esso Australia Resources Ltd v FCT*,[8] overruling *Grant v Downs*, held that the common law test for legal professional privilege is the dominant purpose test rather than the sole purpose test. However, the Commissioner has retained the sole purpose test for determining the availability of the accountants' concession.

While it would be logical, and in line with the Commissioner's policy objective in introducing the accountants' concession, to align the scope of application of the accountants' concession as closely as possible to the scope of application of legal professional privilege, this is not the approach taken by the Commissioner currently. The authors' experience is that the Commissioner is interpreting the scope of application of the accountants' concession narrowly, such that, according to the Commissioner, the concession is limited in its application to the formal written communications of external professional accounting firms, given for the sole purpose of providing Australian income tax advice. In that regard, for example, the Commissioner would say that the accountants' concession does not apply to communications constituting:

– requests for Australian income tax advice; or
– the Australian income tax advice of an external professional accounting adviser contained in a document which also contains other communications, ie communications that do not constitute the Australian income tax advice of the external accounting adviser.

In addition, while the Commissioner will only seek to "lift" the accountants' concession in "exceptional circumstances", given:

– that "exceptional circumstances" include any instance where the Commissioner is investigating the possible application of the general anti-avoidance rule in Pt IVA of the *Income Tax Assessment Act 1936* (Cth); and
– the propensity for the Commissioner to consider the application of Pt IVA as his default argument in any large-scale tax audit,

the authors' experience is that, in the conduct of any such audit, invariably the Commissioner will seek to lift the accountants' concession in relation to the tax advice of the external professional accounting advisers.

Indeed, the authors have even seen the Commissioner saying that he intends to lift the accountants' concession:

– prospectively in relation to any accountants' concession claims not yet made, but which may be made in the future; and
– in circumstances where he has already issued Pt IVA determinations and amended assessments giving effect to those determinations (and so, necessarily, must have already come to a considered view on the application of the Part).

In the authors' view, the Commissioner's approach of putting the accountants' concession on a different footing to legal professional privilege by failing to align the scope of application of the accountants' concession with the scope of application of legal professional privilege, and by being prepared to lift the concession in circumstances that do not appear to be exceptional, is counterproductive to the proper operation of the Australian tax system. It ought to be a matter for reflective thought on the Commissioner's part that this approach to the accountants' concession constitutes a fundamental flaw in the manner in which ATO officers undertake information and document gathering exercises in the course of the Commissioner's taxation audits.

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2 [2006] FCA 1234.
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4 [2015] FCAFC 183.
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6 Federal Court, Victorian Registry, 30 October 2017, No. VID1183/2017.
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Superannuation

by Shaun Backhaus and Daniel Butler, CTA, DBA Lawyers

NALE and NALI: tax impact on contributions

Advisers should include appropriate warnings to clients regarding the substantial tax rates that may apply on concessional contributions.

Overview

This article focuses on the non-arm's length income (NALI) and non-arm's length expenditure (NALE) provisions in s 295-550 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) on contributions made to superannuation funds.

The impact of these provisions can be severe, and the discussion below shows that a 75% tax rate applies if a member has excess concessional contributions (CCs) and a 120% tax rate applies if a member has excess non-concessional contributions (NCCs).

A range of professional bodies have requested a carve-out for CCs from NALI to provide more fairness and to protect members' compulsory minimum superannuation guarantee (SG) contributions from being subject to excessive tax rates.

When does NALI/NALE apply to contributions?

The ATO's view is that a general fund expense, such as a $100 discount on an accounting or adviser fee, can taint all of a fund's income (including all ordinary and statutory income). This ATO view is reflected in LCR 2021/2 that issued on 28 July 2021. The following paragraphs are extracted from this ruling:

> "19. In some instances, the [NALE] will have a sufficient nexus to all of the ordinary and/or statutory income derived by the fund. For example, a fund may incur expenditure that does not specifically relate to a particular amount being derived by the fund but still has a sufficient nexus more generally to all income derived by the fund …
>
> 20. Where the fund incurs [NALE] of the nature outlined in paragraph 19 of this Ruling, the nexus between the expenditure and all the income derived by the fund is sufficient for all the income to be NALI …"

Where NALI/NALE applies to a specific asset or source of income, the ATO view is that NALI/NALE will generally apply to all future income from that asset or income source (including all ordinary and statutory income). However, unlike a general fund expense that invokes NALE (eg a $100 discounted adviser fee), where an asset is acquired by a fund for, say, $100 lower than market value, it is only all future income from that asset or income source that is NALI.

