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The Tax Institute

Taxation *in* Australia

Incentives for innovation and infrastructure
The Tax Institute

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Invitation to write

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

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

Tax News – at a glance

by TaxCounsel Pty Ltd

March – what happened in tax?

The following points highlight important federal tax developments that occurred during March 2022. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 513 (at the item number indicated).

Amendments now law

A number of amendments to give effect to various tax measures are now law. **See item 1.**

Patent box amendments introduced

An amending Bill (the Treasury Laws Amendment (Tax Concession for Australian Medical Innovations) Bill 2022), which was introduced into parliament on 10 February 2022, contains amendments to give effect to the proposed patent box regime which will provide concessional tax treatment for ordinary and statutory income derived by a corporate taxpayer as a result of exploiting a medical or biotechnology patent. **See item 2.**

AAT recovery stay power

An amending Bill (the Treasury Laws Amendment (Streamlining and Improving Economic Outcomes for Australians) Bill 2022), which was introduced into parliament on 17 February 2022, contains amendments which will enable the Small Business Taxation Division of the AAT to make a stay order in relation to a reviewable objection decision that relates to a small business taxation assessment decision. **See item 3.**

Employee share scheme expenses

The Commissioner has released a draft determination that sets out his views in relation to the deductibility of expenses incurred by an employer company in establishing and administering an employee share scheme as part of its remuneration strategy (TD 2022/D2). **See item 4.**

Reimbursement agreements

The Commissioner has released a draft ruling and a draft practical compliance guideline in relation to the operation, and the Commissioner's administration, of the reimbursement agreement provision (s 100A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36)) of the trust provisions in Div 6 ITAA36 (TR 2022/D1 and PCG 2022/D1). **See item 5.**

Division 7A: revised approach to UPEs

The Commissioner has released a draft determination that sets out his revised views (to apply from 1 July 2022) on the way in which Div 7A ITAA36 applies where a private company is a beneficiary of a trust and there is an unpaid present entitlement or there is a sub-trust (TD 2022/D1). **See item 6.**

Discretionary trusts: adult children arrangements

The Commissioner has released a taxpayer alert in relation to arrangements under which parents enjoy the economic benefit of trust income appointed to their children who are over 18 years of age (TA 2022/1). **See item 7.**

Electronic sales suppression tools: administrative penalties

The Commissioner has released a final practice statement that provides ATO officers with guidance on the application and remission of administrative penalties for the production, supply, possession and use of an electronic sales suppression tool (PS LA 2022/1). **See item 8.**

JobKeeper eligibility

The AAT has upheld a decision of the Commissioner that the taxpayer company was not entitled to JobKeeper payments in August 2020 in respect of nine employees because those employees were not employed or to be treated as employed by the taxpayer on 1 July 2020 (*North Australian Contracting Pty Ltd and FCT* [2022] AATA 223). **See item 9.**

Director's fees: derivation issues

The AAT has held that certain payments, and the benefit of share issues, relating to the service of the taxpayer as a director of three companies were derived by the taxpayer and not (as contended for by the taxpayer) by his company to which they were paid (*Mobbs and FCT* [2022] AATA 201). **See item 10.**

Profit-making transaction

The AAT has held that a gain of approximately $13m made by the taxpayer on an exchange of shares and options in a shelf company that he had incorporated for valuable shares and options in another company was assessable as ordinary income (*Whiddon and FCT* [2022] AATA 197). **See item 11.**

Decision impact statement

The Commissioner has issued a decision impact statement in relation to the decision of the Full Federal Court in *FCT v Virgin Australia Regional Airlines Pty Ltd* [2021] FCAFC 209. That decision concerned the interpretation of "primary place of employment" in s 136(1) of the *Fringe Benefits Tax Assessment Act 1986* (Cth), when read with the extended meaning of "business premises" in s 136(2) of the Act.

Special leave refused

The High Court has refused applications by two taxpayers for special leave to appeal from a decision of the Full Federal Court in two appeals which the Full Court held that distributions by discretionary trusts to foreign residents of a capital gain that was not attributable to taxable Australian property were assessable to the beneficiaries. The decision of the Full Federal Court is *Peter Greensill Family Co Pty Ltd (Trustee) v FCT* [2021] FCAFC 99.

President's Report

by Jerome Tse, CTA

Reflecting on the Federal Budget 2022–23

From the Federal Budget and tax reform to Tax Forum Season, it's a busy time at the Institute.

It's a busy time for the Institute and our members at the moment. From the recent Federal Budget 2022–23 announcement and the upcoming election to your own professional development and events outside your professional life, I hope you are keeping well and keeping up.

The big news at the moment is, of course, the Federal Budget. Our Tax Policy and Advocacy team have produced a wonderful analysis of the announced measures, demonstrating the high calibre resources the Institute continues to produce for the benefit of members. I hope you have read the report, and if not, I encourage you to do so.

I hope you also found value in our post-Budget webinars, which gave you the opportunity to take a deeper look at key Budget measures with our experts. We are continually working to improve the way we communicate important developments and announcements like this to you.

Unfortunately, though not unexpectedly, the Budget did not make any great strides in introducing sweeping tax reform as we have been advocating for some time. Welcome measures included addressing the rising cost of living through cash grants and tax offsets, measures to stimulate innovation and support for those affected by floods and other disasters. However, many of these positive measures were temporary and did not address the structural inefficiencies and unfairness present in our tax system.

Still, outside of the Budget, we have gained some significant ground in the push for tax reform, most recently Treasury's recognition of the complexity and inefficiency of current NALE/NALI rules and commitment towards addressing this.

This result has come after 12 months of hard work from our Tax Policy and Advocacy team, who coordinated efforts from a dozen other professional bodies in a joint advocacy effort. It's a fantastic example of the strength of the Institute's leadership within the profession.

Despite this progress, there is still a long way to go until we achieve holistic tax reform. We can't afford to wait for the Federal Budget 2023–24 announcement to make improvements to our tax and superannuation systems. The Tax Institute will continue to lead the way in this discussion.

Inspector-General of Taxation and Taxation Ombudsman reviews

As you may be aware, the Inspector-General of Taxation is currently undertaking investigations into the ATO's administration and management of objections, the exercise of the general powers of administration, and the exercise of the Commissioner's remedial power.

The Tax Institute has been consulting with members to understand their experiences with the ATO's management of objections. With the assistance of our National Dispute Resolution Technical Committee, we have now lodged a submission covering the issues and concerns raised.

Coming up at the Institute

We have a full calendar of events for 2022 and I am excited to say that our face-to-face events are steadily increasing once more. The opportunity to hold events where we can all connect in-person hasn't been guaranteed these past couple of years, so the fact that we are now holding most events both online and in-person is wonderful.

For those of you still unable to travel or uneasy about in-person conference environments, rest assured that events are still being offered virtually and we are taking a flexible and adaptive approach to registrations, allowing you to attend in the safest and best way for you.

It's very exciting that we are now in the midst of Tax Forum Season. The Tax Forum events, held around the country in South Australia, Western Australia, Queensland, New South Wales and Victoria, are some of our premier events, with programs covering the latest and most important topics for practitioners. They also present the chance to showcase local experts and address challenges facing practitioners in each state.

For those members outside these five states, I hope that you have taken advantage of the hybrid event format allowing you to tune in online to a program that interests you. There are important insights for all practitioners, and our digital world means you need not be limited by geography.

Last, but certainly not least, in the final quarter of this financial year, we are looking for and hope to have selected and appointed an independent Chair to oversee strategy and governance of National Council, which will complete our board governance modernisation. The President and Vice President will still, however, be the face of the Institute, and will continue to serve our members.

CEO's Report

by Giles Hurst

Supporting you through change

We are continually improving the way we support you through busy and important times.

A Federal Budget announcement is always a busy time for The Tax Institute and for our members. This year is no exception.

After last week's Budget was announced, the Tax Policy and Advocacy team got to work doing what they do best — analysing and summarising relevant measures and communicating them to you.

We know that, with time constraints and the many challenges faced by those all around the tax profession lately, having this analysis quickly and in an easy to digest format is important. This year's report was designed to let you dip your toes in the Budget or to dive into deeper analysis where it was relevant to you.

We also held two follow-up webinars last week, during which our team reflected on practical implications, client impact, and missed opportunities from the Federal Budget 2022–23. Since we began them, these sessions have always been well attended and offer significant value. I hope you took the opportunity to tune in and take part in the live Q&A, but if you missed it, the on-demand recordings will be available to all members in due course.

Our annual coverage of the Federal Budget is one example of a resource we have been refining in recent years to better serve the needs of members. During this time, not only has the tax profession tackled the immense challenge of navigating new and unprecedented economic support measures, but the way we work has also changed. We went virtual in a way many had previously believed was decades away. We redrew the lines between work and home. We developed a new (and much needed) focus on mental health and balance.

This changing work environment meant that the Institute needed to respond with resources and experiences fit for our new world. That comes in many different forms: quick, thorough analysis of new tax guidance or policy; virtual events that keep you in the loop and connected to our community — but always mindful of your health and wellbeing; and advocacy that brings your concerns and thoughts on issues to the fore of the conversation. To paraphrase Darwin, the key to survival is the ability to adapt. We have adapted and continue to do so.

Just as the Budget report has evolved over time, so have these benefits to members. Our events continue to be held in accordance with health guidelines, in a flexible hybrid form that allows attendees to connect in-person or access the program remotely, as needed. Our advocacy has grown stronger and more involved as we have responded to calls from the profession for leadership and support on important issues. We continue producing a wealth of valuable resources and utilising platforms like social media and Community to ensure that you have access to those resources when and where you need it.

This year and beyond promises further refinement of member offerings and resources. With a federal election coming up, we will have a close eye on the policy environment. Whether or not the election brings about significant change in our economy, our profession and our tax system remains to be seen, but rest assured that we will be supporting you to navigate changes and to make your voice heard on important policy issues.

As you work your way through the implications of the Budget, support your clients with their needs, and prepare for future busy periods such as the end of financial year, please stay engaged with your member resources and with our team at the Institute. As always, we are here to help.

Associate Tax Counsel's Report

by Abhishek Shekhawat, ATI

Opening our eyes to s 100A

With the tax sphere abuzz about the ATO's draft guidance on s 100A, we take a step back and look at how we got here and where we are headed.

On 23 February 2022, the ATO released long-awaited draft guidance concerning s 100A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36). PCG 2022/D1 and TR 2022/D1 provide taxpayers and tax practitioners with insights into how the ATO will approach and apply s 100A.

Brief history of s 100A

Section 100A was introduced in 1979[1] as an anti-avoidance provision intended to address arrangements designed to lower an entity's tax using a "reimbursement agreement". A "reimbursement agreement" refers to an agreement[2] that provides for money to be paid or property transferred to, or services or other benefits provided for, someone other than the beneficiary or to the beneficiary and some other person or persons (s 100A(7) ITAA36).

The policy intent of s 100A was to target arrangements that purported to make another beneficiary presently entitled without intending for that beneficiary to receive the economic benefit of their entitlement. Effectively, the ultimate benefactor was often someone else.

In the late 1970s, the top marginal tax rate was 61.5%, amid public concerns regarding the use of "trust stripping" arrangements by the wealthy to avoid tax in Australia.[3]

Guidance and case law

Since its introduction, and despite its inherently broad application, s 100A has rarely been applied by the ATO, resulting in a shortage of historical guidance material[4] for the public to refer to or rely on. This contrasts starkly to other anti-avoidance provisions, such as Pt IVA or s 45B ITAA36.

Given the lack of previous guidance, the recent draft guidance by the ATO has an important role in educating taxpayers and tax professionals. Substantial clarity and education regarding the mechanics, nuances and intricacies of s 100A is needed, as well as a clear understanding of the ATO's compliance approach going forward and in respect of historical arrangements. Much work still needs to be done on the draft guidance to ensure that it best supports and educates the community.

Importantly, the precedential cases on s 100A have been limited to, and mostly concerned, more egregious behaviour.[5] For this reason, Logan J's recent decision in *Guardian AIT Pty Ltd ATF Australian Investment Trust v FCT*[6] is notable as it signifies the first time that the Federal Court has considered the operation of the "ordinary family or commercial dealing" exemption in s 100A. This case will potentially provide valuable jurisprudence on the application of the law. We keenly await the outcome of the appeal[7] and any potential future judicial decisions on s 100A that may provide further guidance.

Currently available resources

The Tax Institute is working to ensure that our members have access to the most useful resources and information to better understand and apply s 100A. Currently available content includes:

- overview of the draft ATO guidance;
- Section 100A: In response – an overview of some of the key concerns about the draft ATO guidance and what The Tax Institute is doing in response to support our members; and
- TTI webinar discussing the draft guidance and what it means for tax professionals (held on 4 March 2022).

Next steps

The Tax Institute is working with a specially created sub-committee (drawing on members from our National SME Technical Committee) to prepare submissions to the ATO, identifying the most pertinent issues arising from the draft guidance. Submissions are due on 8 April 2022 and will be publicly available on our website once they are submitted to the ATO.

The Tax Institute will also continue to work with our sub-committee and the ATO to ensure that we can support our members by providing useful tools and resources to help you better understand and apply s 100A and the ATO's compliance approach. This includes an upcoming "cheat sheet" on how to work through the detail of s 100A, and a webinar on 8 April 2022, with the ATO joining us in a panel session to further analyse and discuss the draft guidance.

Let us know in The Tax Institute's Community what advice and guidance you would like to see from The Tax Institute.

References

1 See cl 18 of the *Income Tax Assessment Amendment Act 1979* (Cth).

2 Section 100A(13) ITAA36 defines "agreement" broadly but does not include those entered into in the course of ordinary family or commercial dealing.

3 See M Butler, "Section 100A: when is a dealing between members of a family not in the course of ordinary family dealings", presented at The Tax Institute's 34th National Convention on 13 to 15 March 2019.

4 For the previous ATO guidance, see www.ato.gov.au/law/view/document?LocID=%22SGM%2Ftrusttaxation%22&PiT=99991231235958.

5 See E Hennebry, "Section 100A: 'oh no not you again'", 56(8) *Taxation in Australia* 487.

6 [2021] FCA 1619.

7 See www.comcourts.gov.au/file/Federal/P/QUD36/2022/actions.

Tax News – the details

by TaxCounsel Pty Ltd

March – what happened in tax?

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

Government initiatives

1. Amendments now law

A number of amendments to give effect to various tax measures are now law. The more significant are noted below.

Temporary full expensing extension

The amendments that extend the temporary full expensing regime by 12 months until 30 June 2023 became law on 22 February 2022. Other than the extension, the operation of the temporary full expensing regime remains the same.

The amending Act is the *Treasury Laws Amendment (Enhancing Superannuation Outcomes For Australians and Helping Australian Businesses Invest) Act 2022.*

Corporate collective investment vehicles

The amendments that establish the regulatory and tax frameworks for corporate collective investment vehicles (CCIVs) became law on 22 February 2022 and have effect from 1 July 2022. The amending Act is the *Corporate Collective Investment Vehicle Framework and Other Measures Act 2022* (the CCIV Act 2022).

Loss carry back

The CCIV Act 2022 also amended the income tax laws to extend the loss carry back rules by 12 months, allowing eligible corporate tax entities to claim a loss carry back tax offset in the 2022-23 income year. This means that the normal rules for losses will apply from the 2023-24 income year.

Employee share schemes

The CCIV Act 2022 also made amendments that remove cessation of employment as a taxing point for employee share scheme (ESS) interests which are subject to deferred taxation.

This measure applies to ESS interests for which the ESS deferred taxing point occurs on or after 1 July 2022.

2. Patent box amendments introduced

An amending Bill (the Treasury Laws Amendment (Tax Concession for Australian Medical Innovations) Bill 2022), which was introduced into parliament on 10 February 2022, contains amendments to give effect to the proposed patent box regime which will provide concessional tax treatment for ordinary and statutory income derived by a corporate taxpayer as a result of exploiting a medical or biotechnology patent.

Where a taxpayer meets the eligibility criteria for the patent box regime, income directly attributable to the eligible patent will benefit from being subject to an effective income tax rate of 17%, to the extent that the taxpayer undertakes the R&D of that patent in Australia. This concession is designed to encourage innovation and commercialisation of medical and biotechnology inventions to occur and remain in Australia.

Patents must link to a therapeutic good entered in the Australian Register of Therapeutic Goods to ensure that the patent box concessions are targeted towards relevant medical inventions.

As a result of the consultation process, patents issued by the United States Patent and Trademark Office or granted under the European Patent Convention will be able to access the patent box regime.

The amendments are to apply to patents granted or issued after 11 May 2021 in respect of income years starting on or after 1 July 2022.

3. AAT recovery stay power

An amending Bill, which was introduced into parliament on 17 February 2022, contains amendments which will enable the Small Business Taxation Division of the AAT to make a stay order in relation to a reviewable objection decision that relates to a small business taxation assessment decision.

The purpose of the amendments is to provide small business entities with a cheaper, faster and simpler way to pause the effects of a decision to recover a tax debt during a merits review of the decision as compared to applying to a court. However, this is balanced by the need to ensure that the tax law applies fairly to all, and that taxpayers who do not have a genuine disagreement with their tax debts cannot simply lodge a request for review in order to seek interim relief and avoid the prompt payment of those debts as and when they fall due.

The amendments are contained in Sch 3 to the Treasury Laws Amendment (Streamlining and Improving Economic Outcomes for Australians) Bill 2022 and are to apply in relation to applications for review made on or after the date of the commencement of the Schedule (which will be the day after the amending legislation receives royal assent).

The Commissioner's perspective

4. Employee share scheme expenses

The Commissioner has released a draft determination that sets out his views in relation to the deductibility of expenses incurred by an employer company in establishing and administering an employee share scheme as part of its remuneration strategy (TD 2022/D2).

The expenditure to which the draft determination relates often includes establishing and administering an employee share trust (EST) that holds shares or rights for employees participating in an employee share scheme (ESS) as defined in s 83A-10(2) of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).

Establishment expenses (that is, outgoings associated with the creation of an ESS) are not deductible to the employer company as a general deduction under s 8-1 ITAA97 because they are capital in nature. However, establishment expenses are deductible to the employer company in equal proportions over five years under s 40-880 ITAA97 (business-related costs) to the extent that the business is carried on for a taxable purpose.

Establishment expenses include: legal fees incurred in establishing the EST and ESS plan rules; start-up costs (for example, trustee company commencement charges); and registration fees with various authorities (for example, stamp duty and ASIC fees).

Amendment expenses (that is, expenses incurred amending an ESS) are not deductible to the employer company as a general deduction because they are capital in nature. However, as with establishment expenses, amendment expenses are deductible to the employer company in equal proportions over five years to the extent that the business is carried on for a taxable purpose.

On the other hand, ongoing expenses associated with the administration of an ESS are deductible under s 8-1 ITAA97 as a general deduction. Such expenses would include brokerage fees, audit fees, bank charges, making new offers to employees under an existing ESS, and other ongoing administrative expenses.

5. Reimbursement agreements

The Commissioner has released a draft ruling and a draft practical compliance guideline in relation to the operation, and the Commissioner's administration, of the reimbursement agreement provision (s 100A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36)) of the trust provisions in Div 6 ITAA36.

Draft ruling

The draft ruling (TR 2022/D1) explains that s 100A is aimed at cases where a beneficiary's present entitlement to a share of trust income arises out of, or in connection with, an arrangement:

- involving a benefit being provided to another person;
- intended to have the result of reducing someone's tax liability; and
- entered into outside the course of ordinary family or commercial dealing.

In these cases, s 100A generally applies to make the trustee, rather than the presently entitled beneficiary, liable to tax at the top marginal rate.

TR 2022/D1 provides the Commissioner's view about these arrangements and the four basic requirements for s 100A to apply, namely:

- the "connection requirement": for s 100A to apply, broadly stated, there must be a present entitlement, or a deemed present entitlement, of a beneficiary (other than a beneficiary under a legal disability) to a share of trust income, which has arisen out of, in connection with or as a result of a reimbursement agreement (being an agreement, understanding or arrangement that has the three qualities described in the following three points);
- the "benefit to another requirement": the agreement must provide for the payment of money or the transfer of property to, or the provision of services or other benefits for, a person other than that beneficiary;
- the "tax reduction purpose requirement": a purpose of one or more of the parties to the agreement must be that a person would be liable to pay less income tax for an income year; and
- the "ordinary dealing exception": the agreement must not be one that has been entered into in the course of "ordinary family or commercial dealing".

Draft practical compliance guideline

The draft practical compliance guideline (PCG 2022/D1) sets out how the ATO differentiates risk for a range of trust arrangements to which s 100A might apply and how the ATO tailors its engagement. In doing so, it also provides more certainty to taxpayers and their advisers to:

- assess the level of risk regarding trust distribution arrangements based on the risk framework;
- determine the level of engagement that can be expected from the ATO; and
- decide whether to contact the ATO to discuss how the risk profile of an arrangement may be reduced.

PCG 2022/D1 denotes the different risk ratings according to four coloured zones. There is a table that summarises each of these zones and the corresponding ATO compliance approach. The Appendix to the draft guideline contains examples that illustrate the application of the different risk zones.

PCG 2022/D1 states that the information provided in it does not replace, alter or affect the ATO's interpretation of the law in any way. It complements, and should be read together with, the contemporaneously issued TR 2022/D1 (as to which, see above).

Clarifying litigation

When considering TR 2022/D1 and PCG 2022/D1 (discussed above), it is important to note that there is presently litigation in the Federal Court on the operation of s 100A. This litigation has reached the stage of a first instance decision of Logan J in *Guardian AIT Pty Ltd ATF Australian Investment Trust v FCT*[1] which was handed down on 21 December 2021. The Commissioner is appealing from this decision to the Full Federal Court. It should be noted that, in this litigation, the Commissioner is seeking to rely on the general ant-avoidance provisions (Pt IVA ITAA36) if his reliance on s 100A is not successful.

PCG 2022/D1 states that the ATO is continuing work to identify taxpayers who wish to nominate themselves as a test case to obtain further judicial guidance in relation to s 100A.

6. Division 7A: revised approach to UPEs

The Commissioner has released a draft determination that sets out his revised views (to apply from 1 July 2022) on the way in which Div 7A ITAA36 applies where a private company is a beneficiary of a trust and there is an unpaid present entitlement (UPE) or there is a sub-trust (TD 2022/D1).

Division 7A is an integrity provision that aims to prevent tax-free distributions of profits of private companies to their shareholders. A loan (including any form of "financial accommodation") provided by a private company to its shareholder or shareholder's associates will, subject to specific exceptions, be included as a dividend in the shareholder's or shareholder's associates' assessable income.

The ATO's view in TD 2022/D1 is that a private company with UPEs will broadly provide financial accommodation to anyone the company allows to have access to the amounts to which they are entitled (whether or not they pay interest or other compensation). As a result, Div 7A can apply.

The key consequence of the ATO's view in TD 2022/D1 is that, for UPEs made for the income year ending 30 June 2023 or later, taxpayers will need to consider the operation of Div 7A when putting in place any sub-trust arrangements set out in PS LA 2010/4. Specifically, in order to avoid Div 7A applying to deem the loans to be deemed dividends, taxpayers will need to consider making them Div 7A complying loans. For most taxpayers, the practical impact will be a switch from arrangements requiring interest payments only to principal and interest repayments, without the complexity associated with setting up a sub-trust arrangement.

When TD 2022/D1 is finalised, it will only apply from 1 July 2022. That is, it will generally impact trust distributions made for the income year ending 30 June 2023 or later. Existing TR 2010/3 and PS LA 2010/4 will then be withdrawn. The compliance approach in the finalised determination will make it clear that the ATO will stand by its positions in TR 2010/3 and PS LA 2010/4 for dealings with pre-1 July 2022 entitlements.

The operation and implications of TD 2022/D1 are discussed in the Tax Tips column of this issue of the journal (see page 519).

7. Discretionary trusts: adult children arrangements

The Commissioner has released a taxpayer alert in relation to arrangements under which parents enjoy the economic benefit of trust income appointed to their children who are over 18 years of age (TA 2022/1).

The common feature of the arrangements is that trust income is appointed between members of the family group but, in substance, it is the parents who exercise control over and enjoy the economic benefit of the income.

In some arrangements, there is an understanding that trust income appointed to the children will be paid to their parents or otherwise dealt with at their parents' discretion. In others, the trust income appointed to the children is recorded as applied (with or without their knowledge) to repay amounts owed by them to their parents, being amounts owed in respect of expenses that benefit the children but are properly understood as parental expenses. Examples of these expenses are the costs of their upbringing as a minor or for the kinds of ongoing financial support parents would ordinarily provide their children.

The arrangements that the ATO is concerned about are those which are more properly explained by the tax outcomes obtained, including the accessing of tax-free thresholds and lower marginal tax rates of family members, rather than ordinary familial considerations. These arrangements, if effective, may have unintended tax consequences or may attract the application of specific or general anti-avoidance provisions.

For some of the expense repayment arrangements, there will be no contemporaneous evidence of the claimed obligation of the children to repay their parents. In cases involving the parents' management of the entitlements from the trust for the benefit of the family members, there may be no documentary evidence to demonstrate how that objective will be achieved.

The children may or may not be aware of their purported entitlements, or obligations, or the application of their entitlements against relevant expenses incurred on their behalf by their parents.

The ATO considers that the following consequences may arise:

- the purported entitlement of the children to trust income may be a sham or otherwise ineffective for trust law purposes;
- the arrangement may constitute a reimbursement agreement under s 100A ITAA36;
- ss 95A(1) and 97(1) ITAA36 may apply to treat the parents as presently entitled where the means by which the trustee permits the use of the funds evidences the exercise of a discretion to pay or apply those amounts to the parents (notwithstanding that the appointments are recorded as "beneficiary loans"); or
- the general anti-avoidance provisions (Pt IVA ITAA36) could apply.

While TA 2022/1 specifically considers arrangements involving the children of controlling individuals, the ATO is also concerned about similar arrangements involving other family members of controlling individuals that would have lower marginal tax rates than those of the controlling individuals.

8. Electronic sales suppression tools: administrative penalties

The Commissioner has released a final practice statement that provides ATO officers with guidance on the application and remission of administrative penalties for the production, supply, possession and use of an electronic sales suppression tool (ESST) (PS LA 2022/1).

PS LA 2022/1 covers the following:

- what an ESST is;
- when an ESST penalty applies;
- factors to consider when deciding whether to remit an ESST penalty; and
- notifying a taxpayer of their penalty.

Recent case decisions

9. JobKeeper eligibility

The AAT has upheld a decision of the Commissioner that the taxpayer company was not entitled to JobKeeper payments in August 2020 in respect of nine employees because those employees were not employed or to be treated as employed by the taxpayer on 1 July 2020 (*North Australian Contracting Pty Ltd and FCT*[2]).

These employees (who were referred to as "additional employees"), while employed by the taxpayer in August 2020, were not actually employed by the taxpayer on 1 July 2020, but rather by an associated company, North 23 Pty Ltd (North 23). The issue for decision by the AAT was whether s 9(6)(b) of the *Coronavirus Economic Response Package (Payments and Benefits) Rules 2020* (Cth) (the Rules) applied to treat the taxpayer as having employed the additional employees on 1 July 2020. Aside from this issue, there was no dispute as to the taxpayer's eligibility for the JobKeeper payments.

The taxpayer and North 23 were engaged in the construction industry, specifically in providing fit-out services. The taxpayer and North 23 had contracts with several builders which they referred to as tier one and tier two builders. Tier one builders were large companies such as Lendlease and Multiplex. Tier two builders were smaller state or national builders.

The taxpayer was generally used for the tier one work because most of that work was "union work". The taxpayer had an agreement with the relevant union and all work had to be in accordance with that agreement. North 23 could be more competitive on smaller projects because it did not have an agreement with the union and incurred a lower hourly rate for labour costs than the taxpayer. Staff moved between employment by the taxpayer and North 23 as required.