It is possible for NALI to be invoked in a superannuation fund context by a fund obtaining a lower general expense or a lower specific expense that relates specifically to the contributions in question. However, a fund's contributions are most likely going to be exposed to NALI due to a lower general fund expense (eg a $100 discounted adviser fee).

Note that CCs are assessable as statutory income under ss 295-160 and 295-190 ITAA97. Thus, applying the ATO's view (as shown above in paras 19 and 20 of LCR 2021/2) results in CCs being taxed as NALI. The current tax rate for NALI is 45% for FY2022. However, in addition to this 45% NALI rate, other taxes must be considered, such as:

- Div 293 tax under the ITAA97. Members who earn more than $250,000 in a financial year pay an extra 15% tax on their CCs (below their CC cap) to the extent that their CCs exceed the adjusted income threshold which is currently $250,000;
- excess CC tax. Concessional contributions made in excess of the CC cap are included in the member's assessable income and taxed at their marginal tax rate (the authors assume the top personal tax rate of 45% in the analysis below). A maximum 15% tax offset applies in personal tax returns; and
- a 45% tax rate applies to NCCs that exceed the member's NCC cap. Broadly, a member can choose to avoid this 45% tax on their excess NCCs if they release the excess amount. If this choice is made in time, the member is taxed on the deemed associated earnings on the excess amount for a prescribed period that starts from the beginning of the relevant financial year.

The following extract from the ATO's website (refer to QC 19749) illustrates the severe tax rate that can apply to excess NCCs even where NALI does not apply:

> "From 1 July 2017, if you do not or cannot elect to release your excess concessional contributions, you could be taxed up to 94%. This is because any excess **concessional** contributions that is not released from the fund count towards your **non-concessional** contributions cap."

Would NALI apply to a large APRA fund as well as to an SMSF?

The short answer to whether NALI would apply to a large APRA fund as well as to an SMSF is "yes". However, the ramifications of NALI being applied to a large APRA fund can be enormous. Table 1 reflects the impact on NALI applying to contributions to:

- an SMSF where each of two members has contributed $27,500 to their SMSF; and
- a large APRA fund which, at 30 June 2020, had over 2.3 million members with $180b of assets and $12,159m in contributions (assuming that all of these contributions are CCs).

The ATO appears to be aware of the above risks given its comments in the following paragraphs in LCR 2021/2:

"90. It is particularly important for trustees of large APRA … funds to have appropriate internal controls and processes in place … Having appropriate controls and processes should form part of the fund's tax risk management and governance framework.

91. Nevertheless, the Commissioner is alive to concerns that a finding that general fund expenses are non-arm's length is likely to have a very significant tax impact on the complying superannuation fund, even where the relevant expenses are immaterial."

What is interesting here is the ATO's view that a lower general fund expense can have a sufficient nexus to all of a fund's income (including the fund's statutory income which includes CCs). The ATO reasoning also results in the case of the large APRA fund being subject to NALE relating to, say, a $100 accounting fee discount to 2,300,000 plus members' compulsory minimum SG contributions being subject to a 45% or higher tax rate. Based on the large APRA fund's FY2020 financial statements discussed above, this would increase its tax on CCs alone by around $3,647m (assuming there were no excess contributions).

The authors suggest that CCs should be excluded from NALI as CCs are a contribution of capital to a fund and are not in the nature of income; CCs are only deemed by statute to be income (ie statutory income). There is unlikely to be much causal connection between a lower expense and the contributions that a fund may receive.

Analysis: a 45% to 120% tax rate on contributions with NALI

The Appendix shows the detailed analysis of how the authors have calculated the tax rates shown in the Executive Summary below:

Executive Summary	
(Assuming NALI applies to the fund)	
Maximum tax rate as set out in greater detail below	
	Tax rate
CCs	45%
CCs with Div 293 tax	60%
Excess CCs	75%
Excess NCCs	120%

The Appendix shows the assumptions and thinking behind the calculations. Note that the tax rates in the spreadsheet and Executive Summary reflect nominal and not effective tax rates.

Advisers need to be aware of the above tax rates that can apply to contributions, as many do not factor in the NALI risk when providing advice. Given the considerable uncertainty surrounding NALE and NALI following the finalisation of the ATO's views in LCR 2021/2 and how easy it is for these rules to be invoked, advisers, especially tax advisers and those providing financial product advice, should include appropriate warnings to clients of the substantial tax rates that may apply on contributions. Unless they do so, a client who incurs greater than 15% tax on their CCs may seek recovery via legal recovery proceedings.

Table 1. Examples of tax at 15% versus 45% on concessional contributions

SMSF	
CCs	
Mum	$27,500
Dad	$27,500
Total	$55,000
	Tax
Tax at 15%	$8,250
Tax at 45%	$24,750
Extra NALI tax	$16,500
Large APRA fund	
FY2020 financial statements	
CCs	$12,159,000,000
	Tax
Tax at 15%	$1,823,850,000
Tax at 45%	$5,471,550,000
Extra NALI tax	$3,647,700,000

Conclusion

As you may glean from the above, NALE/NALI can result in some nasty impacts to superannuation funds and members. Numerous professional bodies are seeking legislative change to the NALE/NALI provisions, including having contributions (including compulsory minimum SG contributions) excluded from NALI, and hopefully there will be some change soon to ensure a better outcome.

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Appendix. Summary of tax on contributions

Taxes on concessional contributions (CCs)				If the member's earns more than $250,000 in a FY		
				Div 293 tax applies if the member's adjusted taxable income exceeds $250,000		
A	Tax on CCs	15%		Tax on CCs — refer above	15%	*Note 1*
				Div 293 tax	15%	*Note 2*
				Total	30%	
B	If NALI applies to the fund					
	Tax on CCs — refer to A above	45%		Tax on CCs — refer above	45%	
				Div 293 tax	15%	
				Total	60%	
C	Impact if NALI and excess CCs					
				Tax on CCs up to $27,500 CC cap (ie, the amount not in excess):		
	Tax on CCs — refer to B above	45%		Tax on CCs — refer above	45%	
	Top up tax on excess CCs after a 15% tax offset (that applies to excess CCs)	30%		Div 293 tax applies to CCs up to the $27,500 CC cap per FY	15%	
		75%		**Total**	60%	
				Tax on excess CCs above $27,500 CC cap (ie the excess CCs):		
				Tax on CCs — refer above	45%	
				Div 293 tax applies to CCs up to the $27,500 CC cap per FY	0%	*Note 3*
				Top up tax on excess CCs — refer to B above	30%	*Note 2*
				Total	75%	
D	Impact if NALI and excess NCCs					
	Tax on CCs — refer to B above	45%				
	Top up tax on excess CCs after a 15% tax offset (that applies to excess CCs)	30%				
	Tax on excess NCCs	45%	*Notes 2 & 4*			
	Total	120%				

Notes:

1 This tax is imposed on the fund trustee.

2 This tax is imposed on the member.

3 Div 293 tax applies to CCs but not excess CCs.

4 A 45% tax applies to excess NCCs if the member fails to release excess CCs that count as a NCCs that give rise to excess NCCs.

Alternative Assets Insights

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Victorian windfall gains and land tax amendments

The windfall gains tax and land tax concessions for certain build-to-rent developments have now been enacted by the Victorian Government.

Introduction

The long-awaited windfall gains tax (WGT) and the concessions to land tax for the build-to-rent (BTR) industry have now been enacted under the *Windfall Gains Tax and State Taxation and Other Acts Further Amendment Act 2021* (Vic) (the WGT Amendment Act).

The WGT measure was foreshadowed in the most recent Victorian Budget. It reflects the Victorian Government's desire to share gains made in uplifts in value resulting from amendments to planning schemes (within the meaning of the *Planning and Environment Act 1987* (Vic)) that take effect on or after 1 July 2023. The legislation seeks to impose the WGT on the increase in value of land resulting from a rezoning. A small number of rezonings are excluded and certain transitional provisions will be in place for particular contracts, option arrangements and proponent-led rezonings that were underway when the measure was announced on 15 May 2021.

The BTR measures were foreshadowed even earlier in the previous state Budget in November 2020 and seek to provide concessions to the BTR industry in the form of a 50% reduction to the taxable land values relied on for land tax for an eligible BTR development and (where relevant) a full exemption from the absentee owner land tax surcharge.

In detail

Windfall gains tax

Since the original announcement of the WGT, many property industry participants had lobbied the Victorian Government on the announced changes, including the basis on which the WGT is to be calculated, when the WGT is to be paid, and the types of land and rezonings that are to be impacted. The legislation seeks to address these issues, including deferring the introduction of the WGT to 1 July 2023.