For s 9(6)(b) of the Rules (on which the taxpayer relied) to be satisfied, the additional employees would need to have been employed by an entity (the taxpayer) in the "same business" as they were employed in by another entity (North 23) at the earlier time.

In rejecting the taxpayer's submissions, the AAT said that the adoption of the taxation definition of "entity" in the Rules should be taken to have been done against the context of the usual application of that expression in taxation laws and the way business is conducted. It would not be appropriate to adopt a strained reading of s 9(6)(b) that would require the concept of an entity carrying on a business to be approached in a way that is contrary to the usual and accepted application of such concepts and contrary to ordinary experience under which either a single entity carries on a business or two or more do so in partnership.

The taxpayer's construction implied that the Rules should be taken to have contemplated the conduct of business by multiple entities carrying on the same business, but not doing so jointly with a view to profit – which was outside the normal conception of how a business is carried on. Indeed, it was difficult to conceptualise how a business could be simultaneously carried on by multiple enterprises each pursuing their own separate objectives, rather than jointly with a view to profit.

10. Director's fees: derivation issues

The AAT has held that certain payments, and the benefit of share issues, relating to the service of the taxpayer (a Mr Mobbs) as a director of three companies were derived by the taxpayer and not (as contended for by the taxpayer) by his company to which they were paid *(Mobbs and FCT*[3]).

The payments were made to the taxpayer's company (Hastcombe Pty Ltd) but the Commissioner contended that that was at the direction of the taxpayer, so that they represented income derived by the taxpayer. The shares were issued to Hastcombe Pty Ltd or, in some cases, to the taxpayer's superannuation fund.

As indicated, there were three companies (the companies) for which the taxpayer acted as director. Hastcombe Pty Ltd issued invoices for the taxpayer's services as a director to the relevant company.

The essential case for the taxpayer was that, in each case, the invoiced companies did not agree to pay the taxpayer for his services as a director. Rather, the taxpayer contended, the companies agreed to pay Hastcombe Pty Ltd to make available the taxpayer's services as a director. On that premise, the payments and shares would not have been derived by the taxpayer. The Commissioner's case was that the taxpayer had not discharged the burden of proving that the payments and shares were not derived by the taxpayer directly and merely directed by him to be paid, or the shares issued, to Hastcombe Pty Ltd.

The AAT said that the challenge for the taxpayer was that there was no documentary evidence directly corroborating his evidence that the invoiced companies agreed to pay Hastcombe Pty Ltd to make available his services. That left the primary evidence in support of the application to the AAT the taxpayer's own self-serving statements (which the AAT considered should not be accepted without corroboration) and the issuing and payment of the invoices.

The AAT said that it was not the mere absence of any documentary records of the asserted arrangements that was troubling. It was the absence of such records in circumstances where it would ordinarily be expected that such records would exist.

Because of its conclusion, the AAT did not need to consider arguments raised by the Commissioner as to the application of the general anti-avoidance provisions (Pt IVA ITAA36).

The AAT also upheld penalty tax assessments made by the Commissioner in relation to the share issues that were raised on the basis of a base penalty of 50% for recklessness which the Commissioner had remitted to 25%.

11. Profit-making transaction

The AAT has held that a gain of approximately $13m made by the taxpayer on an exchange of shares and options in a shelf company (CLNR Holdings Pty Ltd) that he had incorporated for valuable shares and options in another company (Rialto Energy Ltd) was assessable as ordinary income (*Whiddon and FCT*[4]).

The exchange occurred pursuant to a share purchase and merger agreement dated 22 October 2009 (SP&MA). The taxpayer accepted that the shares in CLNR Holdings Pty Ltd were ventured in a commercial transaction and that the prospect of the disposal was contemplated by the terms of the SP&MA. The fundamental issue for the AAT to decide was whether the taxpayer had shown that he did not enter into the SP&MA for the not insignificant purpose of profiting on such a disposal.

Underlying the transaction was an interest in a petroleum asset off the west coast of Africa. The interest comprised shares in a company called C&L Natural Resources Ltd that was a party to a product sharing contract (PSC) relating to rights to explore for and produce oil and gas over an area called Block CI-202.

It was common ground that the time for testing whether the taxpayer had the not insignificant purpose of profiting on the exchange of the CLNR Holdings Pty Ltd shares was when those shares were ventured into the arrangement contemplated by the SP&MA. However, a controversy emerged regarding whether the AAT's task was to determine whether the actual, subjective intention of the taxpayer was to obtain a profit, as the taxpayer maintained or, as the Commissioner contended, it was an intention or purpose that was to be determined objectively, albeit that evidence of the taxpayer's subjective intention or state of mind may be relevant.

The essence of the taxpayer's submission was that his intention in entering into the SP&MA was to obtain an effective interest in the PSC and Block CI-202 by ending up with shares in Rialto Energy Ltd and to maintain that interest. The taxpayer contended that, because it was his intention to maintain that interest, his intention was to maintain a long-term effective interest in the underlying asset and not to dispose of the shares in CLNR Holdings Pty Ltd at a profit.

The AAT said that the difficulty for the taxpayer was that, even accepting that his intention was to obtain and maintain an effective interest in the underlying asset, that was not sufficient to discharge his burden of proof. That was because the relevant question was not whether the taxpayer intended to retain his effective interest in the underlying asset through his shares in Rialto Energy Ltd. Nor was the relevant question whether the taxpayer intended to hold the asset obtained in return for his shares in CLNR Holdings Pty Ltd on capital account. An asset received in return for personal effort or other commercial activity may be held on capital account, but that did not mean that the transaction in which the asset was received was capital in nature. For example, the value of an asset provided in return for services rendered would be income even though the service provider may intend to hold the asset indefinitely.

In the view of the AAT, the relevant question was whether the taxpayer had an intention or a purpose of disposing of his shares in CLNR Holdings Pty Ltd at a profit. Although the taxpayer denied that he had such an intention, the AAT said that a person must be taken to have intended the obvious and contemplated outcome of their actions. The AAT asked rhetorically: where that outcome is the exchange of shares of nominal value for valuable shares, how could it be accepted that an intended outcome was not a gain that is the difference in value between the valuable shares received and the nominal value of the shares for which they were exchanged?

Obtaining that gain may not have been the taxpayer's main objective, but the authorities established that it is not necessary for profit-making to be the main purpose of a transaction. It is sufficient if it is a "not insignificant purpose".

The AAT also rejected an alternative contention of the taxpayer that he was not a resident of Australia at the relevant time.

Finally, the AAT upheld the Commissioner's imposition of penalty tax on the basis of a lack of reasonable care.

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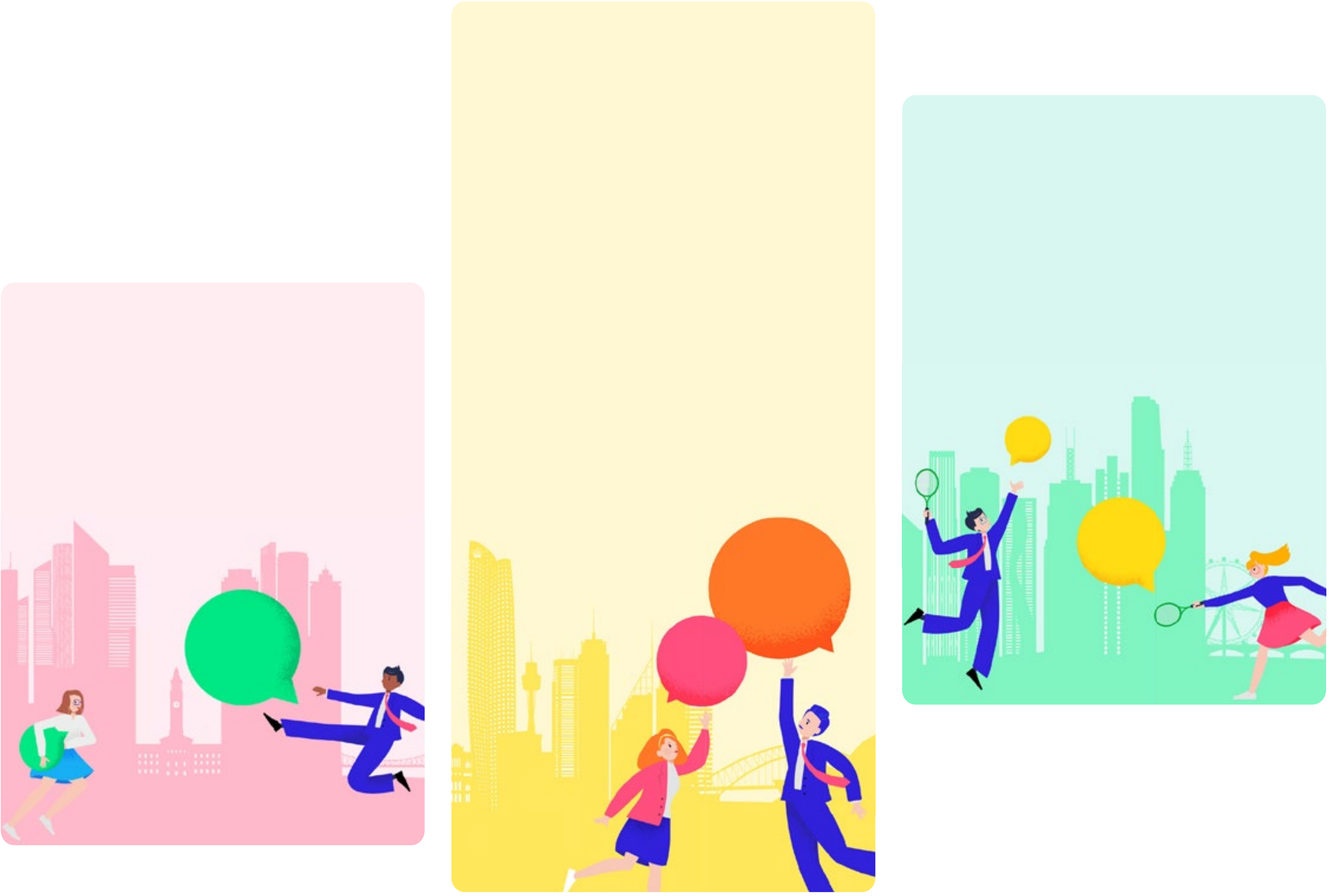

Tax Tips

by TaxCounsel Pty Ltd

Division 7A and UPEs: new ATO approach

A recently issued draft determination sets out the Commissioner's current views on how Div 7A operates where a private company has a UPE.

Background

The implications that may arise from Div 7A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) where a private company becomes presently entitled to income of a discretionary trust and the present entitlement is not paid have, for a number of years, been effectively governed in practice by an ATO ruling (TR 2010/3) and an ATO practice statement (PS LA 2010/4).

On 23 February 2022, the Commissioner released a draft determination (TD 2022/D1) which, when finalised, will set out the Commissioner's revised views on the operation of Div 7A in these circumstances. Underlying the new approach is the Commissioner's present view as to the circumstances in which there may be a loan for the purposes of Div 7A by reason of the provision of financial accommodation.

It is intended that the final determination will apply to trust entitlements arising on or after 1 July 2022.

This article outlines the approach that is taken by the Commissioner in TD 2022/D1.[1]

As is noted later, a number of changes to Div 7A that were announced some time ago are yet to be implemented.

Division 7A definition of "loan"

For the purposes of Div 7A, the expression "loan" is defined in inclusive terms in s 109D(3) ITAA36. What is of present relevance in relation to TD 2022/D1 is the inclusion, within the concept of a loan, of:

> "(b) a provision of credit or any other form of financial accommodation."

TD 2022/D1 states that the phrase "financial accommodation" in para (b) has a wide meaning and extends to cases where an entity with a trust entitlement has knowledge of an amount that it can demand and does not call for payment.

The draft determination describes when a private company provides financial accommodation (and thus makes a loan) where it is made presently entitled to income of a trust and either:

- that entitlement remains unpaid (an unpaid present entitlement (UPE)) – see below under the heading "Where there is an unpaid present entitlement"; or
- the trustee sets aside an amount from the main trust fund (main trust) and holds it on a new separate trust (sub-trust) for the exclusive benefit of the private company beneficiary – see below under the heading "Where there is a sub-trust".

In contrast, it was accepted in TR 2010/3 and PS LA 2010/4 that a private company beneficiary did not provide "credit or any other form of financial accommodation" (within the meaning of para (b)) to a trustee where the funds representing a UPE were held on sub-trust and re-invested in the head trust on particular terms.

Where there is an unpaid present entitlement

A private company beneficiary with a UPE, by arrangement, understanding or acquiescence, consents to the trustee retaining that amount and to continue using it for trust purposes if the company:

- has knowledge of an amount that it can demand immediate payment of from the trustee; and
- does not demand payment.

This constitutes the provision of financial accommodation to the trustee (and thus a loan by the private company to the trustee) under s 109D(3)(b) (see above).

Time of making loan

Where there is the provision of financial accommodation to the trustee, the loan by the private company beneficiary would be made when the financial accommodation is provided (s 109D(4) ITAA36). This will occur at the point in time when the private company beneficiary has knowledge of an amount that it can demand immediate payment of from the trustee and does not demand payment of the amount.

If the private company beneficiary and the trustee have the same directing mind and will, the private company beneficiary would be taken to have knowledge of the amount that it can demand immediate payment of from the trustee when the trustee does.

The time when the amount of a beneficiary's entitlement is known will depend on how that entitlement is expressed. If a trustee resolves to make a private company beneficiary presently entitled to:

- a *fixed* amount from the trust income, the private company beneficiary has a right to demand immediate payment of that amount from the trustee; or
- a percentage of trust income or some other part of trust income identified in a calculable manner,[1] the private company beneficiary cannot demand immediate payment from the trustee; it will only be able to demand

immediate payment of an amount from the trustee when the trust income (or the relevant part that they are entitled to) is calculated, typically, after the end of the relevant income year.

Where the present entitlement is to a fixed amount, the Div 7A loan that would arise would be made by the private company when the trustee makes the distribution resolution, which would be 30 June or an earlier date of the income year to which the distribution relates.

On the other hand, where the present entitlement is to a calculable amount, the Div 7A loan that would arise would be made by the private company at some point in time in the income year following the income year to which the distribution relates.[2] It would seem that this would be the case not only where there is an actual distribution by the trustee of a discretionary trust to a private company beneficiary, but also where the private company beneficiary becomes entitled because it is a default beneficiary.

Where there is a sub-trust

Where a private company beneficiary is made presently entitled to trust income and the trustee sets aside an amount from the main trust and holds it on sub-trust for the exclusive benefit of the private company beneficiary, the present entitlement to income is paid and there is no UPE. The amount set aside by the trustee ceases to be an asset of the main trust and forms the corpus of the sub-trust (the sub-trust fund). The trustee's obligation in respect of the entitlement to distributed income comes to an end and a new obligation arises for the sub-trustee under a separate trust.

The private company beneficiary has a new right to call for payment of the sub-trust fund and, by making such a call, can bring the sub-trust to an end. A choice by the private company not to exercise that right does not constitute financial accommodation in favour of the trustee in its capacity as trustee of the sub-trust because the sub-trust fund is held for the private company beneficiary's sole benefit.

However, the private company beneficiary, by arrangement, understanding or acquiescence, consents to the sub-trustee allowing those funds to be used by the private company beneficiary's shareholder or their associate if:

- all or part of the sub-trust fund is used by that entity; and
- the private company beneficiary has knowledge of this use.

This constitutes the provision by the private company beneficiary of financial accommodation to the entity using the sub-trust fund (and hence a loan by the private company under s 109D(3)(b) ITAA36). This will be the case whether or not the use of the sub-trust fund is on commercial terms whereby a return is paid to the sub-trust fund.

Time of making loan

The loan would be made when the financial accommodation is provided, that is, the point in time when the private company beneficiary has knowledge of the use of an amount of the sub-trust fund and does not call for payment of that part of the sub-trust fund by the private company beneficiary's shareholder or their associate. The amount of the loan in those circumstances would be the amount of the sub-trust fund that the private company knows (or is taken to know) is used by its shareholder or their associate.

If the private company beneficiary and the trustee have the same directing mind and will, the private company beneficiary is taken to have knowledge of the use of the sub-trust fund (or part of the sub-trust fund) when the trustee does.[3]

Examples

TD 2022/D1 gives several examples of the way the views expressed in the draft determination apply.

Implementation of a complying loan agreement

In cases where financial accommodation is provided, as described in TD 2022/D1, the trustee and the private company beneficiary can avoid a dividend being taken to be paid if, before the private company's lodgment day (as defined) for the income year in which the financial accommodation arises:

- the trustee pays the trust entitlement to the private company beneficiary; or
- the private company beneficiary and the trustee enter into a complying loan agreement that satisfies the terms of s 109N ITAA36 in respect of the financial accommodation.

If a complying loan agreement is entered into in respect of the financial accommodation, the first minimum yearly repayment will be due by 30 June of the year following the income year in which the financial accommodation was provided.

Date of effect

When the final determination is issued, it is proposed that:

- it will apply to trust entitlements arising on or after 1 July 2022; and
- TR 2010/3 and PS LA 2010/4 will be withdrawn, with effect from 1 July 2022 for trust entitlements arising on or after that time.

The Commissioner will take a compliance approach of not devoting compliance resources to sub-trust arrangements conducted in accordance with PS LA 2010/4 in respect of trust entitlements arising before 1 July 2022.

Some observations

As explained above, when TD 2022/D1 is finalised, it is proposed to apply on a prospective basis in relation to trust entitlements that arise on or after 1 July 2022, from which date TR 2010/3 and PS LA 2010/4 are to be withdrawn.

If TD 2022/D1 correctly reflects the operation of Div 7A as a matter of law, it is difficult to see how the Commissioner can do anything other than apply the law. Accordingly, it is not clear why the commencement of operation of TD 2022/D1 is being deferred to the 2022-23 income year.

Terms of distribution resolution

A practical point that arises out of TD 2022/D1 is that the way that a distribution of income by the trustee of a discretionary trust is made will impact on the timing of the commencement of a potential loan for the purposes of Div 7A.

Example 1

On 30 June 2023, the trustee of the Magpie Discretionary Trust makes a resolution to distribute the 2022-23 income of the trust. Among the distributions is a distribution of an amount of $80,000 to Rosella Pty Ltd, a company that is under the same control as the Magpie Discretionary Trust.

That will mean there will be a provision of financial accommodation loan from Rosella Pty Ltd to the Magpie Discretionary Trust on 30 June 2023.

If the amount of the distribution is not paid, the operation of Div 7A to deem a dividend to have been paid to the Magpie Discretionary Trust could be avoided by a Div 7A compliant loan agreement being entered into before the lodgment day of Rosella Pty Ltd for the 2022-23 income year.

Example 2

On 30 June 2023, the trustee of the Parrot Discretionary Trust makes a resolution to distribute the 2022-23 income of the trust. The distribution resolution provides for specific amounts to be paid to certain beneficiaries and for the balance of the income for the 2022-23 income year to be distributed to Swallow Pty Ltd, a company that is under the same control as the Parrot Discretionary Trust.

That will mean there will be a provision of financial accommodation loan from Swallow Pty Ltd to the Parrot Discretionary Trust that would arise during the 2023-24 income year.

If the amount of the distribution is not paid, the operation of Div 7A to deem a dividend to have been paid to the Magpie Discretionary Trust could be avoided by a Div 7A compliant loan agreement being entered into before the lodgment day of Rosella Pty Ltd for the 2023-24 income year.

Division 7A reform?

Significant changes to the operation of Div 7A were announced some time ago. These changes had their ultimate genesis in an announcement made by the then Assistant Treasurer on 18 May 2012 that the Board of Taxation would conduct a post-implementation review of the Division. Subsequently, in October 2014, it was announced that the terms of reference for the review were to be expanded and the reporting date was to be extended.

The Board completed its post-implementation review and provided its report to government on 12 November 2014. The government adopted a number of the Board's recommendations in the 2016-17 Budget. It was stated that the changes would provide clearer rules for taxpayers and assist in easing their compliance burden while maintaining the overall integrity and policy intent of Div 7A. It was envisaged that the changes would include:

- simplified Div 7A loan arrangements;
- a self-correction mechanism for inadvertent breaches of Div 7A;
- appropriate safe-harbour rules to provide certainty; and
- technical adjustments to improve the operation of Div 7A and provide increased certainty for taxpayers.

As announced, these changes were to apply from 1 July 2018 but the start date has been pushed out several times and it is now proposed that they will commence on the 1 July following the date on which the amendments become law.

In the 2018-19 Budget, the government announced that it would be made certain that UPEs come within the scope of Div 7A. The Commissioner has stated that the position taken in TD 2022/D1 is consistent with the intended policy of this announcement. It is suggested that the attempt to implement the UPE change by a taxation determination does not provide a solution that would be as satisfactory as a legislative amendment.

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References

1 It should be noted that, in some circumstances, there may be an interaction between Div 7A and s 100A ITAA36. Reference may be made in this regard to PCG 2022/D1.

2 This would be the case, for example, where there is a distribution of the balance of the trust income after providing for distributions to other beneficiaries.

3 What this time is would be a question of fact. For the purposes of the examples given in TD 2022/D1, the time the income of the trust for the relevant income year is determined is taken to be relevant.

Mid Market Focus

by Peter Bembrick, CTA, HLB Mann Judd

When is an asset "active" for CGT purposes?

The small business CGT concessions offer fantastic tax savings when selling a business and have several key requirements, including that one or more active assets must be sold.

Considering that it is such a fundamental requirement for applying the small business CGT concessions, deciding whether an asset is "active" is not always as easy or straightforward as it sounds.

The basic condition for accessing the small business CGT concessions is that the taxpayer must either have an aggregated turnover of less than $2m[1] or aggregated net assets with a value not exceeding $6m,[2] with extra requirements when selling shares in a company.

None of that matters, however, unless the asset being sold is an active asset,[3] which is broadly defined in the legislation and has been the subject of much interpretation by the courts and the ATO as it is a concept that depends on the specific facts and circumstances in each case.

What is an "active asset"?

For the purposes of the small business CGT concessions, an active asset is one that the taxpayer owns and uses, or holds ready for use, in the course of carrying on a business.[4]

Active assets may be tangible, such as land and buildings and equipment, or intangible, such as goodwill, patents, copyrights and other intellectual property (for example, software).

When selling shares in a company, the shares will be active at a point in time if the market value of its active assets equal at least 80% of the total market value of all of the company's assets.[5]

It is conceivable that intangible assets may not meet the requirement that they be used in the relevant business; the rules require that such intangible assets must also be inherently connected with the business that is being carried on by the taxpayer to qualify as an active asset.

The asset must have been active for the lesser of 7.5 years and one-half of the relevant ownership period. This means that, if an asset has been an active asset for at least 7.5 years, it will be an active asset indefinitely, regardless of when it is sold or any other uses of the asset.[6]

In addition, if an asset is used or held ready for use by a taxpayer's affiliate, or another entity connected to the taxpayer, in the course of carrying on its business, then that asset will also be treated as active when sold.[7]

A critical point is that assets whose main use is to derive rent, even in the course of carrying on a business, are specifically excluded from qualification as active assets.[8] However, applying this exclusion is not straightforward and the ATO has provided guidance by way of examples in TD 2006/78, explaining when premises used by a business will and will not satisfy the active asset test. In any case, as discussed below, the specific circumstances of each situation need to be carefully considered.

So, what exactly does it mean to be "carrying on a business"?

Unfortunately, there is no definitive test as to whether a business is being carried on. However, in TR 2019/1, the ATO has indicated that the following factors may be relevant:

- the intention to carry on a business;
- the expectation, and likelihood, of a profit;
- the size, scale and permanency of the activity; and
- whether the activity is repetitive and regular and organised in a business-like manner.

Example 1. Property used in carrying on a business that qualifies as an active asset

Ron owns the Very Good Building & Development Company. Ron uses one of its properties for storage only, while the activities of building, bricklaying and paving take place at building sites. It is reasonable to argue that the property is still used in the course of carrying on the company's business, and is not merely preparatory, so should be treated as an active asset.

Support for Ron's example can be found in the recent Federal Court decision, *Eichmann v FCT*,[9] where the definition of "active asset" was given a broad meaning. The relevant factors are the use of an asset and whether the asset is used in the course of carrying on that business, which involve issues of fact and degree and should be applied in a concessional way.

There have also been a number of cases where the taxpayer has successfully argued that conduct of a rental property business is carrying on a business. In one such case, *YPFD and FCT*,[10] the taxpayer owned nine rental properties and, although they were managed by an agent, devoted a considerable amount of time undertaking tasks in connection with the properties.

Despite the taxpayer's methods being relatively unsophisticated, the Administrative Appeals Tribunal concluded that the taxpayer was carrying on a business. However, while it is possible to carry on a rental property business, the courts have rejected arguments that an asset whose main use is to "derive rent" is an active asset even if it used in carrying on a business.

When will the main use of a property be treated as deriving rent?

Recent private binding rulings and cases suggest that, where the occupier has a right to exclusive possession of the property, payments involved are likely to be rent. On the other hand, if the occupier is only allowed to enter and use the premises for certain purposes (which do not amount to exclusive possession), the payments involved are unlikely to be rent.

Other factors to consider include the degree of control retained by the owner and the extent of services provided (eg providing meals, room cleaning, supplying linen and shared amenities).

Some common scenarios have been analysed by the courts and the ATO, including the examples set out in TD 2006/78 and private rulings given to taxpayers, which help to illustrate the specific factors that will determine whether an asset is used to derive rent or whether it is an active asset.

Example 2. Short-term accommodation

Ann operates the Pawnee Guest House, where visitors must leave the premises by a certain time. Ann has the right to enter rooms at any time, she provides common areas and offers services such as cleaning and meals, and she has the right to move residents to another room in the house at short notice. The ATO does not consider this to be a landlord/ tenant relationship and the property will be an active asset.

This can be contrasted with the decision in *Tingari Village North Pty Ltd and FCT*,[11] where residents of a mobile home park were held to be paying rent for their sites despite the provision of additional services and the availability of common facilities.

Example 3. Provision of commercial storage

Chris runs Eagleton Storage Solutions, offering storage sheds for short or longer-term hire, with 24-hour security and various other services, and with the right to relocate clients to another shed and, importantly, to enter without their consent. The ATO accepts this would not be a rental arrangement, and the asset would be active.

There are, however, many other examples in ATO private rulings where short-term commercial storage providers were treated as receiving rent, so their properties were not active assets, with the deciding factors usually being a lack of other services and arrangements giving exclusive possession.

Example 4. Owning and operating a shopping centre

Donna operates Pawnee Mall, a large shopping centre with a wide range of tenants who enjoy the use of substantial common areas and a range of services. While the ATO does not dispute the scale and commercial nature of Donna's business, its view remains that, as her tenants each have exclusive access to their shops under their leases, Donna is receiving rent and the property cannot be active. The ATO has consistently

Example 4 (cont)

rejected private ruling requests seeking active asset treatment for operators of shopping centres, often with very substantial operations.

What does "main use" mean and how is it determined?

The term "main use" is not defined in the legislation and a number of factors will be relevant, such as the comparative areas of use of the premises between deriving rent and other purposes, the comparative periods of use, and the comparative levels of income derived from the asset.

It would appear, based on a review of relevant ATO examples, that the most important consideration is the comparative levels of income derived.

Example 5. Properties used for both business and rental purposes

Andy owns land on which there are several industrial sheds. He uses one shed (45% of the land by area) as a production studio for his business as a children's entertainer and he leases the other sheds (55% of the land by area) to two unrelated third parties, Ben and Tom. The income derived from Andy's business is 80% of his total income, with the rest derived from leasing the other sheds. Having regard to all circumstances, the ATO's view is that Andy's "main use" of the land is not to derive rent, but rather the rental use is secondary to his business activities.