The WGT will be imposed on a WGT event, which is defined as a rezoning other than an excluded rezoning. A rezoning means "an amendment of a planning scheme that causes land to be in a different zone from the zone that it was in immediately before the amendment".[1]

Broadly, an "excluded rezoning" includes:

– a rezoning between schedules in the same zone;

– a rezoning relating to growth and infrastructure contribution areas as defined under the *Planning and Environment Act 1987* (Vic); or

– a rezoning of land to a "public land zone" or to a "different public land zone".

The Victorian Treasurer has the ability to declare a rezoning to be an excluded rezoning.

When does liability for the WGT arise?

The liability will arise when the rezoning takes effect under the *Planning and Environment Act 1987* (Vic) and where the gain (or "taxable value uplift") is more than A$100,000. The owner of the land is liable to pay the WGT. While the Commissioner of State Revenue (the Commissioner) will issue assessments on a WGT event, payment of the WGT can be deferred.

Rate of WGT

The rate of WGT is set out in Table 1 and is based on the taxable value uplift.

Taxable value uplift

As noted above, the liability to pay WGT, and the rate of WGT, depends on the taxable value uplift. This is defined as the "value uplift" of the land less any deductions prescribed by the regulations. The value uplift is determined in accordance with the following formula:

$$VU = CIV2 - CIV1$$

CIV1 and CIV2 are references to the capital improved value of the land (as defined under the *Valuation of Land Act 1960* (Vic)). CIV1 reflects the capital improved value for the land immediately before the WGT event occurs, and CIV2 is determined by a supplementary valuation certified by the Valuer-General. The supplementary valuation is intended to value the land at the same date as CIV1 but as if the new zoning resulting from the WGT event was in place at that time. This means that the WGT should only capture the value uplift from the rezoning.

It will be interesting to see what, if any, regulations will be proclaimed and the type and extent of deductions that will be permitted when calculating the taxable value uplift.

There are also aggregation rules that will mean members of a group are assessed for the WGT on the aggregated taxable value uplift on land owned by the separate members of the

Table 1. Rate of WGT

Taxable value uplift	Rate of WGT
Not more than A$100,000	Nil
More than A$100,000 but less than A$500,000	62.5% of that part of the taxable value uplift that exceeds A$100,000
A$500,000 or more	50% of the taxable value uplift

group that is rezoned by the same WGT event. This removes the ability to split the WGT across separate landholdings held by different taxpayers and potentially paying less (or no) WGT on certain landholdings.

Grouping provisions for corporations, similar to those used under the current *Land Tax Act 2005* (Vic), will be used for these purposes. Trustees holding separate parcels of land for different trusts can be assessed on a "group" basis where the same person or persons have a "controlling interest" in each trust. Discretionary trusts do not escape the grouping provisions, with separate landholdings held under different discretionary trusts also capable of being aggregated in certain circumstances.

Deferral of payment

Windfall gains tax will initially be payable on the due date given in a notice of assessment provided by the Commissioner. However, the owner of land that is the subject of a WGT event can choose to defer payment of the WGT and must elect to do so prior to the day on which the WGT is payable. Interest will accrue at the 10-year bond rate on deferred WGT. The unpaid WGT and accrued interest becomes a first charge on the land.

Where a taxpayer chooses to defer the WGT, the amount deferred and any accrued interest must be paid within 30 days after whichever of the following occurs first:

- a dutiable transaction (other than certain excluded dutiable transactions) in relation to the land;
- a relevant acquisition (other than certain excluded relevant acquisitions) in respect of a company or unit trust that is a landholder who is the owner of the relevant land; and
- 30 years after the WGT event.

Transactions giving rise to an economic entitlement as defined under the *Duties Act 2000* (Vic) are excluded transactions, as well as certain other transactions (for example, transactions where no consideration is payable) where the transferee "elects" to assume the WGT liability, including the accrued interest.

Windfall gains tax on land used for charitable purposes can also be deferred where the transferee "assumes" the WGT liability. A waiver of any WGT on land used for charitable purposes is available if the land has remained as charitable land for 15 years after the WGT event.

For acquisitions in landholding entities, it will be important to determine whether the land of the landholder company or trust is "encumbered" by a WGT liability as the payment of that liability may arise on the making of a relevant acquisition.