In a recent case, *The Executors of the Estate of the late Peter Fowler and FCT*,[12] the term "use" was argued to include "non-physical" uses, such as holding a property for the purpose of capital appreciation, but the tribunal held that the concept of "use" referred only to physical use.

Can passively held assets still meet the definition of "active asset"?

Generally, owners of passively held assets (such as factories, warehouses or office buildings) are not carrying on a business and therefore cannot access the small business CGT concessions. However, an exception is when a taxpayer owns a passively held asset that is used in the small business carried on by an affiliate or an entity connected to the taxpayer.

Example 6. Property used by spouse in running a business

With reference to example 5, instead of owning the land himself, the land is owned by Andy's wife April, who leases it to Andy so he can carry on his business. While spouses are not usually "affiliates" for the small business CGT concessions, a special rule applies in a situation like this to "deem" Andy to be April's affiliate, which makes the land an active asset for April because it is used in Andy's business.

Sale of intellectual property, including software

Taxpayers must be able to show that intellectual property (IP) is not merely being used to derive rent or royalties and that the asset was not simply developed for sale. In other words, it is essential to show that the IP was held for use in an active business.

Developing IP that might be a target for a would-be purchaser may still be part of a company's business plan. However, in order to claim that it is an active asset, it is still necessary to show that using the IP in the course of carrying on the business was the main objective.

Example 7. Software sold after building up subscriber base

Leslie has developed software for managing all of a city's parks and recreation facilities, and after initially testing it in Pawnee and nearby cities, she has ambitious plans to expand her business nationally and globally. Leslie has built up a significant subscriber base so that, as she refines the software, she is earning revenue from using it in her business, which gives her a strong argument for treating it as an active asset when she receives an offer to sell.

There is little ATO guidance in relation to the classification of software and other items of IP as active assets, and careful consideration should be given to both the financial and non-financial aspects of each case.

There are many factors to consider when selling your business, of which tax is just one – albeit a very important one. It is therefore vital to seek advice from a qualified tax professional to understand the likely consequences, as well as information on any relevant small business CGT concessions that may be available.

Peter Bembrick, CTA
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Higher Education

Applying knowledge from CTA2A Advanced

The dux of CTA2A Advanced for Study Period 2 2021 discusses how he applies the knowledge he has acquired to his work.

Patrick Norman
Lawyer, Birchstone Tax Law, Western Australia

Please provide a brief background of your career in tax.

I graduated from Curtin University in 2020 with a Bachelor of Laws and Bachelor of Commerce (Taxation) double degree.

I held a number of tax-related roles during my time at university. From 2018 to 2020, I worked as an administration officer in the Prosecutions Department at the ATO. In this role, I prepared prosecution notices and written court submissions, and attended court with delegated authority from the Commissioner of Taxation. I also volunteered at the Curtin Tax Clinic, an organisation that assists unrepresented taxpayers in meeting or complying with their tax affairs.

In October 2020, I joined Birchstone Tax Law in a full-time role as a law graduate. I commenced my practical legal training in January 2021 and was admitted as a lawyer in August 2021. In this role, I provide tax law advice to privately owned enterprises and high net worth individuals, with a particular interest in restructuring and the application of the small business CGT concessions.

Why did you choose to study the CTA2A Advanced subject?

I undertook the CTA2A Advanced subject as part of The Tax Institute Higher Education's Chartered Tax Adviser Program. I was very interested in the CTA2A Advanced subject because many, if not all, of the modules within the subject are directly relevant to my day-to-day work in the SME space.

What have you learned from the subject, and have you applied this to your role?

The real value I have gained from the CTA2A Advanced subject is being able to identify different tax issues in the matters that I am working on. The CTA2A Advanced subject exposed me to a wide range of different areas within tax law, and this has made it much easier to pinpoint what tax-related issues my clients may have. Most notably, I found the superannuation and partnership modules to be very helpful as I had limited knowledge in these areas.

How did you juggle study, work and other commitments?

My firm was very accommodating which allowed me to juggle study, work and other commitments. I found that doing *some* study each day, even if that is only five minutes of reading on the bus or train, was very beneficial as it kept the concepts fresh in my mind.

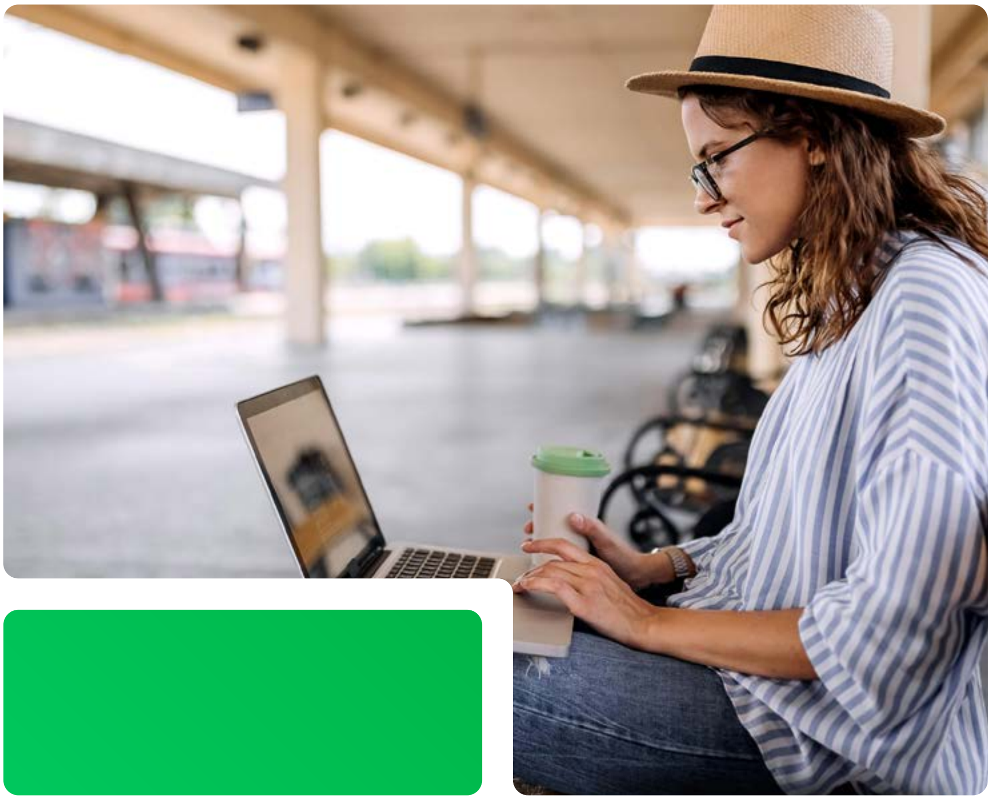
I would recommend covering all of the reading at least a few weeks before the exam so that you can focus on practice questions and applying the concepts that you have learnt.

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

I will now complete the CTA2B and CTA3 subjects, and in the future, I may undertake a Master of Taxation.

What advice do you have for other tax professionals considering the Chartered Tax Adviser Program?

I would highly recommend the Chartered Tax Adviser Program to other tax professionals as it is a great value-add for yourself and your clients.



Member Spotlight

Alison Stevenson

Member since:	**2005**
Member level:	**CTA**
Current role:	**Taxation & Succession Specialist**

What made you choose tax as a career and join The Tax Institute?

Educated as a lawyer and having worked in both accounting and law firms, I was drawn to tax as a career as it encapsulated the skillsets of both professions. To me, a tax practitioner's role is to successfully combine the proficiencies of a lawyer and an accountant in both practice and mindset. I initially joined The Tax Institute as a graduate seeking professional development and to broaden my network, but I have gained so much more than that over the last 17 years.

How is your membership beneficial to your practice and clients?

The Tax Institute provides a network of professional advisers who I can work with to the benefit of our firm and our clients. Over the years, we have utilised The Tax Institute's education, the Emerging Leaders Program and the Tax Mentor Program, together with the broader CPD technical sessions offered. These initiatives have allowed me to invest in myself, as well as several staff members, in order to continue to develop the professional standard of our practice.

What is your most memorable career achievement to date?

A standout career highlight was winning the Tax Adviser of the Year RESPECT SME category in 2021. It was certainly a humbling experience and an absolute privilege to be recognised by my professional peers, especially during a year where our entire profession went above and beyond as we navigated the changing tax landscape throughout the COVID-19 pandemic, often in the middle of a lockdown working from home.

What do you see being the main challenges for tax practitioners this year?

As we adjust to the "new norm" of living with a pandemic and having spent nearly two years focusing on the roll-out of COVID-19 stimulus packages, as well as maintaining clients, I hope 2022 will instil an outlook of growth and opportunity for our clients that will lead to new challenges.

What do you see as the key attributes of an effective leader in the tax profession?

I believe an effective leader in our profession must possess a balanced mix of five attributes: integrity, commitment, motivation, the ability to empower others, and the ability to effectively communicate complex issues in an easy to understand manner.

Do you have any advice for young professionals just beginning their career in tax?

As someone who has walked in those shoes, I encourage young professionals who are just beginning their career to become part of the tax community – join a discussion group, attend networking events and CPD sessions, or take up membership with The Tax Institute. It's a very welcoming community, with a strong volunteer base which encourages and embraces with open arms.

What does it mean to have won a prestigious Tax Adviser of the Year Award for 2021 and why?

To be acknowledged by my colleagues and associates is an absolute honour of the highest calibre. One could never really understand the challenges we have faced as a profession without having worked through it, especially during the last two years. To be bestowed such a prestigious accolade in the midst of that is a wonderful recognition of what, to me, is simply doing my job.

Incentives for innovation and infrastructure

by The Tax Institute

The world will continue to innovate, and those who do not will be left behind. The global economy is evolving and developing at exponential rates with the ongoing search for efficiencies, increased productivity and new ways to increase competition. This chapter of the *Case for Change* paper explores how the tax system can support innovation and growth in our economy. Since first publication of this chapter, there have been some announcements that address some of the recommendations, such as the introduction of a patent box regime. On the other hand, the Board of Taxation was due to report to the government by November 2021 on its review into the dual administration of the R&D tax incentive. We are yet to hear what the outcome of the Board's review is and whether the government will support any recommendations for improvement of the current system. Indeed, one hopes that the government takes the opportunity of that report to adopt the recommendations in this chapter.

What is 'innovation'?

For the purposes of the *Case for Change* paper and the debate on what level of support the Australian Government should provide for innovation, it is necessary to first understand what is meant by 'innovation'. According to the *Macquarie dictionary*, 'innovation' is 'something new or different introduced; the act of innovating; introducing of new things or methods'.[1] The general definition accepted by the OECD is:[2]

> "An **innovation** is a new or improved product or process (or combination thereof) that differs significantly from the unit's previous products or processes and that has been made available to potential users (product) or brought into use by the unit (process)."

When considering government support for innovation, such support can be provided for that innovation itself, or the activities, processes and products supporting the development of an innovation, or a combination thereof. In this regard, the OECD provides further definitions around those activities, processes and products related to innovation:[3]

> "**Innovation activities** include all developmental, financial and commercial activities undertaken by a firm that are intended to result in an innovation for the firm.
>
> A **business innovation** is a new or improved product or business process (or combination thereof) that differs significantly from the firm's previous products or business processes and that has been introduced on the market or brought into use by the firm.
>
> A **product innovation** is a new or improved good or service that differs significantly from the firm's previous goods or services and that has been introduced on the market.
>
> A **business process innovation** is a new or improved business process for one or more business functions that differs significantly from the firm's previous business processes and that has been brought into use by the firm."

The world will continue to innovate, and those who do not will be left behind. The global economy is evolving and developing at exponential rates with the ongoing search for efficiencies, increased productivity and new ways to increase competition. Not only is there the development of new products and new technologies, but there are also new ways to utilise such technologies to achieve new outcomes. Our future holds a greater use of technology, automation, artificial intelligence and digital disruption.

The graph in Figure 1 highlights this exponential growth. As can be seen, the number of patent applications globally (including those actually granted) has risen at ever-increasing rates, demonstrating the rate at which new innovations are now emerging. This reinforces the importance of governments investing in, supporting and protecting innovation within their jurisdictions so their economies can remain globally competitive for years to come.

The innovation cycle

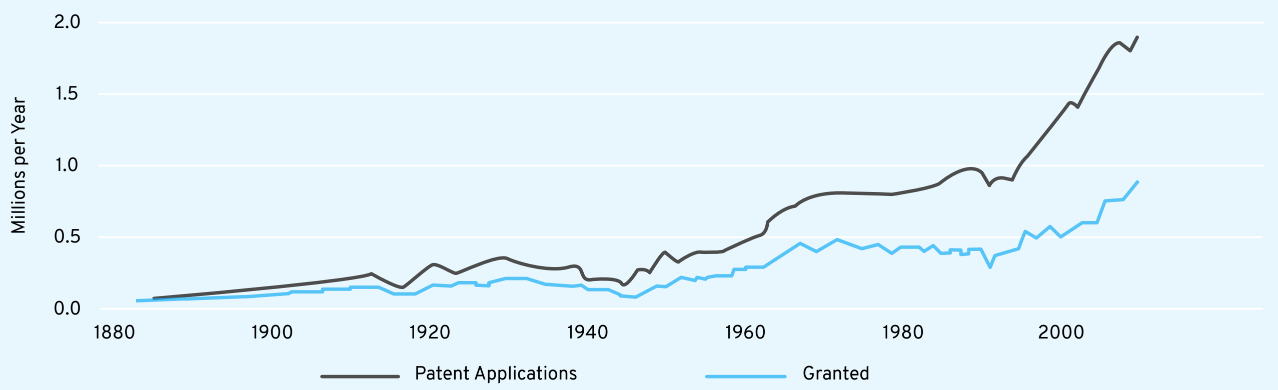
There is a need to understand the innovation cycle, as often when we refer to supporting innovation, minds immediately turn to the research and development tax incentive (R&DTI). R&D itself is only one link in the chain. Innovation is a virtuous circle from research to development to commercialisation and back again. Throughout this process, innovators face continual challenges with funding and risk.

The innovation cycle is diagrammatically presented in Figure 2.

Funding is required at every stage throughout the life cycle. Innovators often seek external sources of capital to support their activities and this may be from public or private sources. While there may be numerous forms, some of the main identified sources of funding include:[4]

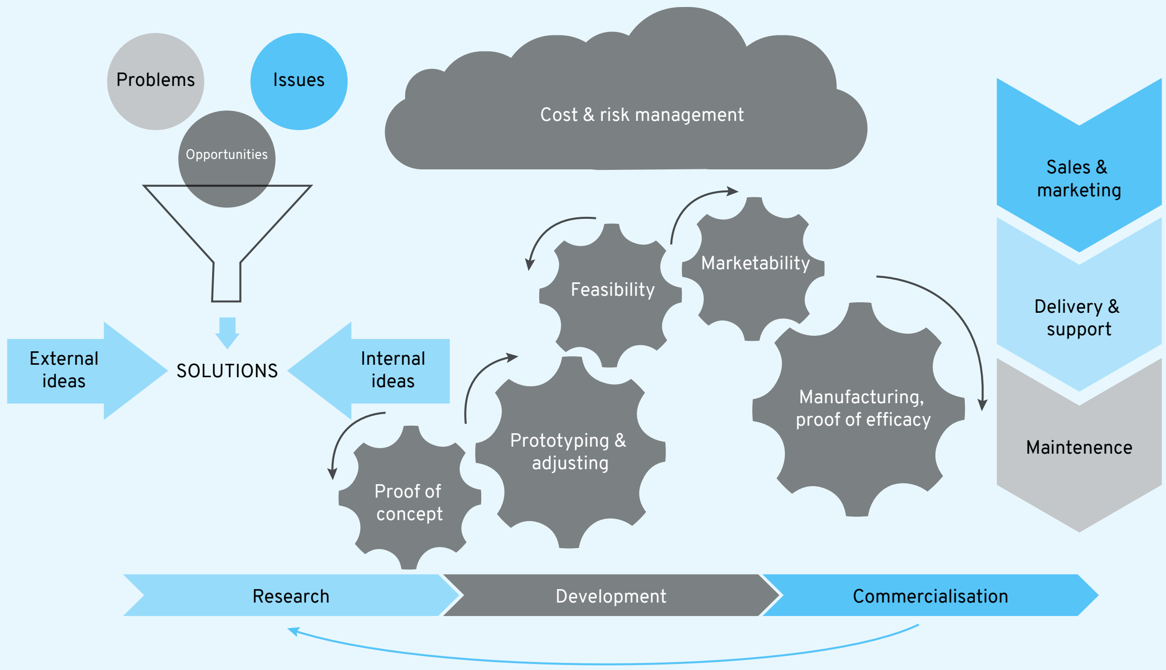
- venture capital: funding provided by venture capital funds backed by high net worth individuals, corporations, large superannuation funds and other entities;
- angel investors: like venture capital, but predominantly high net worth individuals with an expertise or interest in a specific industry or technology;

Figure 1. Patent applications and patent grants worldwide, 1883–2011



Source: ResearchGate[5]

Figure 2. Innovation cycle



- debt funding: non-dilutive funding with set repayment terms;
- R&DTI financing: specific financing for R&D, with finance amounts and repayment terms linked to claims expected to be made under the R&DTI;
- bootstrapping: funding the activities with your own capital and sustainable revenue sources;
- accelerator funding: accelerators are often market- or industry-focused and offer professional guidance, assistance and networking in addition to startup capital;
- government grants: specific eligibility criteria and application processes apply;
- corporate venture funds: similar to venture capital, but often backed by a corporate with a specific industry focus;
- equity crowdfunding: predominantly a large amount of individuals investing small amounts of money;
- blockchain-based crowdfunding: utilising blockchain/cryptocurrencies to undertake crowdfunding; and
- friends and family funding: utilising personal networks.

Risks also exist at every stage throughout the life cycle and innovators are required to manage and mitigate these. According to the ABS, around 50% of all small businesses fail in the first four years of their operation.[6] Acknowledging that there are many reasons why small businesses may fail,[7] due to the increased risks associated with innovation, those small businesses seeking to develop new or improved products or processes would account for the greater proportion of these failures.

As a consequence of these risks, potential investors are more selective with the ways in which their scarce resources are allocated. They are selective towards the industries and activities in which they wish to invest, the stage of the business life cycle at which they wish to invest, and the amount they are willing to invest in a particular venture, depending on their motivations and the portfolio's investment mix.

These risks of innovation influence the ease and availability of any of the funding avenues noted above. Furthermore, and most importantly for innovation entities, they influence the cost of the required capital, either through effective costs of borrowing or the dilution of equity ownership.

The role of the tax system in innovation

The revenue collected from the tax system is important to fund expenditure in areas such as health, social welfare and education, and other community projects. Such expenditure may be direct funding of activities, payments via the transfer system or concessions provided through the tax system.

In addition to raising revenues, the tax system may be used to create economic stability or even to facilitate or promote economic growth. It is acknowledged that there are limitations on what tax incentives can achieve, particularly given the need to avoid any tax-induced allocation of resources into unproductive activities;[8] however, the OECD observes that expenditure-based R&D tax incentives have emerged as the primary R&D support tool across many OECD countries, with 30 of the 36 OECD countries offering such incentives in 2019, up from 19 in 2000.[9]

> "… there is a need to consider the mix between direct funding support and tax incentives …"

How deep support for innovation should go in so far as targeting specific industries or regions is open for debate, particularly when considered in light of the fundamental principles that a tax system should exhibit equity, efficiency and simplicity.

A dichotomy arises in relation to investment in innovation; one impacting the benefits of investment for both the private entity and the entire Australian economy. The broader economic benefit may often outweigh the perceived personal benefit for private entities to invest in innovation, giving rise to perceived underinvestment in innovation necessary for economic growth. This dichotomy can be difficult for governments to manage in order to generate an acceptable return on investment for innovation incentives. This is highlighted in the Henry review and by the OECD.

As noted in the Henry review:[10]

> "Where the research and development of a firm generates spillover benefits for others, the social returns from research and development may be greater than the private returns. A tax-preference or government expenditure that appropriately targets such spillovers may therefore be beneficial and improve overall productivity.
>
> But where a subsidy is inappropriately targeted, such incentives can bias the allocation of resources in the economy and actually reduce productivity."

The OECD has further noted:[11]

> "Research and development (R&D) is an important driver of innovation and economic growth, but the existence of knowledge spillovers coupled with financing difficulties may make firms invest less in R&D than what would be socially optimal. To encourage demand driven business R&D investment, governments worldwide make use of various policy instruments to incentivise R&D performance. In addition to R&D grants and purchases of R&D services ('direct support'), many governments use the tax system as an additional inducement mechanism. These preferential tax provisions may relate to R&D inputs (expenditures) or outputs (incomes from licensing or asset disposal attributable to R&D or patents)."

In managing the dichotomy, governments must consider the return on investment for the broader economy through the government providing support for innovation, and the mechanism through which support is to be provided (i.e. direct funding by way of grant) – indirect funding by way of tax incentive or a mix of both. From a policy perspective, the OECD notes the following:[12]

> "Policy mix: The exploratory analysis indicates a similar degree of input additionality for direct R&D government funding measures (IR: 1.4) compared to tax incentives and hints at the potential complementarity of direct and indirect support measures. Direct support measures appear more conducive towards promoting research whereas tax support is principally associated with heightened levels of experimental development. Additionally, a lower level of corporate income taxation is also associated with more R&D investment, although with a lower incrementality ratio than the more targeted R&D support policy measures. One unit of foregone tax revenue corresponds to a 0.24 unit increase in business R&D expenditure."

In a global sense, Australia performs well on the gross incrementality ratio ('bang for the buck') for R&D tax incentives. The results based on OECD R&D survey data indicate a gross incrementality ratio for R&D tax incentives of around 1. This implies that, on average, one extra dollar of R&D tax support translates into one extra dollar of R&D. Noting that not all eligible entities actually benefit from tax incentives, the implied incrementality ratio of tax support may increase by about a third to 1.4. Prior to the recent amendments in October 2020, Australia itself had an implied incrementality ratio of 1.41, demonstrating that there is merit to continued support of R&D activities to create enduring benefits for the Australian economy.[13]

Tax is only one part and cannot be considered in isolation. As noted above, there is a need to consider the mix between direct funding support and tax incentives, the impact of tax policy on access to capital and other funding, and the motivations that influence commercialisation and the desire to retain IP in Australia.

Figure 3 demonstrates government support of R&D activities as a percentage of GDP, comparing the balance of tax incentives for R&D and R&D grants within particular economies. As can be observed, most countries appear to remain relatively stable in their mix; however, of the leading countries, Australia is out of kilter with many of the key economies.

There is a need for governments to support the whole innovation process (the inputs to the outputs), not just one component, balancing the challenges of finance with the encouragement to spend on extra R&D activities. There is also the need to support the appropriate level of risk-taking, not only merely to incentivise capital investment, but also to encourage taking the risk of loss associated with being innovative. This is particularly relevant in the context of the number of failed businesses as highlighted above.

Importance of infrastructure in innovation

It is well known that investing in infrastructure brings with it both social and economic benefits. It not only helps connect towns and cities and supports a growing population, but it also assists industrial growth, boosts competitiveness and improves overall societal wellbeing. Investing in the right infrastructure stimulates the productivity of the economy in both the short and long term.[14] Poor infrastructure, or a lack of investment in infrastructure, is therefore an inhibitor to economic growth, productivity and innovation.

In Australia, there has been unprecedented levels of expenditure on infrastructure projects.[15] However, in a global context, it is said that 75% of the global infrastructure projected to be in place by 2050 does not yet exist. Astoundingly, considering the levels of finance currently applied to the sector, significant investment gaps arise, which some estimate to be approximately US$15trn by 2040.[16]

This places Australia in a precarious position. Many of the infrastructure projects in Australia are targeted through deliberate spending by the government on specific projects. However, across infrastructure projects more broadly, the number of public–private partnerships (PPPs) has not seen a continued growth trend.[17] Some analysts are predicting that, even with the record spending on infrastructure, based on Australia's infrastructure needs out to 2035, Australia will have an investment shortfall equal to 1% of GDP. The Australian Government needs to consider the longer-term outlook, particularly in light of whether the government will be able to sustain such high levels of direct infrastructure spending, to ensure that Australia remains competitive in attracting infrastructure investment, given projected global demand for finance, in order to meet our future needs.

The current system in Australia

To provide context, outlined below are some of the programs contained within Australia's tax laws which are targeted towards, or directly influence, investment in innovation.

Infrastructure support

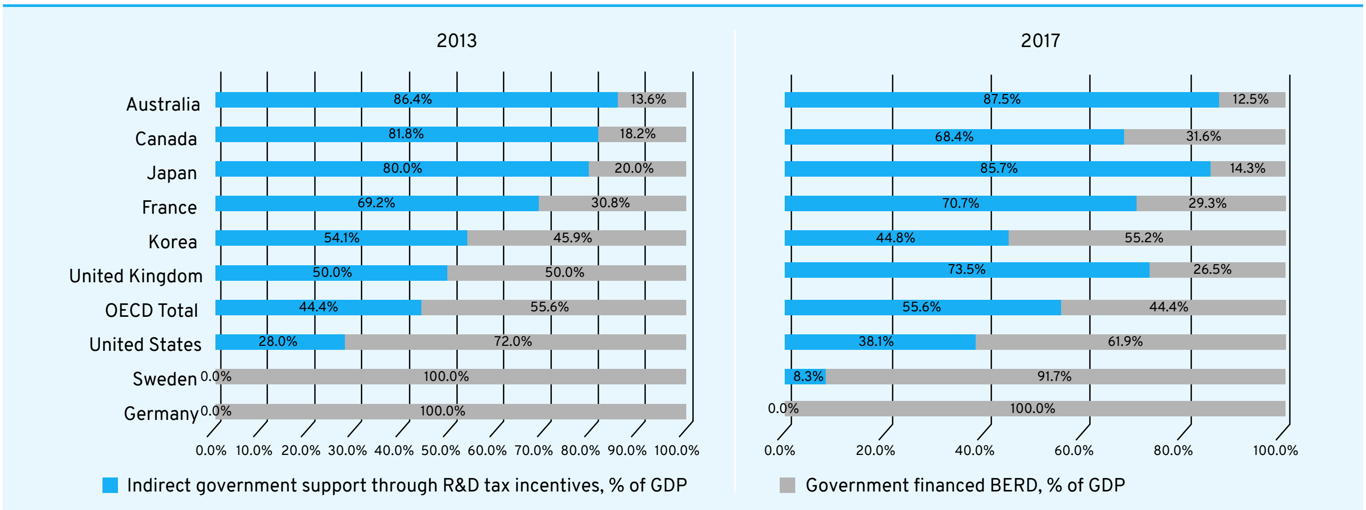
Structures for investment into infrastructure projects can vary significantly for a variety of reasons; from simple trust structures to more complex PPPs comprising a variety of entities to facilitate, among other things, investment by domestic, international and not-for-profit entities. The tax treatment will generally follow Australian tax principles relevant to the chosen investment vehicle and the tax profile and tax residency of the ultimate investor.

Managed investment trusts

One vehicle that is often utilised, either alone or in conjunction with other entities, is the managed investment trust (MIT).

Specific criteria, as set out in s 275-10 of the Income *Tax Assessment Act 1997* (Cth) (ITAA97), apply in determining whether a trust is eligible to be an MIT. Certain MITs in

Figure 3. Government support of R&D as a percentage of GDP



Source: OECD[18]

which members have clearly defined rights to the income and capital of the trust at all times may make an irrevocable choice to be treated as an attribution managed investment trust (AMIT). AMITs provide further concessions for the trust and somewhat ease certain specific administrative burdens.

While there are intricacies and complexities in the specific application of the tax laws to MITs and AMITs, generally speaking, the non-resident withholding tax (WHT) rates apply to certain payments made to non-resident investors, with the addition of the following:

- 15% for fund payments made to a resident of a country that has an exchange of information (EOI) agreement with Australia;
- 30% for fund payments made to a resident of a country that does not have an EOI with Australia;
- if the MIT is treated as having non-arm's length income, that income is subject to 30% tax payable by the trustee; and
- trustees of an MIT may make an irrevocable election to apply only the CGT provisions to the sale of eligible assets.

In relation to the 15% WHT for fund payments to residents of countries with which Australia has an EOI arrangement, this rate becomes 30% to the extent that the fund payment is attributable to non-concessional MIT income. An amount will be non-concessional MIT income if it is any of the following:

- MIT cross staple arrangement income;
- MIT trading trust income;
- MIT agricultural income; or
- MIT residential housing income.

The government has released a guidance note to provide an exception to the 30% MIT WHT where a government agency receives approval of an application they make under the economic infrastructure staples tax concession. Where approval is granted, the WHT rate is reduced to 15% to the extent that the income is rent from an investment in land attributed to an approved new economic infrastructure facility or an approved improvement to an economic infrastructure facility. The reduced rate applies only for 15 years.

Incentives for investment in innovation

Early-stage innovation companies

Where taxpayers, including both resident and non-resident taxpayers, invest in newly issued shares in a qualifying early-stage innovation company (ESIC), Div 360 ITAA97 provides eligible investors with:

- a non-refundable carry-forward tax offset equal to 20% of the amount paid for their eligible investments (capped at an annual affiliate-inclusive amount of $200,000 for sophisticated investors or $10,000 for all other investors); and
- the disregarding of capital gains and losses on qualifying shares that are continuously held for at least 12 months and less than 10 years.

To be classed as an ESIC, a company must not be a foreign company and it must have:

- been incorporated or registered in the Australian Business Register;
- total expenses of $1m or less in the prior income year (including any wholly owned subsidiaries);
- total assessable income of $200,000 or less in the prior income year (including any wholly owned subsidiaries);
- no equity instruments listed for quotation in an official list on any stock exchange (domestic or international); and
- passed the 100-point innovation test or the principles-based innovation test to ensure the company is truly focused on innovation.

The data in Table 1 indicates the extent to which this incentive is utilised.

It should be observed that, over the three years of data provided, there has been a significant and continued decrease in the access to this concession. Furthermore, and assuming all relevant investors were sophisticated investors, it should be noted that the maximum total tax benefit under this program in 2019 was $36m (or an average of $54m per year over the three years of data provided).

Venture capital

Limited partnerships are often utilised in commercial situations to provide flexibility around the nature of investments made into such partnerships while providing a level of legal protection akin to a company. Australia generally taxes limited partnerships as companies.

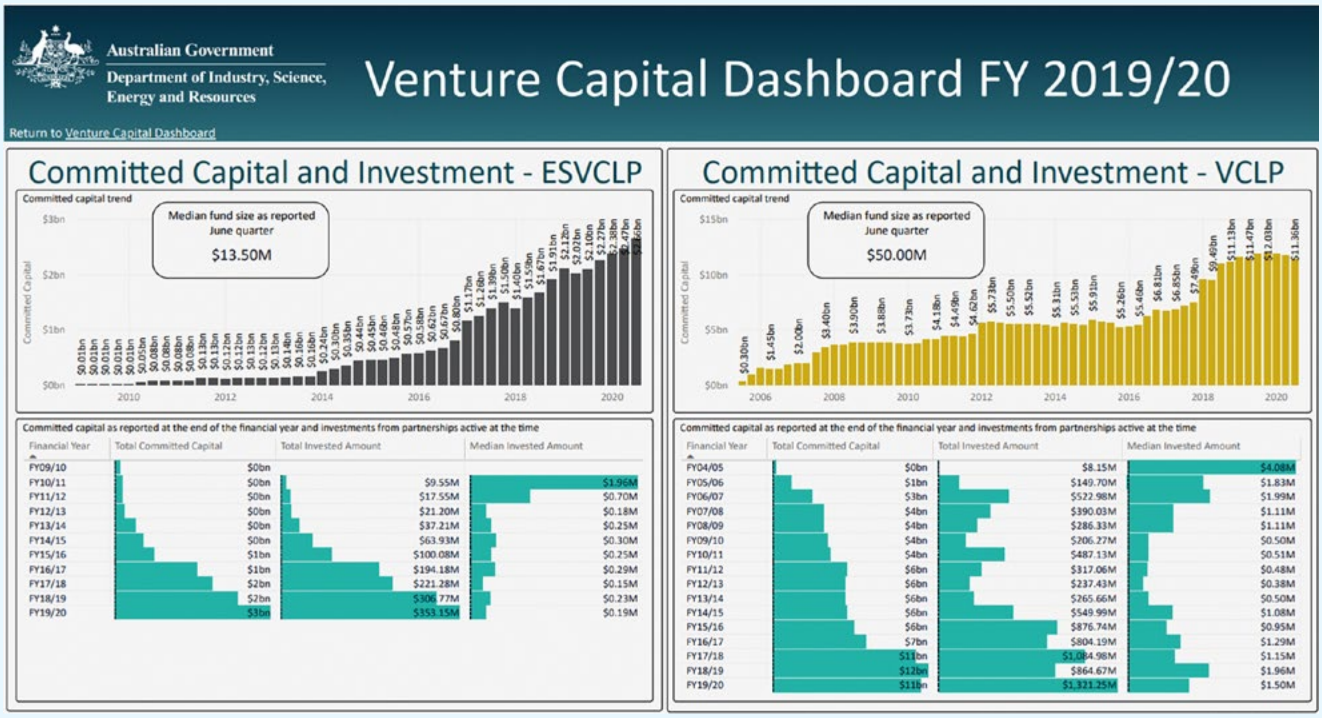
However, recognising the commercial benefit of limited partnerships and to encourage investment in innovation, the tax laws contain two core exclusions from the corporate tax treatment of limited partnerships, these include the venture capital limited partnership (VCLP) and the early stage venture capital limited partnership (ESVCLP).

VCLPs and ESVCLPs are jointly administered by the Department of Industry, Science, Energy and Resources (DISER), as well as the ATO. To be eligible

Table 1. ESIC data based on ESIC forms[19]

Year	No. of ESIC companies	No. of investors	Invested amount ($m)
2017	410	4,300	340
2018	350	3,750	290
2019	230	2,200	180

Figure 4. Venture capital dashboard FY 2019–20



for the underlying tax concessions, an eligible limited partnership must first register with DISER as either a VCLP or an ESVCLP. In addition to various conditions which are intended to maintain integrity in the system, the partnership deed must ensure that the partnership is in existence for between five and 15 years and have at least $10m committed capital for VCLPs and between $10m and $200m for ESVCLPs.[20]

Registered VCLPs can make venture capital investments (subject to certain criteria) in companies or unit trusts with total assets of not more than $250m. Registered ESVCLPs can make early stage venture capital investments (subject to certain criteria) in companies or unit trusts that are at the following stages of development:

- pre-seed;
- seed;
- startup; or
- early expansion.

The investments must be held for a minimum of 12 months.

With regard to the tax benefits, the VCLP and ESVCLP are flow-through vehicles, therefore they themselves are not taxed. Generally, eligible foreign investors in VCLPs are exempt from income tax on their share of profits (capital or revenue); however, Australian resident investors are taxed according to ordinary concepts.

Limited partner investors in an ESVCLP receive a non-refundable carry-forward tax offset of up to 10% of the value of their eligible contributions. In contrast to VCLPs, investors in ESVCLPs are also exempt from tax on their share of:

- income and gains from eligible early stage venture capital investments; and
- income and gains from disposing of eligible venture capital investments (this may be in part where the investee's value exceeds $250m).

General partners of both VCLPs and ESVCLPs can claim their carried interest in the entity on capital account, rather than revenue account.

The dashboard in Figure 4, extracted from DISER's most recent reporting, demonstrates the growth in popularity of both VCLPs and ESVCLPs.[21]

In addition, it is interesting to note the significant variance between the total commit ted capital and the total amount actually invested between the two different entity types.

Employee share schemes

For completeness, we note that the employee share scheme provisions also provide support and assistance to companies, specifically startup entities, investing in innovation. These concessions facilitate the provision of share capital in lieu of other forms of remuneration to help fund the human capital investment rather than drawing on the scarce cash resources often associated with pre-commercialised innovation.

Research and development tax incentive

The R&DTI is contained within Div 355 ITAA97, with the object set out in s 355-5:

> **"Object**
>
> (1) The object of this Division is to encourage industry to conduct research and development activities that

might otherwise not be conducted because of an uncertain return from the activities, in cases where the knowledge gained is likely to benefit the wider Australian economy.

(2) This object is to be achieved by providing a tax incentive for industry to conduct, in a scientific way, experimental activities for the purpose of generating new knowledge or information in either a general or applied form (including new knowledge in the form of new or improved materials, products, devices, processes or services)."

Registered companies with an annual aggregated turnover of less than $20m receive a refundable tax offset (refundable where they are otherwise in a tax loss position). All other registered companies receive a non-refundable tax offset, reducing the tax they would otherwise be required to pay.

Following recently enacted amendments, from 1 July 2021, the tax offset rate applicable to registered companies with annual aggregated turnover of less than $20m will be set at 18.5 percentage points above the corporate tax rate (based on present laws, this will result in a 43.5% refundable tax offset). All other registered companies will have a two-tiered R&D intensity system, providing a premium intensity benefit of 8.5 percentage points above the corporate tax rate for R&D intensities up to 2%, and 16.5 percentage points above the corporate tax rate for R&D intensities above 2%. The R&D intensity is calculated as R&D spend compared to total business expense.

In Australia, the R&DTI is co-administered. AusIndustry is responsible for the registration process, determining whether an activity is eligible R&D and providing advance and overseas finding. The ATO is responsible for the claims process, ensuring that eligible participants claim only those expenses incurred on the registered (core and supporting) R&D activities and that they are appropriately substantiated.[22]

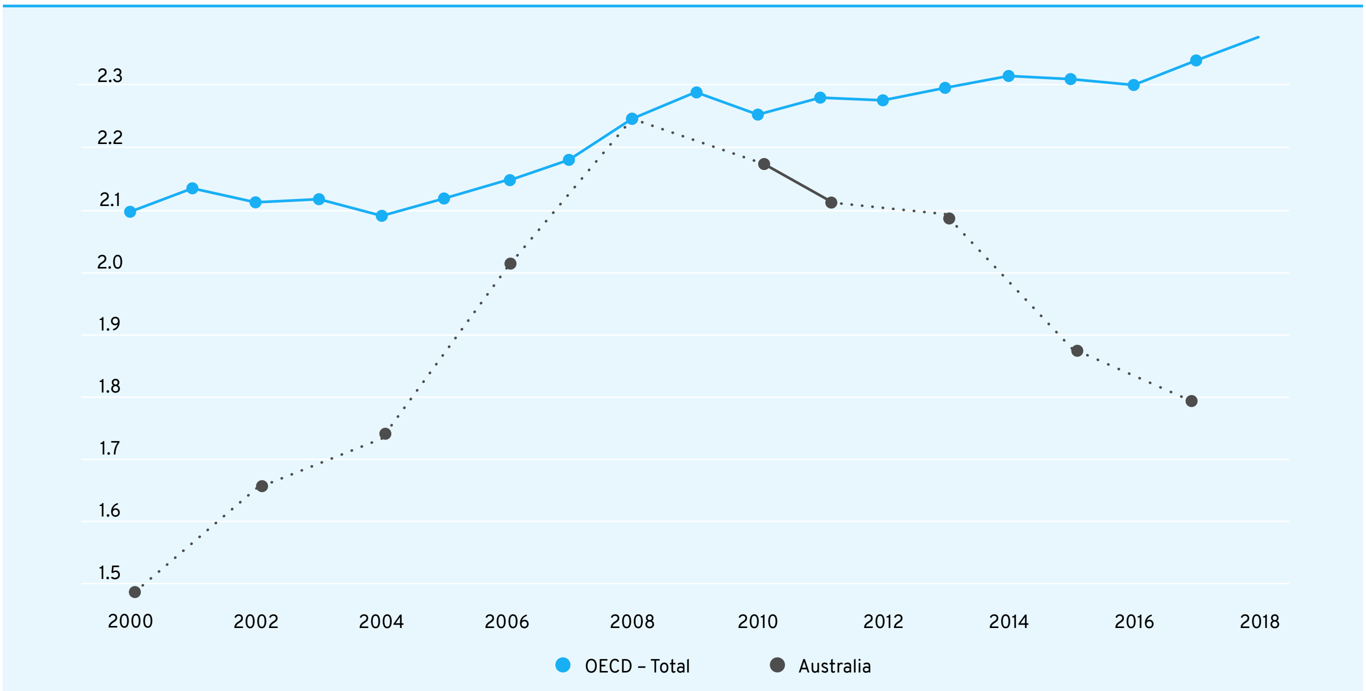
Participants must register their eligible R&D activities with AusIndustry, and they have up until the end of the 10th month following year-end to do so. However, participants must have registered their activities before they are eligible to make a claim through their income tax return.

The registration and claim processes are fully self-assessed. Participants are required to incur, and fund, the relevant expenditure for an income year, registering and claiming only after the end of a relevant year of income. Both agencies then undertake their reviews post-lodgment, in accordance with the review periods prescribed by the tax laws, to ensure that claims are appropriately made and substantiated.

It should be noted that, based on data released under freedom of information, the ATO advises that, in the three years to 2017–18, it only conducted compliance activities on an average of 1.4% of all companies claiming the R&DTI.[23] This same period coincided with a reduction of $1.4b in total offsets claimed to a total of $5.4b and, according to the *Commissioner of Taxation annual report 2019–20*, this has reduced by a further $1b to a total of $4.4b for 2019–20 across an approximate 13% reduction in the number of claims processed across the period 2017–18 to 2019–20.[24]

The above reduction in tax offsets is indicative of a continued reduction in R&D spend within the private sector. When compared to our OECD counterparts, this trend is further exacerbated. From the graph in Figure 5, it can be observed that the domestic spend on R&D as a percentage of GDP in Australia is declining and starting

Figure 5. Gross domestic spending on R&D – total, % of GDP, 2000–2018



Source: OECD[25]

to lose pace with other OCED countries. This trend is in stark contrast to the earlier observation of the OECD's analysis of Australia's incrementality ratio and becomes indicative of the additional deterrent, being the cost of compliance associated with Australia's dual administration and self-assessment regime.

Issues in the system

In light of the above context, it is relevant to consider the key issues and obstacles with respect to the support of innovation within the current system in Australia. A number of the most easily identifiable issues in the current tax system are highlighted below, and it is noted that a more comprehensive and independent review will assist in ensuring that all issues are otherwise identified.

Access to finance

As noted earlier in the *Case for Change* paper, Australia faces increasing competitiveness in attracting global finance for infrastructure projects. As the global infrastructure gap and competition increase, available capital will naturally flow to those jurisdictions presenting the greatest opportunity for the highest after-tax commercial return. Australia's tax system limits the attractiveness of Australia's future capital investment. The high corporate tax rate already acts as a disincentive for foreign investors; however, the lack of support for infrastructure investment compounded by the overly complex administrative requirements with varied tax outcomes places Australia further behind.

This same issue also arises for other innovation entities, including, but not limited to, startup entities. Innovation entities are faced with inherent difficulties in raising funds for their ventures which are exacerbated by the underlying development and commercialisation risks. As noted above, this leads to significant costs of finance and the difficulty in attracting investors. The evidence strongly suggests that the current incentives within the tax system do not go far enough to support the necessary risk-taking by investors to encourage sufficient investment in innovation.

The funding conundrum is further complicated by Australia's mix of direct government support and support provided by way of tax incentive. As noted above, Australia remains significantly out of alignment with the OECD in this regard. As a consequence of this, confusion arises in the R&D market, with companies often perceiving the tax offset as a grant;[26] this is exceptionally dangerous in the self-assessment system as the risk of audit and subsequent repayment exists for some years after the refundable tax offset is paid to the innovation entity. Such audits and any consequential audit adjustments may put an innovation entity out of business, particularly those with no, or minimal, income streams.

This shortcoming has also given rise to new funding products, including R&DTI finance. R&DTI finance is a new product which has emerged in the Australian market in recent years. The product provides entities with a loan, in advance of the incurring of any R&D expenditure for a particular year, based on the expected refund the entity will receive for that year if those R&D expenditures are in fact incurred. When the entity's tax return is lodged with the respective R&DTI claim, the loan is repaid from the resultant refundable tax offset. These products contain significant risk, particularly given the self-assessment nature of the R&DTI.[27] The loans are an attempt to convert what is a tax offset into an upfront advance of funds so as to finance R&D activity to otherwise substitute the shortfall of direct government funding of R&D in Australia.

The shortcomings of the tax system resulting in the development of such products is particularly concerning for the integrity of the system. Such products can influence the incidence of fraud within the system due to the requirement to repay the underlying funding. The products also increase the liquidity risk of the innovation entity as any repayment of overclaimed R&DTI will not only have been subject to the cost of finance, but also to interest and penalties from the ATO, which could further compromise the survival prospects for the business in certain circumstances. The entity holding all the risk is the innovation entity, and this takes the risks of innovation to unacceptable levels for many potential innovators.

Infrastructure

Perceived abuses of the tax system in the infrastructure space led to the ATO releasing TA 2017/1, *Recharacterisation of income from trading businesses*, and a response in which the government introduced legislative measures to address non-concessional MIT income (referred to above). The taxpayer alert focuses on arrangements which recharacterise operating income into more favourably taxed passive income. While not the sole arrangement being addressed, stapled structures are a predominant focus of the alert.

Compounded by these changes, it is perceived that the Australian tax system generally lacks support for infrastructure investment as the access to the limited concessional tax treatments are unnecessarily restrictive. The restrictions inhibit private sector infrastructure projects and therefore further restrict new innovation and Australia's overall progress. The limited concessions which are available contain significant complexities in their administration, and the tax outcomes are mixed and varied. The system's current design therefore further deters potential investors.

Research and development

Low level of collaboration compared to OECD

In Australia, the university sector undertakes a significant amount of research and, for many, these activities further inspire innovation. However, within the present tax laws, there is no inducement for business to collaborate with universities to ensure effective knowledge transfer.

In the *Global innovation index 2016*,[28] Australia ranked 20th in the world for university–industry research collaboration. In 2020, Australia had dropped to 39th.[29]

The following comments are observed in the *Performance review of the Australian innovation, science and research system* of 2016:[30]

> "R&D tax incentive: the biggest lever the government has does not currently incentivise collaboration with research organisations. This is in contrast to the R&D tax initiatives in some other countries, such as France, which provide a collaboration taxation offset premium as well as a taxation offset premium for employment of researchers. The recent review of the R&D tax incentive recommended the introduction of a collaboration premium under the R&D tax incentive to provide additional support for collaboration activity."

It then continued:[31]

> "Australian universities are producing some of the best research in the world (see 'Skills'). However, only 4.8 per cent of innovation-active businesses in Australia collaborate with universities or higher education institutions on innovation. Further, between 2003 and 2012, only 9.8 per cent of Australian patents had international co-inventors. In 2010–12, Australia ranked last out of 26 OECD countries on the proportion of both SMEs and large businesses collaborating with universities or other non-commercial research institutions on innovation."

Given the continued lack of incentivisation of collaboration, Australia continues to fall behind in its global positioning and securing its economic future, failing to properly capitalise on its world-leading innovation.

Excessive administration costs

Considering the minimum spend to claim R&DTI is $20,000, from 1 July 2021, a small business entity spending that amount and being eligible to a refundable tax offset of 43.5% would receive an amount of $8,700 (assuming it had no other tax payable). This amount can be fairly represented as:

- $5,000 as being a timing benefit (i.e. the conversion of a loss to a cash refund). The loss would have otherwise been a carried-forward tax loss able to offset future assessable income, the value of which being debatable depending on the risks associated with the project; and
- $3,700 as an effective permanent difference.

The costs associated with the significant processes required to keep the necessary records, prepare the relevant plans and engage with the authorities leave many businesses questioning the level R&D spend required to justify the claiming of the incentive.

This issue is further exacerbated by the lack of certainty in the process, given the entire process is self-assessment. That is, while an entity may be registered, that registration may be called into question by AusIndustry within the prescribed periods of review. Similarly, within the relevant periods of review, any claims made under that registration may be called into question by the ATO as to whether they fairly qualify as 'R&D expenditure'. This uncertainty can exist for many years after the incurring of the original expenditure.

By way of example, in an article authored by Hugh Paynter of Herbert Smith Freehills,[32] a possible dispute resolution timeline (see Figure 6) was set out for the decision in *Moreton Resources*.[33] Interestingly, the Full Federal Court decision was handed down some 51 months (four years, three months) after the last month in which Moreton Resources Limited could have applied for R&D registration for the relevant year; or 73 months (just over six years) after the earliest time the entity may have been eligible to have incurred eligible expenditure.

These costs and the inherent uncertainty act as a significant deterrent to businesses considering whether to invest in R&D.[34]

Current administration of definitions does not capture all innovations

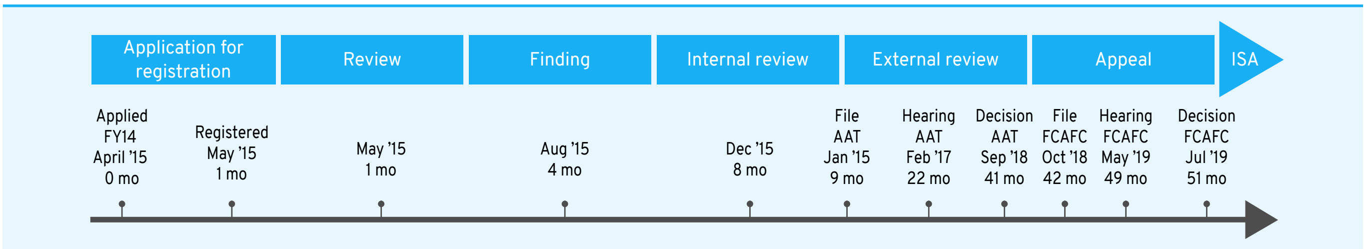
Software represents a significant portion of what we do in Australia; however, it has been long reported that software businesses struggle to gain access to the R&DTI.[35] Where industries critical to the enhancement of new technologies and innovation cannot themselves gain access to the R&DTI that is otherwise intended to support innovation, it is not just the industry that suffers; a restriction is placed on the growth potential of the entire Australian economy.

Longer-term economic investment

No support for commercialisation

The support for innovation entities within our tax system effectively ends once a new product or process is developed. Our system does not contain additional incentives to commercialise or to retain the resultant intellectual property (IP) in Australia. This is exacerbated by the lack of competitiveness of Australia's tax system in the international sense.

Figure 6. Dispute resolution timeline



Source: H Paynter[36]

In 2018, the ABS released data outlining the barriers to innovation for the 2016–17 financial year.[37] For innovation-active businesses, these are summarised in Table 2.

It can be observed that access to capital and costs of development or implementation are the main barriers to innovation.

With no further incentives to facilitate capital investment to improve Australian businesses' ability to commercialise in a market already perceived as less attractive, Australian businesses are hamstrung by obstacles on their pathway to take products to market.

Ongoing offshoring of intellectual property

As noted in the preceding sections, innovation businesses within Australia face continued challenges from inception through to commercialisation. Such difficulties include the availability and competitiveness of required capital for the various stages of the business life cycle, the size of the Australian market in comparison to international markets, and the general competitiveness of Australia's tax system in extracting the best return in a constrained market for the years of effort preceding commercialisation. These factors either directly or indirectly influence the decisions of innovation companies as they move towards commercialisation.

As a consequence of the above challenges, innovation companies may decide that foreign markets could provide more attractive propositions than retaining any developed IP in Australia. This not only has consequences for the retention of skills, knowledge and assets within Australia on which Australia could otherwise continue to build, it also inhibits the growth of Australia's potential future tax revenue streams which would have resulted from the utilisation and exploitation of such assets.

The underlying behaviour reflecting attempts to access international markets, and the attempts by the ATO to utilise administration to deter such behaviour, can be observed from their own publications. Below are extracts from the ATO's *What attracts our attention* publication:

> "**Intangible assets**[38]
>
> We review international arrangements that incorrectly characterise either intangible assets, or activities or conditions connected with intangible assets.
>
> … We are also concerned with migration of intangible assets. Migration refers to any transaction(s) that allows an offshore party to access, hold, use, transfer, or obtain benefits in connection with, Australian intangible assets or associated rights.
>
> …
>
> In particular, we are concerned that: …
>
> - the analysis or methodology used to determine the arm's length conditions or profits connected with these arrangements may result in parties obtaining a transfer pricing benefit for the purposes of Division 815 of the ITAA 1997
> - the Australian entity disposes of their intangible assets to the offshore related party for low consideration on non-arm's length terms, thereby minimising its CGT liability. The Australian entity may have also inappropriately utilised other CGT concessions, such as the rollover in subdivision 126-B ITAA 1997.
> - such arrangements may be entered into or carried out for the dominant or principal purpose of obtaining a tax benefit. This may attract the application of Part IVA of the ITAA 1936 or the diverted profits tax or both
> - intellectual property arrangements involving inadequate reward for:
>   - value contributed by the Australian entity or
>   - non-arm's length migration of rights in property created by the Australian entity.
>
> **Transfer pricing – related party dealings**[39]
>
> Situations that attract our attention include: …
>
> - business restructures that shift Australian assets or operations offshore without arm's length compensation or appropriate recognition for their inherent underlying commercial value."

The ATO is simply administering the current laws and applying them in a manner consistent with protecting Australia's revenue. The drafting of the current laws results in this unnecessary usage of the 'stick' approach, and our country would be better served by laws which promote the retention of IP, thereby reducing the incidence of tax avoidance behaviours and the need to apply scare compliance resources to deter such activities.

Table 2. Barriers to innovation, 2016–17

Lack of access to additional funds	30.7%
Cost of development or introduction/implementation	20.1%
Lack of skilled persons	24.3%
Lack of access to knowledge or technology to enable development or introduction/implementation	6.5%
Government regulations and compliance	11.2%
Adherence to standards	3.9%
Uncertain demands for new goods or services	16.6%

Options

Having outlined the current environment and the issues contained within Australia's tax system, we set out below a number of the opportunities available to the government to improve the investment and retention of innovation and IP in Australia.

Infrastructure

The primary focus for the government should be to ensure that Australia's tax system remains competitive to attract and encourage investment in infrastructure as the global infrastructure gap continues to grow. Australia should focus on the competitiveness of the corporate tax rate and ensure incentives exist within our system to promote private infrastructure development which will ultimately assist the Australian economy.

In doing this, some of the immediate focus areas should include the following:

- reviewing the present thin capitalisation provisions to determine their appropriateness for attracting investment in Australian infrastructure;
- creating a level playing field for our Australian superannuation funds to encourage them to utilise their available capital to invest in infrastructure. This may include providing such entities access to the concessional tax rates available to foreign investors; and
- providing incentives and concessions to drive preferred infrastructure activities, including the investment in 'green' infrastructure, such as solar farms, wind farms etc.

Other areas in which the government should undertake a review include the loss carry-forward rules, the public offer debt WHT exemptions, the taxation of public unit trusts that hold infrastructure assets to enable the retention of flow-through treatment, and the targeted relaxation of the rules for MITs. Each of these provisions act as a constraint on infrastructure investment and development.

Undertaking the above will assist in making Australia an attractive environment for private investment in infrastructure. This will assist in easing the current and significant public investment in infrastructure and facilitate the growth of PPP activities in Australia.