Exemptions and transitional arrangements

There are a number of exemptions from the WGT, including the following:

- up to 2 hectares of residential land (including primary production land with a residence) will receive an exemption where it is rezoned by the same planning scheme amendment;
- rezoning occurs to correct technical errors in the Victorian planning provisions or a planning scheme (referred to as a "correcting event");
- WGT events for land subject to a contract of sale or options entered into before 15 May 2021 that have not been completed by a transfer of the land before the WGT event. This is to recognise that the parties would not have anticipated when negotiating the terms of the deal that a contemplated rezoning of the land would result in a WGT liability for the vendor; and
- where the land is subject to certain rezonings underway before 15 May 2021, subject to certain conditions. The owner of the land must establish, to the Commissioner's satisfaction, that the owner requested the amendment before 15 May 2021, the request was created and registered in the Amendment Tracking System before 15 May 2021 (where relevant), and the owner had incurred costs above a threshold amount in relation to relevant work.

The WGT will be administered by the Commissioner and rights of objection to the valuations used in the calculation of the WGT are provided.

Land tax changes for BTR land

The measures contained in the legislation, foreshadowed in the previous state Budget in November 2020, are welcome changes for the BTR industry. The changes go further than those previously announced as the concessions will be available for up to 30 years from the time of commencement of the BTR benefit.

Under the measures, an owner of land that is eligible for the "BTR benefits" is to be assessed for general land tax as if the taxable value of the land were reduced by 50%. Further, an absentee owner of land is to be assessed for land tax as if the owner of the land were not an absentee owner.

Land is eligible for a BTR benefit in a land tax year if the land is used and occupied solely for an eligible "BTR development" on 31 December in the year immediately preceding the tax year. The BTR benefit is available for one continuous period and for no more than 30 years from the date that a BTR benefit first applies to the land.

What is a BTR development?

A BTR development is defined as "one or more buildings that are constructed or substantially renovated for the purpose of providing multiple dwellings for lease under residential rental agreements".[2] An "eligible BTR development" is a BTR development that provides at least 50 self-contained dwellings that are:

1. fixed on the same parcel of land (and include common areas for the use of residents);
2. owned by one owner or owned collectively (eg jointly owned by co-owners and where no owner is entitled to a specific part of the land);
3. managed by a single management entity (although exceptions to this apply where dwellings are used to provide affordable housing or social housing);
4. suitable for occupancy between 1 January 2021 and before 1 January 2032 (that is, on the date that an occupancy certificate is issued for the dwelling); and
5. rented or available for rent under a residential rental agreement (the agreement must be for a fixed term of not

less than three years, although a renter can agree to a lesser period).

The concession extends to common areas where 1, 2 and 3 above are satisfied.

The effect of the provisions is that only newly constructed or substantially renovated buildings may be considered as eligible BTR developments. Dwellings in a BTR development that have an occupancy date on or after 1 January 2032 cannot form part of an eligible BTR development.
The above requirements must be satisfied for a continuous period of at least 15 years from the occupancy date of the eligible BTR development (being the date an occupancy permit has been issued in respect of each of the dwellings that comprise the BTR development). The above requirements will also apply to any expansion of a BTR development, with the 15-year eligibility requirement commencing from the occupancy date of those additional dwellings.

An owner of a BTR development is required to apply to the Commissioner to access the BTR benefits.

Failure to meet the 15-year requirement (for example, due to a change in circumstances where one or more self-contained dwellings no longer satisfies the requirements or the BTR development no longer consists of at least 50 self-contained dwellings) will result in the imposition of BTR special land tax.

The takeaway

The WGT measures are complex and, while the excluded zonings and other associated exemptions are welcome, there is still a degree of subjectivity on how to calculate the taxable value uplift. This is especially so as some of the details will be dealt with by regulation. The good news, however, is that there is the option to defer payment of the WGT.

On the other hand, the BTR measures are a welcome relief. It is now hoped that BTR developments will increase, following a hiatus period where BTR operators waited for more detail on the measures. The 30-year BTR benefit is a very good outcome for the BTR industry, but care should be taken to ensure the application of the relief measures for a continuous 15-year period.

For those projects under construction where the BTR benefit is not yet available, the Treasurer's guidelines issued in October 2018 will remain relevant for any relief from the surcharge.

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References

1 S 3 of the WGT Amendment Act.

2 S 59 of the WGT Amendment Act.

Events Calendar

February 2022

STATE/EVENT	DATE	CPD
Online		
2022 Private Business Tax Retreat	24/2/22	13
Queensland		
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For more information on upcoming events, visit **taxinstitute.com.au/professional-development**.

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