The government should also consider reforming the tax system to create further longer-term sustainability of revenue collection. Consideration should be given to whether a shift can be made away from traditional taxes to additional user-pay or congestion taxes for the utilisation and consumption of infrastructure assets and services. New technologies have become available, including GPS technologies, which may be able to assist with the effective imposition of such user charges.

Further consideration should continue to be given to broadening the tax base to ensure that Australia can continue to work towards environmental sustainability targets, rewarding those who exceed targets and taxing those who do not. Such taxes can be accompanied by incentives to drive further innovation to assist Australia to be more sustainable longer term. Due consideration should also be given to the use of direct grants or other non-tax support to keep the tax system free from the complexity arising from differential tax treatment.

Support capital investment

Venture capital

The current underutilisation of ESIC and the excess uninvested committed capital within VCLPs and ESVCLPs indicate that the concessions are poorly targeted and that innovation risks are insufficiently supported.

There is an opportunity to review the scope and benefit otherwise provided under the existing ESIC provisions with the prospect of replacing the incentive with a broader, more beneficial incentive; or complimenting the program with other, more targeted, incentives to attract and support investment in innovation entities. Furthermore, there is an opportunity to remove the discrimination towards Australian resident investors of VCLPs to ensure that they are afforded the same concessions as non-resident investors.

Additionally, the support for risks within innovation entities themselves should be considered to encourage the investment of the committed capital of VCLPs and ESVCLPs into these vehicles. One option may be to consider an alternative test to the similar business test for losses[40] of innovation companies which may have retained the same management team yet raised additional capital (hence failing the continuity of ownership test) to invest into a new innovation activity in a new industry following failure in another.

In addition, this sector would benefit significantly, in terms of improving access to capital and being able to compete at an international level, through the elimination of inefficient taxes and reducing the reliance on corporate and personal tax revenue.

Research and development

The government has a number of opportunities before it which would assist with the appropriate targeting and utilisation of tax concessions to encourage and support R&D activities. The immediate priority of the government should be to resolve the inherent uncertainties within the system predominantly arising from self-assessment.

The government should seek to introduce a grant system under which innovation entities could make applications for funding. Adopting a balance of support between grants and the R&DTI consistent with the OECD average would have a number of benefits:

- greater certainty can be provided upfront to innovation entities without the adverse consequences of subsequent repayment;
- the administration of the R&DTI could be separated such that AusIndustry could administer the grants program and the ATO could administer the R&DTI, independent of each other; and
- innovation entities would obtain a greater level of certainty regarding the level of funding they could utilise

for R&D activities without taking on high-risk R&DTI funding.

Following this, the government should revisit the level of support provided through the R&DTI. There are a number of recommendations contained within the *Review of the R&D tax incentive* report (2016)[41] which could be reconsidered and introduced, including the following.

- **Recommendation 2** – collaborative R&D: to introduce a collaboration premium (e.g. up to 20%) for a non-refundable tax offset for collaboration with publicly funded research organisations. Additionally, to encourage strategic R&D partnerships and outsourcing arrangements (sharing risks and benefits and joint ownership of IP rights).
- **Recommendation 3** – introduce a cap (e.g. $2m) on the annual cash refund payable, with remaining offsets to be carried forward. This would have particular relevance where a grant is otherwise introduced.

In reviewing the R&DTI, we support the call by the Australian Small Business and Family Enterprise Ombudsman for greater certainty to be provided to entities conducting innovation on software.[42] The R&DTI should be appropriately updated to make it clear that software development is otherwise included within the current R&DTI or, alternatively, a new program otherwise established to appropriately target software innovation.

Further amendments to the R&DTI could include a shift away from the current level of premiums provided over the corporate tax rate, making adjustments to allow for an increase in depreciation deductions for R&D expenditure. These may ultimately include:

- a further accelerated depreciation, with an innovation premium for all assets held by an innovation entity;
- changes to the corporate tax base (e.g. making the broad instant asset write-off and full expensing of depreciating assets measures permanent features of our tax laws).

Irrespective of the ultimate approach chosen by government, it is hoped that the announced review[43] by the Board of Taxation of the dual administration model of the RDTI will be thorough and will result in improvements to the overall administration of the program, cut the excessive red tape and significant costs of compliance, and ensure that the greatest level of certainty can be provided to innovation entities upfront, in a sector where it is most needed.

Support of commercialisation and retention of intellectual property

Many countries within the OECD have some form of patent box or preferred income regime targeted to support innovation industries. Many of these have now been reviewed by the OECD and are considered to be non-harmful from a base erosion and profit shifting (BEPS) perspective.[44]

One step in the right direction to address the potential offshoring was the announcement in the federal government's 2021–22 Budget to provide for a 'patent box' regime at a reduced tax rate of 17%. While the details of operation are not clear, presumably to ensure competitiveness of such a regime, the experience of similar schemes in other jurisdictions, for example, the UK and Europe, will be followed to ensure its effectiveness.

Unfortunately, the proposal in the Budget suffers from two limitations. Firstly, it only applies to the medical and biotechnology sectors. While a welcome start, there are many other industries that could be supported through the extension of the regime more broadly.

Secondly, the new regime operates in relation to patents applied for and granted after 11 May 2021 and the benefit will only take effect from 1 July 2022. Reports from industry experts suggest that the real effectiveness of this will not be felt until 2026 because of the long lead time between applying for a patent and earning income from commercialisation (often 5–10 years in the medical and biotech sector).[45] Such impediments to the early operation and scope of the regime should be revisited.

The legal rights associated with IP are outside of the scope of the *Case for Change* paper; however, we recommend that the government consider and implement the Productivity Commission's 2016 recommendations.[46]

Options for reform

- Review the tax system's influence on investments into infrastructure and ensure that mechanisms are put in place now to secure Australia's competitiveness in attracting funds for infrastructure investment in the future.
- Conduct a review of the support provided to encourage and support investment in innovation entities and implement appropriate incentives which result in the continued and increased investment in innovation entities. This could be as an adjunct to the announced review into VCLP and ESVCLP incentives.[47]
- Consider and implement the Australian Investment Council recommendations summarised in the *Roadmap to recovery* and member survey.[48]
- Consider and implement recommendations from Innovation and Science Australia's *Australia 2030: prosperity through innovation.*
- Consider some of the reviews of the R&DTI conducted in recent years and reconsider and implement the various recommendations appropriate to improving the administration of, and access to, the concession. This should also give consideration to the current scope of definitions within the R&DTI to ensure that either the current program or a complimentary concession captures the software development necessary for Australia's growth and continued competitiveness.
- Implement an R&D grant and balance the mix between that grant and the R&DTI. This would provide the opportunity to implement an additional benefit of removing the unnecessary complexities and

excessive costs of administration associated with the co-administration of the current incentive.

- Implement an OECD BEPS-compliant patent box regime or other regime appropriately focused on the commercialisation and retention of IP in Australia.

Conclusion

Innovation is critical to our future. Appropriate support for innovation should come not just through direct tax incentives, but also through appropriate settings in the system as a whole. Australia is out of step with the rest of the world in the way it approaches support for innovation and this may, in part, have as much to do with all business tax settings as with particular programs. Accordingly, while there is much room for improvement in supporting innovation and, in particular, early-stage innovation companies, a more comprehensive overhaul of the tax system may remove impediments that currently hamper innovation companies and thus allow for well-targeted and effective incentives that have low administrative and compliance costs.

The Tax Institute

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Allocation of professional firm profits: part 1

by David Montani, CTA, National Tax Director, Nexia Australia

The Commissioner of Taxation issued PCG 2021/4 on 16 December 2021. The guideline is concerned with inappropriate tax outcomes arising from the allocation of profits from professional firms. It is essentially a targeting system, setting out a risk assessment framework by which the Commissioner will judge who within the applicable industries will likely be subject to further analysis and possibly audit, and who will not. Part 1 of this article starts with a brief background on the history of the tax technical matters underlying PCG 2021/4. It then covers the qualifying criteria that must be satisfied in order to rely on the guideline's risk assessment framework, and what happens when they are not satisfied. Part 2 will cover PCG 2021/4's risk assessment framework, the scoring system, and the transitional arrangements with suspended guidelines from 2015.

Introduction

The imposition of a tax on income has been a cornerstone of our tax system for over a century. Australia has a long-held policy of progressive income tax, that is, higher rates of tax on higher incomes. However, due to evolving business structures and practices, it has been necessary over time to implement various anti-avoidance and integrity measures to combat, among other things, inappropriate shifting of income from a person on a higher tax rate to a related person on a lower rate.

Those measures include the original general anti-avoidance rules in s 260 of the *Income Tax Assessment Act 1936* (Cth) (ITAA36), its replacement Pt IVA ITAA36, and the personal services income (PSI) rules in Pt 2-42 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97). In addition, the Commissioner of Taxation has issued a number of rulings and other pronouncements setting out his interpretive views of those laws and his approach to administering them.

The latest development is the Commissioner issuing PCG 2021/4 on 16 December 2021.

Two types of income

It is worth exploring some fundamental concepts that underpin the journey leading us to PCG 2021/4. Fundamentally, there are only two classes of income:

- income from personal exertion; and
- income from property.

In addition, the classes are mutually exclusive. That is, an item of income falls into either one class or the other. The reason is that s 6 ITAA36 defines income from personal exertion, and then defines income from property as income that is not from personal exertion. Income from personal exertion includes things like salary or wages and other receipts, including received in carrying on a business.

However, "income from personal services" is the more relevant concept, which is not the same as income from person exertion, although there would be much overlap. Income from personal services is a broader concept of income derived predominantly as a reward for a person's personal efforts, exercise of skills or the application of labour.[1]

The distinction from income derived from property is relevant nowadays mostly in relation to whether income can be split among taxpayers or retained in a company, or must be assessed to the individual whose personal efforts etc derived the income. This is based on the history of cases applying the current and former general anti-avoidance rules.

Income splitting, retain in a company

A practical overview of the world of income is illustrated in Diagram 1. Broadly, income from property can be split among different people (provided the legal structure so permits). Common examples include the trustee of a discretionary trust appointing trust income to various beneficiaries, and a company paying a dividend to one class of shareholders to the exclusion of others. In addition, income from property can be retained in a company, having borne only the company tax rate.[2]

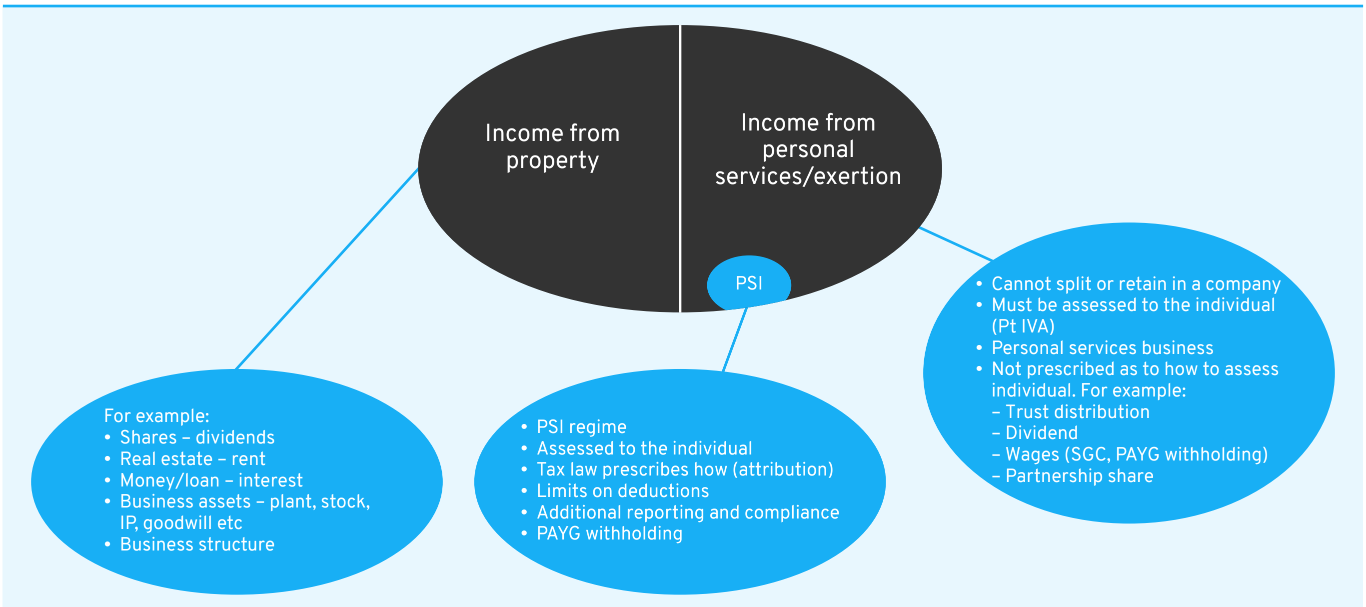
On the other hand, income from personal services cannot be split or retained like that described above. Rather, it must be assessed to the individual whose personal efforts gave rise to that income. There is no prescribed way for that to be achieved, as long as that is the outcome. This is illustrated in Examples 1 and 2.

Example 1. Sole practitioner through a trust

Mark is an accountant in public practice, who operates his business through a discretionary trust. He is the sole director of the trustee company, and there are two employees — Mark and a part-time receptionist. Mark does all of the professional work for his clients, and invoices them at the end of each month.

Mark takes the position that his business's income is derived from his personal efforts. Accordingly, it is income from his personal services. However, the

Diagram 1. Practical overview of income



Example 1 (cont)

business passes the results test in the PSI rules, and thus is a personal services business. Accordingly, the PSI rules do not apply.

As the business's profit is derived from Mark's personal services but is not subject to the PSI rules, it must find its way into Mark's tax return as income. Is does not matter how that happens, as long as it does (in a way permitted by the legal structure).

For the 2021-22 income year, Mark has the trust pay him a $10,000 salary, and it contributes $27,500 to superannuation on his behalf. In late June 2022, Mark resolves, as sole director of the trustee company, to appoint 100% of the trust's income to himself. When Mark completes the trust's 2021-22 financial statements and tax return some months later, the trust's net income turns out to be $280,000. Mark discloses the $10,000 salary and $280,000 of trust net income in his personal tax return.

The above process is repeated each year.

Example 2. Sole practitioner through a company

The circumstances are identical to example 1, except that Mark operates his business through a company, and he is the sole director. The company is wholly owned by a discretionary trust, and Mark is the sole director of the trustee company.

Based on the firm's financial statements to 31 May 2022, Mark predicts a full-year pre-tax profit of $270,000. In addition, the company paid $70,000 in PAYG instalments during the year. In late June 2022, as part of a genuine attempt to extract all of the company's after-tax profit for the year, Mark declares a fully franked dividend of $200,000, payable to the

Example 2 (cont)

shareholder trust. Mark also resolves, as sole director of the trustee company, to appoint 100% of the shareholder trust's 2021-22 income to himself. Mark discloses the salary and 100% of the trust net income in his personal 2021-22 tax return.

When Mark completes the company's 2021-22 financial statements and tax return some months later, the pre-tax profit turns out to be $280,000. Accordingly, there was about $10,000 of after-tax profit retained in the company at 30 June 2022.[3] On 30 November 2022, Mark declares a $10,000 fully franked dividend, clearing out that remaining retained profit that was in the company at 30 June 2022.[4]

The above process is repeated each year.

Referring again to Diagram 1, for income derived from property, the relevant property is usually apparent. For example, rent earned from real property, interest earned on money in a term deposit, and profit derived from business assets such as equipment and goodwill. It would usually be a given that dividends earned from holding shares in a public company is income from that property. However, this cannot be assumed where dividends are earned from holding shares in a private company. Additional examination is required to determine whether the private company's income is derived from any person's personal services, like in example 2.

PSI rules

The PSI rules in Pt 2-42 ITAA97 are somewhat of a subset within the personal services/exertion half of that practical overview of income. Where income is derived from a person's personal effort or skills (whether in their own name or through an entity), and none of the exempting tests are satisfied, the PSI rules apply to that income. The result is similar to examples 1 and 2, whereby the relevant individual is assessed on the captured income. However, there is no flexibility as to how that is to happen. Rather, a prescribed process of attribution applies that achieves that result, with withholding obligations, and there are also limitations on deductions claimable.

Business structure

The key matter of interest in this subject, and what leads to PCG 2021/4, is that of a "business structure". This term was not coined in legislation or case law, but rather was a creation of the Commissioner's in IT 2639. This ruling from 1991 consolidates the Commissioner's views expressed in a number of earlier rulings on determining whether particular income is derived from personal services. It applies to professional firms, distinguishing from other kinds of businesses such as retail or construction. The reason is that professional firms' output is essentially services provided by people. In contrast, the value of people's contributions in a retail or construction business manifests in providing property, not a direct service by those people.

The Commissioner acknowledges that a firm with substantial income-producing assets, or many employees (or both), is more likely to be generating income from the income-yielding structure of the business, rather than from anyone's personal services.[5] He specifically states that a firm with tens, or even hundreds, of practitioners, but without substantial equipment, would be considered to be generating income from a business structure.[6] In particular, IT 2639 sets out a number of factors in para 8 for determining whether income is derived from personal services. It then discusses a specific circumstance where income will *not* be regarded as derived from personal services, which is where it is derived from a "business structure". Such income derived from a business structure can be split or retained (as discussed above). However, the Commissioner also states that a taxpayer can derive income from personal services *and* other income within the same business, and they should be apportioned and treated independently.[7]

Whether a firm's income could be regarded as being derived from a business structure is based on one criterion – the firm has at least as many non-principal practitioners as it does principal practitioners.[8] In other words, the ratio of professional staff to partners is at least 1:1. Where a firm has fewer non-principal practitioners than principal practitioners, it could still be regarded as a business structure, but consideration must be given to those factors set out in para 8 of IT 2639.

Not a "bright-line" test

The Commissioner states that the above non-principal/principal ratio criterion is merely a "guideline", to be applied as a "rule of thumb". However, for over 30 years, practitioners have effectively treated it as a "bright-line" test. That is, if a firm satisfies the ratio, the entirety of the firm's profits have been regarded as being derived from a business structure, full stop. However, the ratio criterion was never a bright-line test.

The very nature of a guideline to be applied as a rule of thumb clearly leaves it open for a firm satisfying that ratio to still not be regarded as a business structure. In such a case, the firm's income would be regarded as being derived from one or more person's personal services, and thus cannot be split, or retained in a company.

The Commissioner now continues on from his above comments in IT 2639 on multiple sources of income within the same business. In PCG 2021/4, he states that the profit or income of a professional firm may comprise different components. Accordingly, even where a business structure does exist, some of a firm's profit may still reflect income from one or more individual's personal services. It follows that redirecting income away from those individuals might still offend Pt IVA ITAA36.[9]

Outdated oversimplification?

The non-principal/principal ratio guideline has perhaps become an outdated oversimplification for determining whether some (or none) of a firm's profit ought to be regarded as being derived from personal services. The Commissioner has decided on now taking a more interventionist approach, culminating in PCG 2021/4.

Practical compliance guidelines

Practical compliance guidelines are a relatively recent addition to the various types of pronouncements issued by the Commissioner. PCG 2016/1 sets out their purpose, which is to provide administrative guidance on assessed levels of tax risk.[10] This may enable taxpayers to position themselves within a range of behaviours, activities or transaction structures that are regarded as low risk and unlikely to require scrutiny.

> "We could view Gateway 1 as 'doing the right things', and Gateway 2 as 'not doing the wrong things'."

The intent for this broader guidance is also to enable the ATO to communicate how it will "sensibly apply its audit resources" where tax laws are uncertain. As practical compliance guidelines are not public rulings, they are not binding on the Commissioner. However, practical compliance guidelines are not prepared for the primary purpose of expressing a view on the way a tax law provision applies in any case. Of course, that still leaves it open for the Commissioner to do so in passing, and in PCG 2021/4, the Commissioner seems to be doing just that in relation to the application of Pt IVA ITAA36 to professional firms.

PCG 2021/4

The primary purpose of PCG 2021/4 is to set out who is more likely to be subject to a review or an audit on the matter of inappropriate alienation of income, and who will likely be left alone. The guideline applies from 1 July 2022, and is concerned with professional firms and the equity and non-equity principals behind them. It sets out the ATO's compliance approach to the allocation of profits from professional firms, and is concerned with the risk that an insufficient amount of firm profit is taxed to the principal professionals. It should be noted that PCG 2021/4 is not a safe harbour of any kind. Rather, it is essentially a targeting system for the application of ATO compliance resources. This is achieved by applying a risk assessment framework, with a scoring system that places practitioners in a green, amber or red zone.

The tax arrangements for those in the green zone will likely not be subject to review, while those in the amber or red zone will likely be subject to review, and possible escalation to audit. The risk assessment framework and zone scoring system are covered in part 2 of this article.

The draft guideline released earlier last year was controversial to put it mildly, and that certainly continues with the final version. However, the ATO will be applying it in its compliance approach. Accordingly, we must be prepared to assist affected clients, and as the accounting and tax profession is one of the affected industries, consider our own tax arrangements.

Professional firm

While the ATO recognises a variety of businesses where equity holders contribute to the business through their labour (eg retail and construction), PCG 2021/4 is interested only in professional firms.[11] A professional firm offers customised, knowledge-based services to clients in a variety of professions. These include, but are not limited to, accounting, architecture, engineering, financial services, law, medicine and management consulting.[12] Paragraph 33 of PCG 2021/4 expands somewhat on what constitutes a professional firm, and one can expect that this will extend to other fields.

Individual professional practitioner

PCG 2021/4 identifies a particular class of taxpayers labelled "individual professional practitioners" (IPPs). IPPs are essentially those abovementioned equity and non-equity principals who provide services to clients of the firm, and where the IPPs and/or associated entities have a legal or beneficial interest in the firm. IPPs also include such individuals who provide services to the firm itself, and so can include someone who is not in a client service role.[12] Where PCG 2021/4 applies, its risk assessment framework applies individually to IPPs, not their firm.[13]

PCG 2021/4 arises from the ATO's concerns that business structures of professional firms are producing an "artificially low" return of income to the IPPs, while associated entities benefit (or the IPPs ultimately benefit) and commercial reasons do not justify the arrangement.[14]

On applying the risk assessment framework, if an IPP's circumstances align with a low-risk rating (green zone), the ATO will generally not review the IPP's tax arrangements.[15] However, anything other than a low-risk rating (amber or red zones) will likely result in further analysis. Several matters in PCG 2021/4 remain unclear as to their application in practice. It is still early days, and some of what follows might require revising as matters are clarified in due course.

When an IPP can rely on PCG 2021/4

Qualifying to rely on PCG 2021/4, and what happens when an IPP does not qualify, is the focus of the remainder of part 1 of this article. For IPPs who do qualify, the risk assessment framework and zone scoring system are considered in part 2 of this article.

For an IPP to rely on PCG 2021/4 when self-assessing the risk of their tax arrangements being reviewed, six qualifying criteria must be satisfied. Where any criterion is not satisfied, an IPP of their own accord cannot rely on the guideline's risk assessment framework. In this case, the IPP can, and the Commissioner encourages them to, engage with the ATO to determine whether the application of PCG 2021/4 is appropriate in their circumstances.[16]

Qualifying criteria

IPPs can apply PCG 2021/4 to assess their green/amber/red risk rating only where the following criteria are satisfied:[17]

1. the IPP provides professional services to the firm's clients, or is actively involved in management, and the IPP and/or associated entities have a legal or beneficial interest in the firm (PCG 2021/4 is not relevant for "silent partners" or other passive equity holders who are not actively involved in the firm's operations);
2. the firm's income is not subject to the PSI rules;
3. the firm operates through a legally effective structure (eg a partnership, company, trust);
4. the IPP is an equity holder, directly or through an associated entity;
5. the arrangement[18] satisfies Gateway 1 (ie it is commercially driven); and
6. the firm and the IPP (note: specifically both) satisfy Gateway 2 (ie an absence of certain high-risk features).

If an IPP and/or a firm do not meet all of the above criteria, para 29 states that it is still possible to apply PCG 2021/4. However, those IPPs/firms will need to engage with the ATO to determine whether applying the guideline is appropriate. IPPs annually need to assess their eligibility to apply PCG 2021/4, and document support for their assessment.[19] The qualifying criteria are examined further below.

Interaction with business structure concept

PCG 2021/4 also specifies that it applies to an IPP only where they have received an amount of income from a firm that generates its income from a business structure (and is not subject to the PSI regime).[20] This might seem confusing where one has (incorrectly) treated the business structure concept in IT 2639 as a bright-line test. Based on that (incorrect) approach, meeting the non-principal/principal professional staff ratio would cause one to (incorrectly) automatically regard the entirety of a firm's profit as being derived from a business structure, and not anyone's personal services.

Following on from the above (flawed) conclusion is that the entirety of the firm's profit can be split or retained — and thus PCG 2021/4 ought to have no relevance in the first place. Hence, the possible confusion over the above statement in the guideline that it applies only where there is a business structure.

However, as noted earlier, the above is not how the business structure concept has operated. The non-principal/principal ratio for determining whether a business structure exists in the first place is not a bright-line test, but rather a mere rule-of-thumb guideline. Accordingly, meeting the ratio does not automatically mean that a business structure exists. Further, where it *can* be said that a business structure exists, that does not automatically mean that none of a firm's profit is derived from anyone's personal services, and thus can entirely be split or retained. Paragraph 7 in IT 2639 merely states that that is "more likely" the case, not absolutely the case.

In summary, meeting the non-principal/principal ratio does not automatically mean that a business structure exists. Further, even where it can be said that one does exist, the firm's profit to some extent might still be regarded as being derived from one or more individual's personal services. That is why, even with a business structure in place, the ATO has concerns that the amount of professional firm profits attributed to IPPs might not reflect that element of personal services. Hence, PCG 2021/4 applies as a means of determining whom the ATO will investigate further to determine whether *any* of the firm's profit is regarded as attributable to an IPP's personal services, and if that has been appropriately allocated to the IPP.

Qualifying criteria examined

The first three qualifying criteria listed above may well be straightforward for the vast majority of firms. However, criteria 4, 5 and 6 require some consideration.

Criterion 4: the IPP is an equity holder

PCG 2021/4 does not apply to all IPPs, just those who are equity holders. The guideline does not explain what constitutes an equity holder. At first glance, it might seem that there is a duplication with the first criterion. That requires the IPP and/or associated entity to have a "legal or beneficial interest" in the firm, whereas this 4th criterion requires the IPP/associated entity to be an "equity holder".

Although PCG 2021/4 does not define these terms, it would seem that "legal or beneficial interest" has a wider meaning than "equity holder". Perhaps it could be said that all equity holders have a legal or beneficial interest, but not all with a legal or beneficial interest are equity holders.

The author takes the view that "equity holder" is intended to include holding a stake in the underlying capital value of the firm, with that capital value at risk, and the profit return subject to the economic performance of the business.

Paragraphs 57 and 58 of PCG 2021/4 make matter-of-fact references to non-equity holders, such as typical salaried partners, or fixed profit draw arrangements, where no capital is contributed and there are no voting rights. This is a consistent opposite with the inferred meaning above of an equity holder at the other end of the spectrum. However, in practice, there are many types of hybrid arrangements falling between these two ends of the spectrum. IPPs' interests in firms could move along the spectrum from these extremes and still be regarded as an equity holder or a non-equity holder. However, it is not known where the Commissioner draws the line. Accordingly, uncertainty remains as to whether IPPs with hybrid equity arrangements would or would not be regarded as an equity holder.

Criterion 5: Gateway 1 – commercial rationale

Paragraphs 39 to 46 of PCG 2021/4 set out the requirements for meeting Gateway 1. Broadly, there must be a genuine commercial basis for the IPP's arrangements and the way profits are distributed, and the arrangements should reflect the commercial needs of the business.

Paragraph 45 lists a number of indicators of a lack of sound commercial rationale, such as unnecessary complexity, a mismatch between tax and commercial results, and non-commercial or non-arm's length arrangements. For many practitioners, it may be straightforward to tick off an absence of these kinds of features.

Paragraph 46 requires there to be a genuine commercial basis for the way in which profits are distributed between the IPP and related parties, and lists a number of matters for consideration. The first one is particularly noteworthy as it requires consideration of whether "the IPP actually receives an amount of the profits or income which reflects a reward for their personal efforts or skill and reflects an appropriate return for the services they provide". It is noteworthy not only for its unhelpful level of imprecision for a qualifying criterion, but also as is seems to effectively duplicate the role played by risk assessment factor 3 (to be covered in part 2 of this article). Other matters for consideration relate to income distributions to associated entities, but the IPP has the predominant use and enjoyment of the money. Such situations could also fall foul of the anti-avoidance rules in s 100A ITAA36, but that is beyond the scope of this article.

Criterion 6: Gateway 2 – high-risk features

Gateway 2 is satisfied where *both* an IPP's and the firm's arrangements have an absence of high-risk features. We could view Gateway 1 as "doing the right things", and Gateway 2 as "not doing the wrong things". There is not an exhaustive list of high-risk features — again, unhelpful for a qualifying criterion. However, they include arrangements covered by a taxpayer alert, and are also considered to "potentially" include the following:[21]

- financing arrangements relating to non-arm's length transactions;
- exploitation of the difference between accounting standards and tax law;
- arrangements where a partner assigns a portion of a partnership interest that is materially different in principle from *Everett*[22] and *Galland*;[23] and
- multiple classes of shares and units held by non-equity holders.

Recall above that this qualifying criterion specifies that *both* the IPP and their firm must pass Gateway 2. Thus, if a firm fails Gateway 2, none of its IPPs can apply PCG 2021/4. This has the potential to disqualify a large number of IPPs, even where the determination of their profit share and their tax arrangements are uncontroversial, and the existence of a high-risk feature in their firm is beyond their control (or perhaps even their knowledge). Excluding large numbers of IPPs in these circumstances, who are then encouraged to engage with the ATO to resolve whether they can still apply PCG 2021/4 (as per para 29), severely diminishes the self-assessment effectiveness of the guideline and the allocation of compliance resources.

In any case, the existence of any of the above examples is not automatically a high-risk feature, merely potentially. Judgment will need to be exercised, which again is unfortunate for a qualifying criterion. PCG 2021/4 goes on to discuss the above in more detail in paras 50 to 59. However, it is paras 58 and 59, about multiple classes of shares and units held by non-equity holders, that warrant further discussion.

Multiple classes of shares or units. It is inherent in the wording in para 47 that this particular potential high-risk feature is relevant only for companies and unit trusts, and not for partnerships. However, there is an inconsistency between the wording used above in para 47 to name this potential high-risk feature, and the further discussion of it in paras 58 and 59.

In para 47, the question of whether there are multiple classes of shares or units is asked only of non-equity holders. On that basis, if all non-equity holders in a firm held shares/units of a single class, this would not amount to the existence of a high-risk feature. However, paras 58 and 59 refer to the issue of multiple classes of shares or units in general, differing from para 47's exclusive reference to non-equity holders. Presumably, the wider parameters in paras 58 and 59 reflect the Commissioner's true intentions. That is, the existence of multiple classes of shares or units across equity and non-equity holders (rather than merely non-equity holders) is a potential high-risk feature. Of course, the mere existence of equity and non-equity holders necessarily means that there must be different classes of share or units on issue in the first place.

Although para 47 names multiple classes of share/units merely as "potentially" a high-risk feature, para 58 describes a particular scenario that the ATO considers to be a high-risk feature. It is where the shares/units do not have accompanying voting rights. The reason is the potential alienation of income by professionals who are non-owners or non-equity holders. It ought to follow that, where shares/units do in fact have voting rights, they are back to merely being a potential high-risk feature. Judgment must then be exercised, taking into account all other factors of the circumstances, to self-assess whether or not they are a high-risk feature.

Examples 3 and 4 illustrate the application of the qualifying criteria.

Example 3. Fixed partnership profit share

Facts

Smith Jones Thomas Lawyers operates as a partnership of discretionary trusts, with each partner holding a one-third interest, as set out in Diagram 2. The firm has 30 professional staff, and is clearly a business structure (in accordance with IT 2639). Debra and Michael are senior associates with the firm, each currently employed on a total remuneration package of $280,000.

From 1 July 2022, Debra and Michael will be admitted as partners, with a fixed profit share each of $300,000 replacing their employment remuneration. They will have no voting rights. Consistent with the existing partnership structure, their respective partnership interests will be held by discretionary trusts, as set out in Diagram 3. The remainder of profit will continue to be divided evenly between the three equity partners.

Apply qualifying criteria

The question at hand is whether Rex, Vickra, Jossy, Debra and Michael qualify to apply PCG 2021/4 to assess their risk rating under the guideline. Looking back at the six qualifying criteria above that must be satisfied in order to apply PCG 2021/4, the first issue to resolve is whether they are IPPs. Referring to the definition in para 20, they all provide professional services to clients. In addition, with each of their trusts having an entitlement to a share of profit – even though Debra's and Michael's is a fixed amount – they each have a legal or beneficial interest in the firm. Accordingly, they are all IPPs, and each will satisfy the first criterion.

Diagram 2. Partnership structure

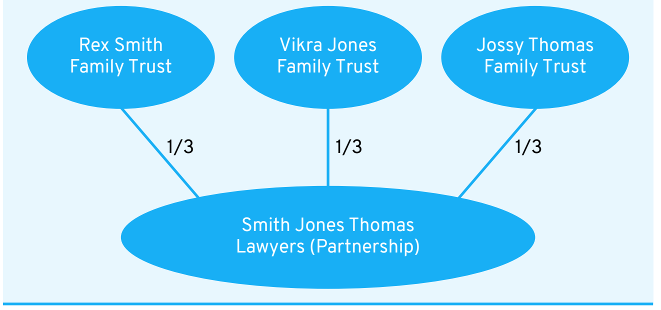
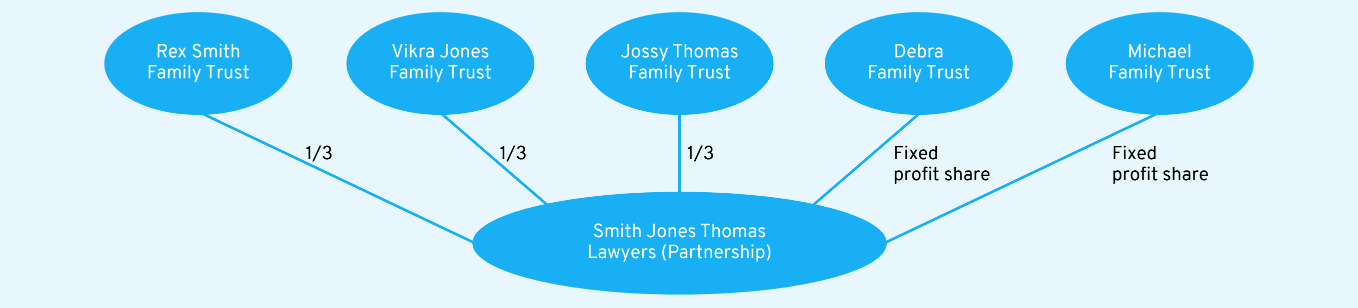


Diagram 3. Expanded partnership structure



Example 3 (cont)

The second and third criteria (not subject to PSI rules; legally effective structure) would also be satisfied, and let's say so also for the fifth (Gateway 1). That leaves the fourth and sixth criteria:

- the IPP is an equity holder, directly or through an associated entity; and
- the firm and the IPP satisfy Gateway 2 (an absence of certain high-risk features).

Rex, Vickra, Jossy, Debra and Michael would all be IPPs, as their trusts each hold a legal or beneficial interest in the firm. However, based on the discussion above, only Rex, Vickra and Jossy are equity holders (indirectly).

As for Gateway 2, the last of the named potential high-risk features in para 47 (multiple class of shares/units) is not relevant for a partnership. Further, let's say there are no high-risk features, and thus Gateway 2 will be satisfied.

Conclusion

The result is that Rex, Vickra and Jossy can apply PCG 2021/4, but Debra and Michael cannot.

The Commissioner views Debra's and Michael's fixed profit shares as linked to their individual performance, and is more akin to remuneration for highly paid employees.[24] The Commissioner does not expressly say so, but it would seem that his expectation is that Debra and Michael have their respective trusts appoint 100% of their profit share to them personally. Despite this, the trusts are still a suitable structure to use, in particular, where they intend to progress to an equity partner in future.

Example 4. Special class units

Facts

The circumstances are the same as example 3, except for the following:

- Smith Jones Thomas Lawyers is operated through a unit trust as set out in Diagram 4. Rex, Vikra and Jossy's respective trusts each hold 100 ordinary units;

Example 4 (cont)

- ordinary units are entitled to a share of the trust's net income in proportion to all other issued ordinary units. Each ordinary unit carries one vote entitlement;
- from 1 July 2022, Debra and Michael will become directors of the trustee of the unit trust. The trustee will issue one A class unit to each of their family trusts as set out in Diagram 5;
- each A class unit is entitled to $300,000 of the unit trust's annual net income. This amount can be changed at the discretion of the trustee, and the trustee can redeem the units at any time; and
- A class units carry the same voting rights as ordinary units.

Apply qualifying criteria

Again, the question at hand is whether Rex, Vickra, Jossy, Debra and Michael can apply PCG 2021/4 to assess their risk rating under the guideline. All of the six qualifying criteria would have the same outcomes as per example 3, except possibly for the sixth – the firm and the IPP satisfy Gateway 2, being an absence of certain high-risk features. This requires a re-examination.

Re-examine Gateway 2: an absence of certain high-risk features

The difference here compared to example 3 is that we must consider that last potential high-risk feature

Diagram 4. Unit trust structure

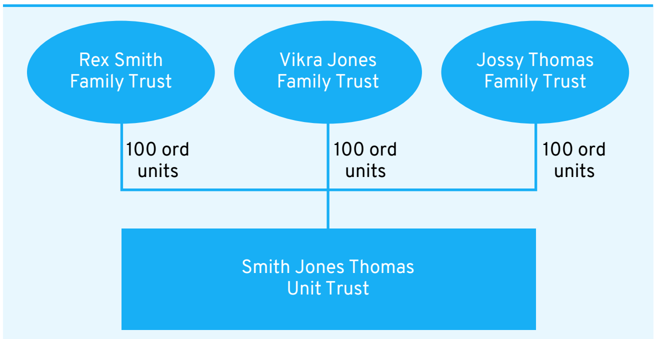
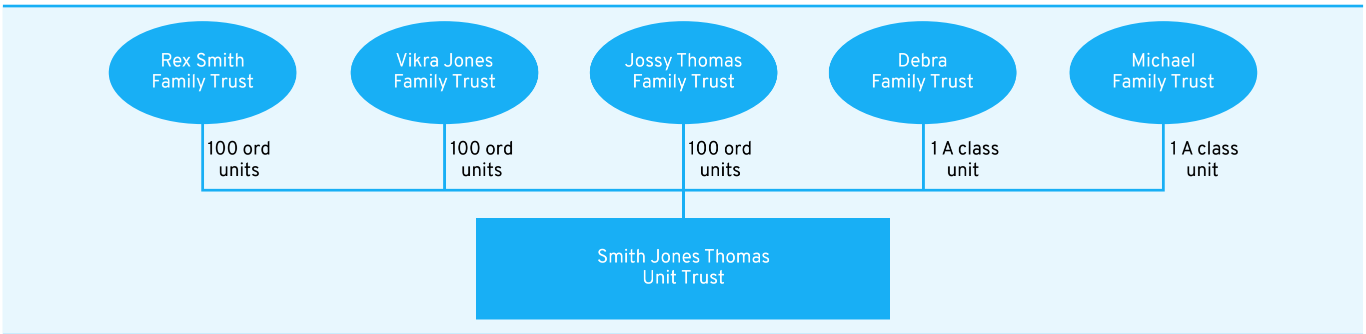


Diagram 5. Expanded unit trust structure



Example 4 (cont)

named in para 47, and discussed in paras 58 and 59 — multiple classes of shares and units among the equity and non-equity holders. Based on the discussion earlier, the ordinary and A class unitholders are neatly at the opposite ends of the equity/non-equity holder spectrum.

The A class units having equal voting rights to ordinary units would seem to mitigate the ATO's concerns in paras 58 and 59 discussed above.[25] This would pull the A class units back to the realm of potentially a high-risk feature, not automatically considered one. Therefore, professional judgment is required to self-assess whether, in this particular circumstance, the A class units are in fact a high-risk feature, thus failing Gateway 2.

If would be counter-productive if the Commissioner took the view in this rather "clean" situation that the firm does not pass Gateway 2, and thus none of the IPPs can apply PCG 2021/4 unless they engage with the ATO to determine if it is appropriate in their circumstances. Such a low failure threshold would be contrary to the point of having this self-assessment guidance in the first place. This is especially so given that the substance is essentially identical to example 3 in which Gateway 2 is passed.

Perhaps a pragmatic approach would be to do the following:

The directors resolve a policy (under threat of redemption) that holders of A class units must cause 100% of their income entitlement to be assessed to the relevant IPP (ie Debra and Michael).

The above goes further than merely mitigating, as it in fact eliminates the Commissioner's alienation concerns raised in para 58. Accordingly, it is arguable that the potential for the A class units to be a high-risk feature is averted, and thus the firm passes Gateway 2.

Conclusion

Having adopted the above approach, Rex, Vickra and Jossy self-assess that they satisfy all of the qualifying criteria to apply PCG 2021/4 to their respective circumstances, and do so in good faith.

Summary of who qualifies to apply PCG 2021/4

An IPP can progress to applying PCG 2021/4's risk assessment framework to their circumstances where:

- the IPP self-assesses with documented support that the six qualifying criteria are met; or
- the IPP does not meet all of the qualifying criteria, but engagement with the ATO results in it being resolved that it is nonetheless appropriate in the IPP's circumstances to apply PCG 2021/4's risk assessment framework.

To reiterate, the purpose of the risk assessment framework, and the resulting green/amber/red zone score, is to determine the likelihood that the ATO will review an IPP's tax arrangements. However, note that, on the second point above, if the ATO determines that it is not appropriate to apply PCG 2021/4, one might expect that the ATO will instigate a review of the IPP's arrangements.

Where a Gateway is failed, or in amber/red zone

The Commissioner discusses in paras 36 to 38 the interaction between Pt IVA ITAA36 and PCG 2021/4. The Commissioner notes that just because a Gateway is failed, or an IPP qualifies to apply the guideline but is in the amber or red zone (covered in part 2 of this article), does not necessarily mean that Pt IVA applies. Rather, the Commissioner would merely give "closer attention" to an IPP's or a firm's circumstances, including a "deeper consideration" of whether the anti-avoidance provisions apply.

Commissioner reviews IPP's arrangements

It is not known what exactly "closer attention" or a "deeper consideration" will entail. There is no legislative or judicial guidance on the extent, if any, to which an IPP's share of firm profits derived through a business structure is to be regarded as attributable to the IPP's personal services. Should it be at least 20%? 40%? 60%? Or is none required to be taxed to them? Accordingly, there is no benchmark metric against which to give that closer attention or deeper consideration. PCG 2021/4 refers to other kinds of tax mischief,[26] but allocation of professional firm profits is not an indicator for most of these mischiefs.

Despite the above, one can imagine a scenario where, on reviewing an IPP's tax arrangements, the Commissioner considers that the proportion of firm income assessed to the IPP was insufficient, and thus offends Pt IVA. In consequence, he issues amended assessments, increasing the IPP's income by an amount that the Commissioner considers appropriate. Here is the point of contention. Whatever additional amount the Commissioner considers ought to be assessed to the IPP, there is no judicial precedence to support his position. What is the IPP to do? The power differential is enormous.

Contesting amended assessments on the application of Pt IVA through the objection process and then through the courts is simply not an option for the vast majority of taxpayers. This is causing angst among participants in affected industries, including the tax profession, not just for themselves, but also with the added burden of clients looking to them for advice.

It is worth noting that, where an IPP satisfies the six qualifying criteria (which includes the two Gateways) and their risk assessment places them in the amber or red zone, there is no suggestion in PCG 2021/4 that the IPP is obligated to contact the ATO.

Test case search

The Commissioner intends to identify one or more IPPs who do not qualify to rely on PCG 2021/4 for a test case. He also invites taxpayers to nominate themselves for a test case.[27] However, it is not clear whether he is also seeking a test case on an IPP who does qualify to apply the guideline, but falls into the amber or red zone. If he were, being open about it would likely be helpful. An inherent element of being a business owner is the need to manage risk and uncertainty. Thus, knowing that PCG 2021/4 is in service of establishing judicially authoritative goalposts, that affected taxpayers can then observe with certainty as to tax risk on this significant matter, would likely achieve much greater buy-in.

One expects that the ATO will use its considerable capability for analysing data in tax returns and other sources to select taxpayers for requesting information to support that they satisfy the qualifying criteria, and verify their risk zone scoring calculations and green/amber/red zone outcome.

Gateway failed, IPP does not contact the ATO

We now turn to the scenario where an IPP does not meet all of the qualifying criteria – in particular, either or both Gateways – and takes no further action. There would be little point in applying the risk assessment framework. The reason is that whichever zone it places the IPP in – including the green zone – is irrelevant: the ATO would want to review the IPP's arrangements irrespective of the zone outcome.

There is of course no legal obligation to engage with the ATO voluntarily. However, were the ATO to initiate a review in this situation, it may come down to a matter of penalties. If the ATO were to amend assessments, the IPP might be denied the penalty-reducing benefit of voluntary disclosure.

Risk assessment framework

Having determined when an IPP qualifies to rely on PCG 2021/4, part 2 of this article will cover applying the risk assessment framework, including the three risk assessment factors and the resulting green/amber/red risk zone. This will lead into how we can help affected clients manage this new risk in their tax arrangements.

Conclusion

Understanding the Commissioner's framework for allocating compliance resources to conduct vaguely worded reviews on matters for which there is no authoritative benchmark metric against which to conduct such reviews continues to be a challenging process. Establishing some judicial guidance on the extent to which, if any, income derived through a business structure can be regarded as attributable to an individual's personal services would be a welcome improvement in taxpayer certainty.

If the Commissioner's intent behind PCG 2021/4 is in fact to identify suitable test cases for that purpose, it would be helpful to be open about it. In the meantime, we need to understand when affected clients qualify to rely on PCG 2021/4. Part 2 of this article will cover applying the risk assessment framework (on the basis that the qualifying criteria are satisfied), leading to a structured process to offer clients that will give them clarity on where they stand and enable them to make informed decisions.

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References

1 IT 2639, para 3.
2 Of course, there are integrity measures to combat the tax-preferred extraction of funds from a company, such as Div 7A ITAA36.
3 $280,000 profit, less $70,000 provision for income tax (25%), less $200,000 dividend declared, leaving $10,000.
4 These practices comply with the Commissioner's expectations in IT 2503, para 11.
5 IT 2639, para 7.
6 IT 2639, para 8d.
7 IT 2639, para 9.
8 IT 2639, para 10a.
9 PCG 2021/4, paras 7 and 8.
10 PCG 2016/1 *Practical Compliance Guidelines: purpose, nature and role in ATO's public advice and guidance.*
11 PCG 2021/4, para 30.
12 PCG 2021/4, para 20.
13 PCG 2021/4, paras 21 and 22.
14 PCG 2021/4, para 5.
15 PCG 2021/4, para 23.
16 PCG 2021/4, para 29.
17 PCG 2021/4, para 28.

18 It is not clear whether "the arrangement" means solely the IPP's tax arrangements, independent of the firm and its other IPPs, or also the firm more broadly. Paragraph 43 of PCG 2021/4 suggests the latter, referring to "how the professional firm operates in practice". But if that were so, why not use the same wording as the last criterion, which makes it clear it is both the firm and the IPP?

19 PCG 2021/4, para 25.

20 PCG 2021/4, para 34.

21 PCG 2021/4, para 47.

22 *FCT v Everett* [1980] HCA 6.

23 *FCT v Galland* [1986] HCA 83.

24 PCG 2021/D4, para 6.

25 As the A class units represent two out of a total of 302 unitholder votes, it is highly unlikely that Debra and Michael could cause any voting upsets.

26 PCG 2021/4, para 68.

27 PCG 2021/4, para 15.

The inherent disincentive of the Child Care Subsidy

by Scott Treatt, CTA, General Manager, Tax Policy & Advocacy, The Tax Institute

As a part of our transfer system, a fair, efficient and effective Child Care Subsidy (CCS) plays an important role in incentivising workforce participation, increasing Australia's productivity and reducing discrimination against primary carers. The various components of the current CCS, including the current rates, the hourly rate cap and the activity test, all work together to create disincentives within the system, effectively capping the productivity gains which result. Getting the CCS balance wrong results in lost access to valuable employees to provide the necessary services across our economy, increasing labour shortages and wage pressures beyond what we are already experiencing. Getting the balance right, unlocks the potential of not only increased productive hours, but also the knowledge of more individuals who can bring new ideas and concepts to the table which can only ever help Australia improve as a country.

I have often been asked why The Tax Institute is advocating for changes to the Child Care Subsidy (CCS). The CCS is only one small piece of the Australian transfer system, as many of our members who assist their clients with Centrelink related benefits can attest. The transfer system plays a crucial role in complementing the tax system. How the tax and transfer systems interact has significant implications for the motivations of individuals to work, spend and save.

It is our opinion that a fair, efficient and effective CCS increases workforce participation, increases Australia's productivity (and consequently tax collections), and reduces discrimination against primary carers (both immediately and in the years following their return to the workforce). This issue also falls squarely on the radar of our current President, Jerome Tse, and his focus on diversity and inclusion.

There are a variety of issues with the current form of the CCS which, in our view, limit the effectiveness of this measure, many of which have been hidden in plain sight. In our opinion, there are issues within the CCS rates, the hourly rate cap, and the activity test. This article highlights our concerns and the continued disincentives that these issues create for primary carers seeking to return to work or increase their working hours.

What is the Child Care Subsidy?

It is beneficial to start with an overview of the CCS.

Australia's federal focus on the importance of government involvement in funding child care, and the quality of that care, commenced with the enactment of the *Child Care Act 1972* (Cth) (Child Care Act).

On 10 October 1972, in the second reading speech[1] for the introduction of the Child Care Bill 1972, Mr Lynch, Minister for Labour and National Service, made the following comments on its purpose:

> "… the Government's initiative springs from its concern for the welfare of children of working mothers. The increase of working mothers in the labour force is a phenomenon of modern industrial society. I do not make a value judgment upon it. It is also a fact that at present 25 per cent of mothers with children under 6 years of age are in the labour force. That a substantial number of such mothers cannot make satisfactory arrangements for the care of their preschool aged children is yet another fact. The purpose of the scheme is to meet this existing problem - to help the children of working and other parents insofar as they are deprived of proper child care either because good quality facilities are not available or because the cost is presently too high. The scheme is not intended either to encourage or discourage mothers from entering paid employment."

Over the last 50 years, while the original Child Care Act remains in force, the ways in which support is provided for child care centres and for parents have significantly shifted. There have been numerous changes in the relevant laws throughout the years. In more recent decades, notably in 1999 through the A New Tax System[2] package, Peter Costello moved to consolidate a number of the complex support measures to "simplify their operation". From 1 July 2018, we had the last significant consolidation of the child care support measures into what is the present day CCS.

While, in our opinion, unnecessary complexity remains in the present system, there is one notable shift in its stated purpose. As noted above, the government's original stated purpose for intervening in the child care system was "not intended to either encourage or discourage mothers from entering paid employment". Noting that there was significant criticism of this comment at the time, incentivisation of individuals to re-join the workforce was always going to be a biproduct of the laws.

In the present day, it is acknowledged that the CCS is a useful tool to incentivise primary carers to return to the workplace. In a joint media release[3] on 2 May 2021 by The Hon. Josh Frydenberg MP, Treasurer, Senator The Hon. Marise Payne, Minister for Foreign Affairs and Minister for

Women, The Hon. Alan Tudge MP, Minister for Education and Youth, and Senator The Hon. Jane Hume, Minister for Superannuation, Financial Services and the Digital Economy, and Minister for Women's Economic Security, "Making child care more affordable and boosting workforce participation", the Ministers stated:

- the purpose of the announced changes was to "cut the cost of living for around a quarter of a million families and to help boost workforce participation"; and
- an important consequence of the changes was that "it lowers the structural disincentive to take on an additional day or two of work for many families".

So, in the present day, the CCS can best be described as a subsidy provided through the transfer system to mitigate the high cost of providing formal child care to children while boosting workforce participation of their parents, and therefore improving Australia's GDP.

As a final point in this overview, when reviewing the effectiveness of any measure, the government must consider the return on investment. The government's view on the return on investment can also be extracted from the same media release noted above. It was stated that the Morrison Government was outlaying an additional $1.7bn (over forward estimates) investment in child care, with an anticipated return of investment of 300,000 extra hours worked per week (based on 40,000 individuals working an extra one day per week). This is expected to boost GDP by $1.5bn per year. It is clear that the government has a very positive view of the return on investment and the decision to invest into the CCS system is not made reluctantly.

Why is it a subsidy and not a deduction?

It has been put to us by various members that the CCS should be a deduction and not a subsidy.

There are a number of reasons, in our view, why a subsidy is more efficient and more effective than a deduction when delivering an incentive in the way of the CCS, including the following.

- the utilisation of the transfer system, rather than the tax system, is a more effective and appropriate tool. It can better match the subsidy with the timing of the cash outlay of the relevant individuals rather than creating additional complexity within the PAYG system. This is a crucial element when providing a cost assistance program;
- meeting costs dollar for dollar through a subsidy is more effective to incentivise behaviour than a deduction. It can deliver the right benefits to the people who need it the most, whereas a tax deduction tends to benefit higher income earners more than lower income earners; and
- a tax deduction does not assist those who are studying to be able to return to the workforce, whereas they may be entitled to a subsidy.

Reasonable minds may always differ on the best way to deliver the incentive, however, in our opinion, the CCS is a very effective and efficient delivery mechanism.

How is the subsidy calculated?

Prior to delving into the technical issues, it is important to first explain how a CCS payment is calculated.

The natural place to start is with the rates, which vary based on family income levels and are set out in Table 1.[4]

It should be noted that the media release referred to earlier in this article introduced further changes which are now law and benefitting families accordingly. These are:

- the removal of the $10,560 cap that previously existed on total CCS payments per child; and
- an increase of 30 percentage points (to a maximum CCS percentage of 95%) for the second, and other children, aged five and under and receiving care in an eligible child care facility (noting that this can include before and after school care).

You would not be criticised for then thinking that this rate is simply applied against the amount of child care that you pay. However, two further factors come into play in the calculation:

1. the hourly rate cap; and
2. the activity test.

Table 1

Your family income	Child Care Subsidy percentage
$0 to $70,015	85%
More than $70,015 to below $175,015	Between 85% and 50% The percentage decreases by 1% for every $3,000 of income the family earns
$175,015 to below $254,305	50%
$254,305 to below $344,305	Between 50% and 20% The percentage goes down by 1% for every $3,000 of income the family earns
$344,305 to below $354,305	20%
$354,305 or more	0%

Hourly rate cap

The hourly rate cap is a prescribed amount, indexed annually to CPI, which applies equally to all Australians.

If your fee is under the cap, your fee remains the relevant figure for the calculations. However, if your fee exceeds the cap, the cap becomes the relevant figure for calculating your entitlement.

The current hourly rate caps are set out in Table 2.[5]

The activity test

The activity test (set out in Table 3[6]) is designed to ensure that an individual actually returns to work or study and is not simply utilising the government's money for personal pursuits (subject to specific exclusions).

Calculation

An example calculation demonstrating the operation of the above elements is set out below and in Table 4. For the purposes of this example, we make the following assumptions:

- the relevant taxpayer is in a relationship and has one child attending long day care. They are located in NSW;
- the primary income earner derives the average ordinary times earnings for individuals located in NSW, while the secondary earner derives a below average income (for this example, say, $70,000 per annum if they were working full time);
- the secondary earner returns to work three days per week, working 7.5 hours a day. The child is sent to day care for these three days; and
- the average child care centre hours for NSW of 10.5 hours are utilised rather than the actual hours of the centre. Similarly, the average fee of $10.90 per hour in NSW is utilised for this example. Note, the cost of child care generally would increase (hence net income decreases) the closer to any main CBD it is based.

In this example, the hourly rate cap and the activity test do not cause adverse consequences, however, this will be explored further below.

Table 2

Type of child care	Hourly rate cap
Centre-based day care – long day care and occasional care	$12.31
Family day care	$11.40
Outside school hours care – before, after and vacation care	$10.77
In home care	$33.47 per family

Table 3

Activity level each fortnight	Hours of subsidised care each fortnight
Less than 8 hours	0 hours if you earn above $70,015 24 hours if you earn $70,015 or below
More than 8 to 16 hours	36 hours
More than 16 to 48 hours	72 hours
More than 48 hours	100 hours

Table 4

Assumed annual full-time equivalent (FTE) income of primary earner		$91,577
Number of working days per fortnight		6
Fortnightly activity (hours)		45
Gross income of secondary earner		$42,000
Gross family income		$133,577
Total care hours per fortnight		63
Total eligible hours		63
Income of secondary earner		
Gross income		$42,000
Tax	*Note: assumes Medicare Levy Reduction does not apply*	($5,362)
Net annual income		$36,638
Gross cost of child care		$16,595
Rebate entitlement (based on family income)		64%
Rebate		**($10,621)**
Net cost of child care		$5,974
Net income of secondary earner after child care		**$30,664**

What are the issues we observe and why are we advocating for change?

The rates

As the Ministers' comments above indicate, the incentive to work drawn from the CCS results in a genuine increase in GDP, providing a return on investment for the government.

However, prior to exploring the general rates, it is worthwhile challenging the incentive created by the new 30% premium for second and later children referred to above.

In making the following observations, we acknowledge the fact that having two or more children in care can impose significant costs on working parents. Indeed, the issues raised in this article are only exacerbated when the number of children is increased from one to two or more. Accordingly, anything to assist with reducing that burden to encourage individuals to return to the workforce is positive. However, in our opinion, the cliff provided by the requirement for the first child to be under six remains an impediment. This introduces a hidden, and likely unexpected, cost in family budgets.

Take an example of an individual paying $17,195 per annum of child care per child for three days of care per week. If they are eligible for a 64% rate of subsidy, they will receive $11,005 in respect of the first child and $16,164 for the second child (leaving a total net cost of $7,221 for the two children). This is shown in Table 5.

However, once the elder child attains the age of six, the additional benefit for the second child disappears. At that time, the parents will then likely incur vacation care and before and after school care costs for the first child to maintain their same working hours. In this case, assuming the 64% rate continues to apply to both, and assuming the total vacation care and before and after school care costs were $10,000 per year, there would be a net cost of $9,790 for the two children. This results in a $2,569 increase in care costs per annum (or $49 per week). This is shown in Table 6.

The net cost of this transition would need to be factored into the choices of those working parents. It is not as simple as the cost of child care having disappeared and therefore the parents are automatically better off. Yes, they are better off in the short-term, but the cost to the family budget remains in the medium to long-term. In this regard, it is therefore our opinion that the take-up of additional hours of work may be somewhat limited. We believe the data on this may also be skewed, particularly by those who have already returned to work but will benefit from this measure without changing their circumstances. The data will also be skewed by those who are picking up more hours now that their first child is of school age, but yet will not reach the age of six until later in the school year or early the next.

Table 5

	Child 1	Child 2
Annual cost of care	$17,195	$17,195
Rebate @ 64%	($11,005)	(11,005)
Additional rebate @ 30%		(5,159)
Net cost of care	**$6,190**	**$1,031**
Total net cost of care		**$7,221**

Table 6

	Child 1	Child 2
Annual cost of care	$10,000	$17,195
Rebate @ 64%	($6,400)	(11,005)
Additional rebate @ 30%		(0)
Net cost of care	**$3,600**	**$6,190**
Total net cost of care		**$9,790**

As such, while we commend the efforts to curb the additional costs of having two or more children in care, we question the actual return on investment from the structure of the new additional CCS amount.

With regard to the rates generally, the many different forms of CCS that have been provided over the years demonstrate the imperfect science related to it. It is complex and much relates to the behavioural changes which follow. Indeed, over the years, the CCS has even been referred to as "middle-class welfare". In our opinion, this could not be more wrong, and KPMG articulated this very well in its 2020 paper, *The Child Care Subsidy: options for increasing support for caregivers who want to work*:[7]

> "The CCS is not 'middle-class welfare', just as government-funded primary and secondary education are not. It represents a productivity-boosting investment in the ability of parents to increase their contribution to the economy according to their needs and preferences."

In fact, if we did not have an education system based on 18th century design, we would probably today create an education system starting at around three years of age up to and including post-secondary education, with hours of attendance more closely aligned with more advanced systems. This would address a significant part of the need for a CCS (although perhaps not completely).

The KPMG paper provided two options for reforming the rate of the CCS. Option 1 being a flat 95% of the hourly rate cap for all families, and option 2 being a modification of the CCS curve to eliminate cliffs and provide CCS to all families. This option would provide a 95% CCS for incomes below $80,000 (being twice the minimum annual wage at the time of the paper), then a decrease of 1% for every $4,000 until the 30% rate was reached (being $340,000), and that 30% rate applying thereafter.

In its paper, KPMG made the following observations:

Regarding option 1:[8]

> "The federal government's spend on the CCS could increase by up to $5.4 billion (net of additional income

> tax receipts from the additional days worked), but the economic benefit (in a year not affected by COVID-19 restrictions on business) could be a GDP increase of more than $7 billion."

Regarding option 2:[9]

> "Under Option 2, the additional spend on CCS could be around $2.5 billion per annum (net of additional tax receipts from extra days worked in response to the policy) but the GDP increase from the extra days worked in the year is estimated at up to $5.4 billion."

The Tax Institute supports these options and, while preferring option 1, accepts that option 2 may be a more realistic transition.

If option 2 was applied to the same fact pattern set out above, the implications for a family would be as set out in Table 7.

This would provide an extra $2,987 per annum ($5,974 in the earlier example less $2,987 above), or $57 per week, into the hands of a family who would most need and benefit from such a CCS. For completeness, it is noted that, if Australian averages are utilised, and if the incomes were increased such that the primary income earner derived $150,000 per year and the secondary earner derived the average wage, again working three days per week, the net cost of child care would decrease from $8,535 to $6,145 per annum. This represents a net benefit of $2,390 per annum ($46 per week) for the higher income family. This provides a good incentive for primary carers to return to work (or increase their hours) while skewing the benefit in favour of lower income earners.

The hourly rate cap

The hourly rate cap is a different issue. Our concerns are not with the fact of having a cap, rather the nature of the cap.

The cost of living is very different throughout Australia, be this by capital city, or between metropolitan and regional areas. At times, but not always, the tax laws appropriately reflect this. Reference is made to the "reasonable travel allowance" for tax purposes, among other things, to highlight this. However, the CCS hourly rate cap is a national cap and it is not adjusted for any cost differences between the states/territories and regions, be that differences in occupancy costs, or costs of the provision of food services.

If one of the purposes of the cap is to keep control of the market to prevent manipulation of the CCS, which could otherwise be done for the purpose of increasing corporate profit if there was no such cap, then a single national cap immediately fails from a policy perspective in this regard. The Tax Institute indeed supports a cap, it is necessary regulation for the abovementioned manipulation risk. However, it is our opinion that such manipulation still exists but is only hidden within a national cap, with those in lower cost jurisdictions able to push the price limits within the supply and demand equation more so than those in higher cost jurisdictions.

Tables 8 and 9 provide insights into the fees and charges across Australia.

It is our opinion that a more comprehensive review of the hourly rate data should be undertaken to set appropriate thresholds for each state and territory, and for the metropolitan and regional areas within those jurisdictions. At the time of writing this article, The Tax Institute has not conducted research into whether there may be any

Table 7

Assumed annual FTE income of primary earner		$91,577
Number of working days per fortnight		6
Fortnightly activity (hours)		45
Gross income of secondary earner		$42,000
Gross family income		$133,577
Total care hours per fortnight		63
Total eligible hours		63
Income of secondary earner		
Gross income		$42,000
Tax	*Note: assumes Medicare Levy Reduction does not apply*	($5,362)
Net annual income		$36,638
Gross cost of child care		$16,595
Rebate entitlement (based on family income)		64%
Rebate		**($13,608)**
Net cost of child care		$2,987
Net income of secondary earner after child care		**$33,651**

Table 8

	NSW	VIC	QLD	WA	SA	TAS	NT	ACT
Hourly rates (note, national cap = $12.31, $12.20 for the same comparison period)								
Government stated average*[10]	$10.90	$10.93	$9.82	$10.80	$10.41	$9.78	$8.21	$11.98
Average cost of care (metro) – Other sources**[11]	$15.18	$13.55	$9.73	$13.55	$10.27	$8.64	$9.45	$11.36

* March 2021 quarter – being latest publicly released data

** An 11-hour average day has been utilised to calculate the average hourly cost

Table 9

	NSW	VIC	QLD	WA	SA	TAS	NT	ACT
Count of services[12]								
Greater metropolitan areas	2,654	1,503	922	548	366	87	68	173
Regional	676	296	804	179	91	25	50	0
Total	**3,330**	**1,799**	**1,726**	**727**	**457**	**112**	**118**	**173**
Count of services above hourly rate cap[13]								
Greater metropolitan areas	629	280	18	84	27	2	1	63
Regional	17	10	4	32	2	1	0	0
Total	**646**	**290**	**22**	**116**	**29**	**3**	**1**	**63**

constitutional limitations in achieving this and we would value any insights from members, or their colleagues, who may have a speciality in constitutional law.

If we take the higher income earners used in the discussion above, given they are more likely to live in areas where there is limited access to child care centres which charge fees lower that the hourly rate cap, the budgetary impact for the government is not overly significant. If a centre charged a fee of $13.55 per hour, and the hourly cap was increased to $13.50, this would result in an increase in the CCS of $975 per annum ($19 per week) for a secondary earner working three days per week.

The budgetary cost of this adjustment would be somewhat mitigated by ensuring that a rate relevant for each state/territory and region was applied.

As a concluding comment, it should also be observed that, while the hourly rate cap is currently indexed to CPI, child care centres are under continued pressure on employment and other costs. As a consequence, fee increases regularly surpass inflation. This can be by as much as 4% or more. In this regard, consideration should be had as to whether CPI itself is the correct indexation factor to be applied to prevent the system from quickly becoming outdated and a form of hidden tax on working parents.

The activity test

The activity test is the last part of the equation, but by no means the least. In our opinion, one of the largest disincentives for those who can return to work, particularly full time, lies within the activity test.

From a policy perspective, the activity test is designed to ensure that individuals don't "free-load" off the tax and transfer system. It does this by requiring individuals to, generally, work or study for certain hours to gain entitlement to a certain number of hours of CCS eligible care. However, the eligible hours max out at 100 hours per fortnight.

One may immediately react by stating that, if you work a 40-hour week, 100 hours per fortnight should be sufficient. Unfortunately, as a consequence of administrative convenience, the 100 hours is based on the hours of care made available to you (ie the hours the centre was open on the day your child attended), rather than on the actual hours you either work or the actual hours your child was in care.

A very limited number of centres try to assist people in working around this by having a 9, 10 or 11-hour day package. But does this actually help? Let's assume you leave home at 7am to get your child to day care. You drop them off and get to the train station by 7.30am. It takes you an hour to get to work, so you start at 8.30am. You leave just after 4.30pm as you have to get to the centre before it closes. You are on the train at, say, 4.45pm, and arrive at the day care at around 5.50pm, giving you 10 minutes to spare. Yes, you've done a "9 to 5" day, and we question the reality of that in the present day, but your child has been in care for 10.5 hours! For many, the "flexible hours" that a child care centre may be able to provide is not relevant.

While the average varies between the states and territories, many centres are open 11 hours a day to accommodate for travel times. This being the case, you require a minimum of 55 hours per week, or 110 hours per fortnight, to be able to work a full-time "9 to 5" job. The cost–benefit analysis of working a 10th day in a fortnight is challenging for those looking to increase their hours at work. For some, working a 10th day may barely cover the cost of buying a take-away coffee to get through the day, let alone the cost of getting to work in the first place! The example below highlights the disincentive of working more hours.

In this example, the following assumptions are made (see also Table 10):

- the relevant taxpayer is in a relationship and has one child attending long day care. They are located in Victoria;
- the primary income earner derives the average ordinary times earnings for individuals located in Victoria, while the secondary earner derives a below average income (for this example, say, $70,000 per annum if they were working full time);
- the child is sent to care each day the secondary income earner works. The secondary income worker works 7.5 hours per day; and
- the average child care centre hours for Victoria of 11 hours are utilised rather than the actual hours of the centre. Further, rather than the average fee of $10.93 per hour in Victoria, the Melbourne fee of $13.55 obtained from external sources (and considered by the author to be more reflective) is utilised for this example.

If the simple change is made to better reflect the hours of care required to work, day 10 in the fortnight changes from $6 to $39 extra disposal income after child care, resulting in almost $900 extra after tax and care for that family. If adjustments were also made to the hourly fee cap, they could be up to $3,600 better off, and then certainly more likely to increase their hours in productive employment.

It is our opinion that the activity test should be updated to better reflect the hours of care required to work the respective days in question, without disincentivising working parents considering their options.

Concluding remarks

There are many other issues related to the CCS which could be explored, and should indeed be debated in future forums. However, one must draw the line somewhere. For completeness, we note these issues as being:

- The inconsistency in assessment of the CCS versus income tax. Should we continue to determine CCS eligibility on the family unit while assessing tax on individuals and not family units? Is this creating additional disincentives or unfairly discriminating against secondary income earners, who in the present day remain predominantly women?

Table 10

	3 days per week	4 days per week	9 days per fortnight	Full-time work
Assumed annual FTE income of primary earner	$91,510	$91,510	$91,510	$91,510
Number of working days per fortnight	6	8	9	10
Fortnightly activity (hours)	45	60	68	75
Gross income of secondary earner	$42,000	$56,000	$63,000	$70,000
Gross family income	$133,510	$147,510	$154,510	$161,510
Total care hours per fortnight	66	88	99	110
Total eligible hours	66	88	99	100
Income of secondary earner				
Gross income:	$42,000	$56,000	$63,000	$70,000
Tax *Note: assumes Medicare Levy Reduction does not apply*	($5,362)	($9,787)	($12,202)	($14,617)
Net annual income	$36,638	$46,213	$50,798	$55,383
Gross cost of child care	$21,314	$29,065	$32,940	$36,815
Rebate entitlement (based on family income)	64%	60%	57%	55%
Rebate	($12,393)	($15,843)	($17,058)	($16,635)
Net cost of child care	$8,921	$13,222	$15,882	$20,180
Net income of secondary earner after child care	**$27,717**	**$32,991**	**$34,916**	**$35,203**
Net daily income of secondary earner after child care	$178	$159	$149	$135
Net weekly income of secondary earner after child care	**$533**	**$634**	**$671**	**$677**
Extra disposable weekly income by scenario	**$138***	**$101**	**$37**	**$6**

* As compared to working 2 days per week

- Is the CCS system effective at managing the debt risks otherwise associated with the subsidy? Unless an individual proactively increases their estimated family income, most particularly when they increase their hours or receive a pay increase or bonus, an unpleasant and unexpected surprise may await shortly after lodgment of the income tax returns for the family.

An effective CCS is crucial for our economy. If we get it wrong, we lose access to valuable employees to provide the necessary services across our economy, increasing labour shortages and wage pressures beyond what we are already experiencing. If we get it right, we unlock the potential of not only increased productive hours, but also the knowledge of more individuals who can bring new ideas and concepts to the table, which can only ever help Australia improve as a country. Accordingly, The Tax Institute will continue to advocate for the issues set out in this article to be reviewed and addressed to reduce the disincentive for primary carers in their decisions to return to work, thereby reducing the inherent discrimination that the present system creates.

For completeness, please note that the focus of this article is on child care centres (rather than the other CCS registered organisations) and should be read in this context.

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Superannuation

by William Fettes and Daniel Butler, CTA, DBA Lawyers

New choice simplifies ECPI claims

Recent legislative changes provide more flexibility and simplicity in relation to claiming a pension exemption for small funds.

On 10 February 2022, the federal parliament passed the Treasury Laws Amendment (Enhancing Superannuation Outcomes For Australians and Helping Australian Businesses Invest) Bill 2021 (the Bill) which contains an important measure that impacts how SMSFs can claim exempt current pension income (ECPI).

In broad terms, the ECPI changes in the Bill improve the ability of fund trustees to claim exempt income under the unsegregated or proportionate method for an income year by providing a choice to opt out of using the segregated method in certain circumstances, ie where, *for part of an income year*, a fund is deemed to be segregated by virtue of being 100% in pension phase.

This change allows SMSFs that are fully in pension phase for part of an income year, and partly in accumulation phase and partly in pension phase for other period(s), to simplify their tax position by obtaining an actuarial certificate covering the entire income year. Importantly, this choice is only available where a fund is not 100% in pension phase for an entire financial year. This measure applies from 1 July 2021.

For simplicity and ease of expression, we refer to "pensions" in this article rather the tax term "superannuation income streams". We also refer to funds being partly or fully in pension phase to convey the extent to which a fund is paying exempt (retirement phase) pensions (eg account-based pensions) compared to accumulation phase benefits at a point in time in an income year.

This article only covers ECPI issues associated with prescribed pensions, ie allocated, market-linked or account-based pensions.

Background

The Australian Government first announced proposed changes to the legislative framework for ECPI in the 2019 Federal Budget. These announced measures were intended to streamline how ECPI is claimed:

- by allowing superannuation fund trustees with member interests in both accumulation and retirement phases during an income year to choose their preferred method of calculating ECPI; and
- small superannuation funds with members with more than $1.6m total superannuation balance have been precluded from using the segregated method under s 295-387 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97). The Bill removes the requirement that an actuarial certificate is required when calculating ECPI using the proportionate method where all members of the fund are fully in pension phase for all of the income year. The rule precluding certain funds from using the segregated method for ECPI is referred to as the "disregarded small fund assets (DSFA) rule".

Between 21 May 2021 and 18 June 2021, Treasury published for consultation exposure draft legislation on "Reducing red tape for superannuation funds – ECPI measures" in relation to the above matter.

Subsequent to this consultation process, legislation addressing the redundant actuarial certificate requirement was enacted on 13 September 2021 (see new subs (3) of s 295-387 ITAA97 which was inserted by the *Treasury Laws Amendment (2021 Measures No. 6) Act 2021* (Cth)).

The Bill therefore aims to address the remaining unenacted measure announced in the 2019 Federal Budget regarding choice of ECPI method.

The problem of forced deemed segregation

The issue that the Bill seeks to address emerged in response to guidance issued by the ATO in relation to its administrative approach to ECPI that was published on the ATO's website in late 2019 (QC 21546).[1]

In broad terms, for the 2017-18 income year onwards, the ATO expects SMSFs to calculate ECPI and obtain actuarial certificates in line with the following:

- unless a fund is precluded from segregation under the DSFA rule for an income year, the fund must claim ECPI using the segregated method for any period (including part of an income year) that the fund is 100% in pension phase;
- where an SMSF uses the unsegregated method for part of an income year, an actuarial certificate is required to claim ECPI for that period, ie unless active segregation is implemented (if available); and
- only one actuarial certificate is required for the period or periods that the unsegregated method is used, even if an SMSF changes ECPI method multiple times in an income year.[2]

This ATO approach has given rise to a number of difficulties and concerns since it was published, particularly in relation to funds that are fully in pension phase for part of an income year bearing extra administration costs. This is because, in many cases, funds were being forced to calculate ECPI based on multiple discrete ECPI periods, for example, where:

- the fund is fully in pension phase for one or more periods during an income year; and
- the fund is partly in pension phase and partly in accumulation phase for one or more periods during an income year.

To overcome these difficulties, many SMSF trustees were forced to take certain steps to prevent deemed segregation from occurring, such as maintaining a small accumulation balance at all relevant times to simplify ECPI.

It should be noted that this ATO view represented a departure from established industry practice. For instance, typically, SMSFs that were partly in pension phase and partly in accumulation phase during an income year would calculate exempt income using the unsegregated method for the full income year, even if there were one or more periods where the fund was 100% in pension phase.

Choice of ECPI method

The Bill addresses the problem discussed above regarding forced deemed segregation by providing trustees with a choice to treat all fund assets as not being segregated current pension assets where a fund is fully in pension phase for part of an income year. That choice is not available where:

- at all relevant times in the income year, the fund is fully in pension phase; or
- the fund is subject to the DSFA rule for the income year.

It should be noted that the exposure draft legislation allowed for this choice to be made on an asset-by-asset basis. However, the choice in the Bill does not operate on this basis – it applies to all fund assets.

Form of choice

The Bill does not specify any formalities in relation to the choice being properly made. The explanatory memorandum to the Bill simply states:

> "5.19 In line with current industry practice trustees will choose which method to use and calculate its exempt current pension income before submitting the fund's income tax return. *This choice is not a formal election and does not have to be submitted to the ATO. However, it is expected that trustees will keep a record of any choice they make and the details of the calculation they use …*" (emphasis added)

Thus, it is important to note that SMSF trustees seeking to rely on the new provisions in s 295-385(8) to (10) must put in place appropriate documentation recording this choice, eg by way of trustee resolutions.

Conclusion

The ECPI changes in the Bill provide some welcome relief in relation to the rigidities of the ATO's current administrative approach to ECPI claims for small funds. In particular, the new legislation will restore the role of choice in the legislative framework for ECPI, providing additional flexibility for SMSF trustees to simplify their tax affairs where a fund may be fully in pension phase for part of an income year. The shift away from the asset-by-asset choice model in the exposure draft legislation is also a positive development as this would have no doubt introduced further complexity, including in relation to advice, costs and risks associated with tax-effective planning.

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Alternative Assets Insights

by Ken Woo, CTA, PwC

CCIV legislation passed

The passing of the CCIV legislation represents a milestone development that began 13 years ago with the recommendations of the Johnson report in 2009.

Introduction

The priority, as those in the world of "start-ups" are well aware, has been to develop the corporate collective investment vehicle (CCIV) to a "minimum viable product" (MVP), rather than seek to perfect it. Practical market needs will determine both the necessity and priority of refinements. Implementation is being undertaken by the ATO and a working group has already been created.

The legislation is a triumph of industry consultation and the desire of the government and Treasury to commence, rather than complete, a major advance in policy execution.

So what's next for CCIVs?

Getting to the right destination

Trying to mesh complex legal and tax concepts has been challenging, to achieve the same tax outcomes for a CCIV that arise for an attribution managed investment trust (AMIT). This has involved resolving two compounding contradictions. First, the CCIV is a single legal form company that paradoxically comprises "single responsible entity" sub-funds, each with segregated assets and liabilities. Second, the CCIV must "flow through" franking credits, discount capital gains and foreign income tax offsets to investors, fundamentally contravening our company tax rules which are based on legal form.

Relevantly, there are a number of approaches in meeting this complexity:

- **concepts:** tax classification strictly follows known, and at times incompatible, concepts (legal, ordinary versus statutory tax concepts, accounting and regulatory frameworks). This can result in conundrums and uncertainty;
- **desired outcome:** use the CCIV process to perfect things that are presently workable but could be improved, specifically, the AMIT tax regime. Going beyond and improving the AMIT regime can result in longer lists of issues that delay and, in some instances, paralyse progress; and
- **focus:** where practical issues arise and the law is at odds with the desired outcome, use deeming provisions to arrive at the desired outcome.

The power of deeming – making breakthroughs for CCIVs

Deeming the sub-fund to be a trust for legal and tax purposes has yielded a major breakthrough for the CCIV. However, some corporate elements remain, for example, the requirement that a dividend represent a distribution of "profits". This is at odds with the existing tax outcomes for a sub-fund should it fail, in any given income year, to qualify for AMIT treatment. Should the CCIV have an accounting loss but have taxable income, the trustee is taxed on that taxable income and flow-through tax treatment is thereby denied. Trust tax rules are designed to mitigate two outcomes that (rather obviously) render a trust unworkable as a collective investment vehicle (CIV):

- the trustee being taxed on the taxable income; and
- unitholders being taxed twice on undistributed income.

These outcomes could be mitigated, and thereby propel the viability of the CCIV, by providing for a minimum cash dividend entitlement where the dividend entitlement equates to the "distributable income" of the sub-fund. This in turn equates to the taxable income of the sub-fund being represented by cash. We can dispense with the company law requirements of a dividend and, in recognition that the sub-fund is a trust, deem a minimum dividend. This would mirror the framework of a unit trust where the trust deed will typically mandate a minimum annual distribution (sometimes called "distributable income") such that the trustee is not taxed on the taxable net income of the trust.

In other words, could a bit more deeming trigger the tipping point in the viability of the CCIV?

Deeming – looking back

On reflection, the tax regime in the funds management industry has been based on deeming. The original complying superannuation provisions introduced in 1988 were based on deeming attributes of a trust to create a regime for taxing funds as entities, for example, deeming certain capital inflows to be taxable contributions, as well as a raft of statutory rules at odds with ordinary concepts.

Similarly, the pooled superannuation trust (PST) created an equivalent non-insurance-based "statutory fund" like vehicle for complying superannuation funds to invest in. This was extended full circle, with the creation of the "virtual PST" (as the "complying superannuation" class) under the rewritten life company tax rules.

More recently, the deemed capital account election for managed investment trusts (MITs) was created to resolve an impasse where the tax law (revenue account) was at odds with government policy, to place investors in MITs in the same position as if they had invested directly in the underlying assets of the MIT (capital account).

Indeed, for CIVs, certain foreign limited partnerships are deemed to be companies and can be further deemed to be a foreign hybrid limited partnership. Similar deeming has also been used in other markets. For example, the US mutual fund can be legally created as a trust, be classified as a company for regulatory purposes, and effectively be deemed a partnership under the Internal Revenue Code.

Deeming – looking ahead

As new concepts and arrangements emerge, it will be important for law makers to recognise that existing frameworks and legal concepts may not provide workable practical regimes. We need only look to the emergence of decentralised autonomous organisations (DAOs) to see that our existing legal concepts appear to struggle when we classify these arrangements. For an entity that does not conceptually require legal personality, as DAOs seek to interact in the traditional world, they may require a process called "wrapping" to gain legal capacity. To this end, written constitutions may assert more about what the DAO is not rather than what it is.

This can be complicated when we attempt to simplify by veneering complexity. For example, construing a DAO arrangement as a company or partnership — as a single reference point — may be flawed, especially in the case of decentralised finance (or "DeFi", as it is known). For example, a prime broker relationship may comprise fiduciary, contractual and agency relationships and perhaps this multi-dimensional approach can better inform the understanding, and desired tax outcome, of a DeFi DAO?

For new arrangements involving the creation, transfer and value extraction of digital assets, we may need to deem a hybrid arrangement based on core concepts that presently do not exist in our legal framework. Thinking back, it would have been challenging when the company was created to conceive a non-existent person having legal personality. But just as we wouldn't solve today's problems with yesterday's tools, why approach tomorrow's challenges with today's tools?

The beginning of a brave new world?

Questions that arise for participants as leaders in the new digital asset world:

- How do we think expansively about the need for deeming? And when is partial deeming incomplete; exactly how far must it be done?
- How do we maintain an MVP approach to the CCIV? If the AMIT regime gets us there, it may be better to stick with it, rather than seeking perfection in terms of tax neutrality, closing every loophole or further refining the AMIT rules.

For all of us, let's see the development of the CCIV as an opportunity to embrace a new expansive approach to getting to the desired destination.

The real opportunity for Australia

We can easily create a long list of technicalities that arise for CCIVs. One need only consider the 13-year evolution of the taxation of financial arrangements rules as an example of what to avoid. It has taken 13 years to get the CCIV legislation passed. Let's not spend another 13 years trying to perfect the rules seeking outcomes based on tortuous interpretations that can create uncertainty and thereby diminish the potential of the CCIV.

Let's find the simplest way to get to our destination. Perhaps our capacity to do this will provide a window into our capacity to execute on our broader desire to be a regional financial centre, not just for CCIVs and fund passporting, but for financial services in the new world.

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Successful Succession

by Tim Donlan, ATI, Donlan Lawyers

Family succession: encourage with caution

A recent case involving sharefarmers has highlighted that parties must be mindful of the potential legal effect of representations made by them to others.

Experienced professional advisers will generally suggest that commercial arrangements concerning their clients are properly documented. While laws in Australia and other jurisdictions generally require dealings with land to be evidenced in writing,[1] there are exceptions to that requirement based in various equitable doctrines. Equity may enable relief against unconscionable outcomes where written formalities are not satisfied.

The doctrine of equitable estoppel operates where a party encourages another to believe that a contract will come into existence or a promise will be performed, and that other party relies on such conduct or encouragement in circumstances where departure from the assumption by the first party would be unconscionable.[2]

In simple terms, if A represents to B that it will do something and B relies on that representation to its detriment, subject to the various criteria that must be satisfied, B may have a remedy in equity to enforce the substance of the representation.

It is important to note that equitable estoppel operates on representations or promises as to future conduct. It is not necessary for the representation to be promissory in form. It is also not the case that every unsatisfied representation will afford a remedy.

In *Stone v Kramer*, Robb J (referring to *Austotel Pty Ltd v Franklins Selfserve Pty Ltd*[3]) stated:[4]

> "… the issue of whether the departure is unconscionable depends on the particular circumstances of the case, so that if the nature of the representation and the circumstances in which it is made are calculated to induce reliance by the plaintiff, departure from the assumption may be unconscionable even if the defendant does not subjectively understand that the representation has motivated the plaintiff's reliance."

In Australia, equitable estoppel traditionally comprises two branches — promissory estoppel and proprietary estoppel.

Proprietary estoppel concerns representations or promises relating to land and can itself be broken down into two sub-branches:

- estoppel by encouragement; and
- estoppel by acquiescence.

Estoppel by encouragement arises:[5]

> "… where the owner of land creates or encourages in another person an expectation that the person will have a certain interest in the land and that person changes his or her position on the faith of that expectation."

Estoppel by acquiescence is established:[6]

> "… where an owner of land, being aware of his/her rights and also that that are being infringed by another, who to his/her knowledge is mistaken about his/her rights, stands in silence in order to profit by the other person's mistake."

In *Stone v Kramer*,[7] the New South Wales Supreme Court recently considered the elements of proprietary estoppel in circumstances where a sharefarmer was ultimately awarded the full beneficial ownership in the relevant land, based on representations made to him by the owners prior to their deaths.

Stone v Kramer

Background

The proceedings concerned a rural property of approximately 100 acres at Upper Colo, New South Wales (the Colo property). The plaintiff, David Stone, brought an application in 2017 against the executor of the estate of the late Dame Leonie Judith Kramer (the deceased). At the time of her death in 2016, she was the sole proprietor of the land. By her will, she left the entire property to her daughter. During her lifetime, she had made oral representations to Stone that she would leave the farmland to him.

Prior to his death in 1989, the other owner of the land had been Dame Leonie's husband, Dr Harry Kramer. He had also made representations to Stone about leaving the land to him.

Unlike in many farming estoppel cases, the Kramers and the Stones were not family relatives.

The basis of the claim, and the relief sought by the plaintiff (Stone), was that both Dr Harry and Dame Leonie had represented to him that the land would be left to him in their wills and that it was unconscionable in the circumstances that the land was instead left to another.

Facts

The plaintiff (Stone) had sharefarmed the land with Dr Harry and Dame Leonie for approximately 40 years pursuant to a sharefarming agreement that was purely oral in nature. He claimed that the representations made to him by Dr Harry and Dame Leonie had induced him to remain on the farm and to forgo other more lucrative endeavours on the basis of his future ownership of the land.

The representations collectively alleged by the plaintiff were:

- some time in the 1980s, Dr Harry had represented to him that he would, through his will, leave him a life interest in the land;
- later in 1987 or 1988, just prior to his death, Dr Harry had represented that he was leaving ownership of the land via his will to Dame Leonie but that she would leave the land to the plaintiff in her own will thereafter; and
- in 1988, after Dr Harry's death, Dame Leonie (the deceased) represented to him that she would leave the land to him in her will, together with money.

The plaintiff alleged that all three representations were predicated on the basis that he continue to manage and sharefarm the land and perform other services with respect to it.

The defendants in the proceedings were the executor and daughters of Dame Leonie and Dr Harry. They stood personally to benefit pursuant to Dame Leonie's will if the land passed to them and not to Stone.

They argued that the deceased had not made the representations to Stone. They also argued that, if they had been made, they were not aware that Stone had relied on the representations to his detriment and that the representations were not otherwise the only reason for Stone remaining on the Colo property and continuing to sharefarm it.

The defendants also argued that, if the court were to make a finding that the relevant representations had been made, it would consequently be required to make a finding that the deceased had acted "dishonestly". That argument was dismissed.

Finally, the defendants argued that the claims of Stone to equitable relief should be dismissed on the basis that he had failed to properly account to the deceased in relation to the sharefarming business, failed to operate the farm in a proper business-like manner (that he had essentially breached the terms of the sharefarming agreement), and that he had received other benefits from the deceased during her lifetime and in her will that should prevent the relief sought by him. Those particular arguments were effectively dismissed outright.

The defendants' denial of the deceased's representations to Stone in relation to the ownership of the land comprised much of the proceedings. Stone alleged specific conversations, such as where the deceased had said to him:

> "[Dr Harry] always admired your honesty. [Dr Harry] and I did agree the farm will pass to you upon my death and I want you to know there will also be a sum of money."

The court accepted the evidence of Stone in that regard.

The law

It is recognised that, whereas clear and unambiguous language in relation to representations may be required to support some branches of equitable estoppel, that requirement does not apply to proprietary estoppel.

Stone's case was based in a branch of proprietary estoppel, that is, estoppel by encouragement.

In *Doueihi v Construction Technologies Australia Pty Ltd*,[8] the New South Wales Supreme Court (referring to the High Court decision in *Waltons Stores (Interstate) Ltd v Maher*[9]), discussed the requirements for promissory estoppel to be established:

> "The need for 'something more' than mere reliance on an executory promise, is readily understandable in cases of promissory estoppel where the parties expect to enter into a contract or otherwise formalise their legal relationship. Without 'something more' a departure from the basic assumptions underlying the transaction between the parties is not unconscionable."

The "something more" manifested in *Waltons Stores (Interstate) Ltd v Maher* was an expectation or assumption that "a particular legal relationship" would exist and that the other party would not withdraw from the negotiations.[10]

In *Stone*, the court recognised that the parties did not contemplate that they would enter into any *formal* legal arrangement with respect to Stone's future ownership of the Colo property. Rather, the court (citing from *DHJPM Pty Ltd v Blackthorn Resources Ltd*[11]) referred to a generally recognised dichotomy of cases where:

> "*Most* fall into one of two categories; those where the parties are in a domestic or family relationship, and those where the relationship is commercial. Parties in the latter category *typically* contemplate a legal relationship and frequently intend to enter into a contract or otherwise formalise their expectation.
>
> In domestic or family cases, the parties are not at arm's length and *usually* have no intention of entering into a contract or formalising their expectation. The party encouraged will frequently expect to receive a gift, inter vivos or testamentary." (emphasis added)

The court reached the view that the relationship between Stone and Dr Harry and Dame Leonie was something of:[12]

> "… an informal halfway house between a commercial and a domestic [relationship], and that even though there was an underlying commercial relationship in the form of the share farming agreement, the parties to that agreement substantially acted upon the basis of trust and the give and take that would commonly characterise a domestic relationship."

The precise terms of the legal relations between the parties and Stone's future ownership of the land were held to be unnecessary to establish. The court held that Stone was entitled to have the Colo property transferred to him. In doing so, it rejected an argument from the defendants that an appropriate remedy could be something less than transfer of the property, and emphasised the general principle in proprietary estoppel cases that the estopped party can only fulfil their obligation by making good the expectation that has been encouraged.[13]

Important other findings

Some of the defences raised by the defendants and addressed by the court clarified certain aspects required to make out an estoppel by encouragement.

First, the court held that the deceased did not have to have subjective knowledge that Stone had relied on the representations in staying on the Colo property and not pursuing other career opportunities. It was enough that the representations reasonably induced such conduct, regardless of what the representors believed. Second, the representations did not need to be the sole reason for Stone engaging in such conduct. It only needed to be "a real and significant factor in him doing so".

Lastly, the court was asked to consider that a finding that representations had been made by the deceased and not met by her would necessitate a finding of "dishonesty". The court did not make any such finding and observed that a finding that a person has acted unconscionably did not require a finding of dishonesty, and that there may be various reasons for a departure from the representation. Such reasons could include circumstances where the representor did not appreciate the significance of the representation on the other person or did not appreciate that they were relying on it. In addition, the court observed that the deceased may simply have forgotten about the representation or its terms as she was suffering from dementia in later years when she changed her will.

Advisers, particularly those assisting clients with estate planning and succession, need to probe their clients very carefully as to previous representations made regarding future ownership of property, and not only representations made to family members. Particular emphasis needs to be placed on the weight of any representations that may have been made on the recipient and whether, in all of the circumstances, it would be reasonable for the recipient to rely on them and whether they had done so.

As stated by the court in *Stone*:[14]

> "… whether a representation or promise has been made, and if so what its meaning is, must be judged 'objectively according to the impact that whatever is said [or done] may be expected to have on a reasonable representee in the position and with the known characteristics of the actual representee."

Conclusion

While testamentary freedom remains a significant feature of the Australian legal system,[15] a testator's freedom to dispose of their assets by will is subject to contractual obligations existing on a testator at the time of death. It is also subject to equitable intervention which may not be understood by the parties and which can upset estate and succession planning if not carefully managed.

Advisers should make their clients aware of the risks of making representations with unintended consequences and encourage them to reduce intended or proposed commercial or family arrangements to writing. Encouraging (or allowing others to be encouraged) as to future arrangements or ownership of property in the absence of some certainty for each party should be discouraged.

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1 See, for example: s 26 of the *Law of Property Act 1936* (SA); s 11 of the *Property Law Act 1974* (Qld); s 42 of the *Real Property Act 1900* (NSW); s 34 of the *Property Law Act 1969* (WA); s 126 of the *Instruments Act 1958* (Vic).

2 *Austotel Pty Ltd v Franklins Selfserve Pty Ltd* (1989) 16 NSWLR 582.

3 (1989) 16 NSWLR 582.

4 [2021] NSWSC 1456 at [35].

5 E Finnane, "Equitable interests in land arising from estoppel", College of Law, Sydney, 9 March 2010, citing K Handley, "Estoppel", (2006) 20(2) *Commercial Law Quarterly* 29 at 31.

6 Ibid; see also *Ramsden v Dyson* [1866] LR 1 HL 129.

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8 [2016] NSWCA 105 at [158].

9 (1988) 164 CLR 387.

10 (1988) 164 CLR 387 per Mason CJ and Wilson J at 406, and per Brennan J at 422-423.

11 [2011] NSWCA 348 at [104]-[105].

12 [2021] NSWSC 1456 at [41].

13 *Giumelli v Giumelli* [1999] HCA 10.

14 [2021] NSWSC 1456 at [228].

15 Various family maintenance legislation exists in all jurisdictions that may otherwise impair a testator's absolutely freedom of testation.

Tax and the rule of law

by Mark Leibler AC, CTA, Senior Partner, Arnold Bloch Leibler

The following Annual Tax Lecture was presented at Melbourne Law School on 23 March 2022.

Introduction

Thank you, Professor Pip Nicholson. And thanks to Melbourne Law School, Professor Miranda Stewart and the Tax Group for inviting me to present this year's lecture. It is a great honour.

I would also like to recognise the Hon. Susan Crennan.

Let me start by acknowledging the traditional owners of the land on which we gather this evening, and paying respect to their history, rich culture and unique, ongoing contribution to this magnificent city.

The rule of law is a wide-ranging concept.

This evening, I will be focusing on its significance for the administration of the Australian tax system.

In particular, I want to explore whether, in circumstances where there is a change in the interpretation of particular tax laws or a longstanding administrative practice, we can be certain that the Commissioner of Taxation exercises his extensive powers within a framework which is consistent with the rule of law and the fair treatment of taxpayers.

As an aside, I should explain that I am using the pronoun "his" for simplicity's sake because the incumbent Commissioner and all of his predecessors are male, while recognising and celebrating the fact that future occupants of the role will undoubtedly include women.

I will be exploring how the Commissioner currently uses his power of general administration, the private and public ruling system, and the statutory remedial power to manage such situations. This exploration will also encompass how similar situations are managed in other jurisdictions.

As we will find, none of these mechanisms is entirely satisfactory in ensuring that taxpayers are always treated fairly and with due consideration.

The solution, I believe, is to be found in a new statutory protection for taxpayers who rely on the stated positions of the Commissioner of Taxation and established administrative practices.

This, in my view, is the only way to ensure sufficient protection for taxpayers, whilst, at the same time, preserving the rule of law and enhancing public confidence in the tax system.

Background

The rule of law is the fundamental principle upon which law-making and governing are founded. It is the cornerstone of civilised society. Put most simply, it protects us from tyranny.

Central to the rule of law is the premise that the power of the executive government is exercised according to an independent justice system. That power must be restricted to the bounds set down by the law, and must rest with a democratically elected body which is ultimately answerable to the people at elections.

Today, that seems a trite summary but it has not always been so.

Wars have been fought, governments toppled and monarchs executed over the rule of law generally, and the power to tax in particular.

The tax system ogles every corner of our society — scrutinising how we live, how we work and how we trade. It cannot be avoided, meaning just about all of us, at some stage of our lives, will interact with tax law and the tax system.

This is why the rule of law is fundamental to the development and administration of our tax laws. Without it, taxpayers could be subject to arbitrary exaction by the government. Taxation would be little more than state-sanctioned theft on a grand scale.

Fortunately, we do not find ourselves in that position in Australia. But extreme potential consequences should never be far from our minds as a backdrop for policy development and administering the tax system.

Upholding the rule of law in the taxation context means that:

- taxation must be according to law;
- the law must be available and clear to taxpayers; and
- the Crown should deal fairly with its subjects.

To that end, we have a number of well entrenched principles. Since 1689, the *Bill of Rights* has provided:

> "That levying money for or to the use of the Crown by pretence of prerogative, without grant of Parliament … is illegal."

The High Court has also expressed the clear view that taxation is not a prerogative power and that the Crown cannot impose tax without the authority of parliament.

That said, the reality is that assessment, collection and administration of the tax system must necessarily be undertaken by an officer of the executive government, that is, the Commissioner of Taxation.

It is the Commissioner's duty to ensure the correct amount of tax is paid by each taxpayer "not a penny more, not a penny less".

The sheer scale of that task means that the Commissioner must have many powers, sometimes frighteningly invasive powers, and many subordinates to facilitate the task of obtaining information and/or bringing compliance action against taxpayers.

Even before compliance and recovery work can begin, the Commissioner must form a view about how the tax law operates and applies to particular taxpayers, and effectively and consistently inform taxpayers of that view.

Theoretically, as an officer of the executive, this should be a straightforward process: the Commissioner should merely execute the commands of parliament as they are set down in the relevant legislation. That would be taxation according to law.

However, in practice, as the tax legislation becomes more voluminous and complex, and with taxpayers' affairs becoming more sophisticated, it increasingly falls on the Commissioner, at least in the first instance, to decide if and how the law applies, sometimes with only minimal guidance from the legislation.

In this environment, it becomes vitally important that taxpayers understand their obligations and have confidence in both the Commissioner and the system more broadly. The only way to instil that confidence is for the Commissioner, by which I really mean tax officers at all levels, to deal with taxpayers fairly and consistently.

This is especially important where the Commissioner has long adopted a particular interpretation of the law or approach to an issue which may be debatable or not clearly required by the law.

For example, the Commissioner has never sought to apply s 99B of the *Income Tax Assessment Act 1936* (Cth) to resident trusts that have never accumulated foreign income. Although this seems consistent with the purpose of the provision, it is not clear either on a literal reading of the statute or the relevant case law that s 99B is confined in that way. Nor is there a public ruling, although there are a few private rulings which directly support that view.

The Commissioner could, if so inclined, change his mind tomorrow and, subject to the time limits imposed by s 170 of the 1936 Act, commence issuing amended assessments on the basis of a literal reading of s 99B. This would be a major reversal and many taxpayers could find themselves adversely impacted by the Commissioner's change of position.

Those taxpayers might have otherwise been fully compliant and quite legitimately adopted an interpretation which not only appears to be consistent with the law, but is also consistent with the Commissioner's position over many years. Even so, they would have no protection if the Commissioner suddenly shifted his approach and their only recourse would be long and expensive litigation under Pt IVC.

Would that inspire confidence in the Commissioner or the tax system? Would it be just?

So we have a tension: does the requirement that taxation be in accordance with the law also mean that the taxpayer has no protection from changes by the executive government?

Is there protection if a decision of a court either overturns an earlier precedent or interprets the law in a way that differs from the Commissioner's longstanding interpretation, established without any binding authority?

Strict adherence to the law, newly articulated by the court or re-interpreted by the Commissioner, with retrospective effect, would lead to taxpayers being punished for following the Commissioner's established approach at the time. Short of time travel, what can even the most conscientious taxpayers do to protect themselves?

Within the confines of the Commissioner's duty to collect the right amount of tax under the legislation, there must be room for the Commissioner to act concessionally in these kinds of circumstances. Circumstances where concerns of clarity, confidence, equity and fairness (which in themselves contribute to upholding the rule of law) demand an approach not strictly in accordance with the letter of the law.

In practical terms, it is possible that this objective can be achieved in three ways:

1. the power of general administration, specifically the allocation of compliance resources;
2. a system of rulings; and
3. a statutorily sanctioned remedial power.

As I will explain, each of these options goes some way to relieving the problem but, until there is a legislative protection for taxpayers who reasonably rely on the Commissioner's practice, the proper balance cannot be struck.

And let me make it quite clear that the observations I am making here should not be interpreted as criticism of either the Commissioner or the Tax Office, who have no choice but to operate within the paradigm delivered to them by legislators and the courts.

Powers of general administration

Firstly, to the power of general administration over which the Commissioner presides.

The general administration power authorises the Commissioner to take action incidental to, or consequential upon, other express powers, such as:

- the power to audit taxpayers at random;
- the power to settle or compromise proceedings; and
- the power to decide whether to allocate limited compliance resources to an issue.

This power has been used pragmatically and generally leads to better outcomes for the tax system and Australian taxpayers as a whole.

For example, in 2014, I was heavily involved in the formulation and implementation of an initiative called Project Do It, whereby the Commissioner gave taxpayers the opportunity to voluntarily disclose offshore interests that had not previously been declared. The Commissioner decided not to apply resources to the issue of fraud or evasion and, consequently, confined reassessments to the four-year period.

Although the Commissioner could not guarantee that taxpayers would not face criminal prosecution, the program was supported by AUSTRAC and the Director of Public Prosecutions.

In practice, the likelihood of any prosecution was minimal.

Taxpayers were given protection in exchange for normalising their overseas arrangements. And by the end of the project, some $6.7b of previously undisclosed assets were brought within the Australian tax net.

This was a pragmatic and efficient use of the power to compromise, which certainly benefitted the tax system as a whole, but also meant greater peace of mind for individual taxpayers who had made use of the protections on offer. Many of them had historical overseas assets that they were afraid to disclose lest the Commissioner initiate prosecutions and seek to tax decades of overseas income.

It provided a fine example of the Commissioner deciding not to allocate resources to a particular issue where that approach was viewed as being beneficial to tax administration.

In determining whether to go down this path, the Commissioner has stated, both publicly and privately, that the decision is — and I quote — "not simply a narrow cost-benefit analysis" of expected revenue against cost of collection, but takes "into account the broader health of the tax system, and especially the public confidence in tax administration" which might otherwise be undermined by a decision to pursue the law strictly.

That is wise policy. The limited resources of the Commissioner should be used to strengthen the system as a whole and to be in the long-term national interest, not merely to collect revenue today.

The approach is often used where the Commissioner has previously adopted one interpretation of the law and later changed the interpretation so that the Tax Office will only apply resources to enforcing the new interpretation prospectively.

But it doesn't entirely solve our dilemma.

In such cases, the Commissioner will refrain from initiating audits on those issues in periods before his change of view. However, if the Commissioner is asked to rule on the issue, or it arises in another context (such as an audit around something else), he considers himself bound to apply his "new" view of the law. It is a limited concession and purely administrative.

Compare that to the legislative protection in s 170B of the 1936 Act. This provision protects positions taken in anticipation of certain amendments that were announced between 2006 and 2012 but did not eventuate following the change of government in late 2013.

At that time, the legislative backlog meant that a number of measures had been announced in Budgets and elsewhere but not enacted. Anticipating that changes would be effective from the time of announcement, many taxpayers had taken positions off the back of those announcements. When the new government decided not to pursue the changes, they were left exposed.

Section 170B was enacted shortly after and prevents the Commissioner from amending an assessment in a less favourable way in respect of announced changes. It also "switches off" the machinery allowing the Commissioner to recover administrative overpayments.

This is a good example of statutory protection for taxpayers faced with a change in position, albeit a policy position rather than an interpretation of the law.

In the absence of such a statutory protection, the Commissioner recognises that the general administration power "cannot be used to remedy defects or omissions in the law".

So much was apparent from the decision in *Macquarie Bank Ltd v FCT* (2013) where the court rejected a contention that the so-called "U-turns" practice statement, PS LA 2011/27, prevented the Commissioner from applying his changed view of the law retrospectively.

In light of that decision, there remain significant questions about whether a taxpayer who has followed an interpretation previously accepted by the Commissioner is protected when those issues come to the attention of the Tax Office after the change of interpretation in the context of an audit, even an audit on other issues.

Is the Commissioner not duty-bound to make an assessment in accordance with the current interpretation of the law? Can a decision about resource allocation really absolve the Commissioner of that duty?

Although useful, resource allocation decisions are not the solution that taxpayers need.

There is a statutory protection from penalties if taxpayers apply the law consistently with an administrative practice. But taxpayers can still find themselves with amended assessments for substantial sums, even where they have always sought to adhere to the law in line with the Commissioner's then view of it.

Australia is not alone in having a general administration power that stops short of a discretionary power to grant relief.

In the United Kingdom, the notion that the general administration power provides for a "dispensing power" has been clearly rejected.

In *Vestey v IRC* (1980), the Inland Revenue Commissioners contended that a provision of the UK tax legislation deemed all beneficiaries of certain non-resident discretionary trusts to be assessable on all the income of the trust. The Commissioners could use their dispensing powers to determine the appropriate amount assessable to each beneficiary, provided the total amount assessed did not exceed the total trust income. The House of Lords found for the taxpayers, with Lord Edmund-Davies concluding that:

> "So remarkable are [the consequences of the Commissioners' contentions], and so disturbing are the unconstitutional devices now resorted to by the Inland Revenue Commissioners, that I am forced to the conclusion that the interests, not only of the respondents but of the public at large alike, demand that the claim of the executive in this matter be challenged and rejected."

In the court below, Walton J was scathing of the Commissioners' claim to a dispensing power, saying that "we are back to the days of the Star Chamber".

Even so, for many years, the revenue authorities in the UK allowed certain "extra-statutory concessions", which it published. These gave more favourable treatment to taxpayers than was provided for under the law.

The practice attracted mixed judicial comment over the years, some from the same judge in different cases. In 1968, in *IRC v Bates*, Lord Upjohn said:

> "… the Commissioners of Inland Revenue, realising the monstrous result of giving effect to the true construction of the section, have in fact worked out what they consider to be an equitable way of operating it which seems to them to result in a fair system of taxation. I am quite unable to understand upon what principle they can properly do so and, like Lord Reid, I hope this matter may receive some consideration in the proper place."

Yet, in the very next year, his Lordship observed that:

> "This practice is very old, works great justice between the Crown and the subject and I trust will never be disturbed."

The balance of opinion was critical and Lord Justice Scott in *Absalom v Talbot* (1943) captures the nub of the issue, which is equally applicable in Australia:

> "No judicial countenance can or ought to be given in matters of taxation to any system of extra-legal concessions. Amongst other reasons, it exposes revenue officials to temptation, which is wrong … The fact that such extra-legal concessions have to be made to avoid unjust hardships is conclusive that there is something wrong with the legislation."

Following the House of Lords' decision in *Wilkinson* in 2005, the practice of issuing extra-statutory concessions was curtailed.

The experience in the UK demonstrates the problems with granting concessionary treatment outside the authority of the legislation, and beyond scope of the general power to compromise a dispute.

It would be neither appropriate nor wise for Australia to attempt to follow that approach.

That said, some of the difficulty in the UK is relieved by the doctrine of "legitimate expectation". The doctrine stems from a tax decision regarding an agreement to settle a dispute and acts much like an estoppel by holding the tax authority to its representations. It is now a substantive protection that can be used against public authorities generally.

In the UK, this doctrine of legitimate expectation can be used against the revenue authority in the case of both published guidance and established practice. As Lord Wilson described it (2011), to establish a legitimate expectation in the case of a revenue practice, the taxpayer must have:

> "… evidence that the practice was so unambiguous, so widespread, so well-established and so well-recognised as to carry within it a commitment to a group of taxpayers including themselves of treatment in accordance with it."

In the United States, the general administrative power within the Internal Revenue Code has a broader application. Section 7805(a) of the Internal Revenue Code permits the Treasury to make broad-ranging regulations.

This provision is said to support Treasury's "longstanding administrative authority to grant transition relief when implementing new legislation". Often this involves relief from complying with procedural requirements. However, sometimes the provision has been used in direct contradiction to legislation that is expressed to be retrospective.

Whilst this generates some concern about the bounds of authority assigned to the Treasury, a power to grant relief, where it is not contrary to the intention of the legislature, is a valuable addition to the more general power of administration.

However, the breadth of the rulemaking power in s 7805 has also been used against taxpayers. It allows the revenue authority to issue what we would regard in Australia as regulations or subordinate legislation, with statutory force.

But, unlike Australia, where regulation-making power is usually confined to a narrow field, the US Treasury issues regulations explaining its interpretation of the tax law.

Following the US Supreme Court's decision in *Chevron USA Inc v National Resources Defense Council Inc* (1984), regulations issued by an administrative body are followed by US courts unless they are "arbitrary, capricious or manifestly contrary to the statute". That applies equally to Treasury regulations in the tax context.

The result is that the revenue authority in the US can promulgate its view of the law, which the courts must follow, even if its construction is not the court's preferred one. In some cases, this has been used to affect the outcome of litigation on foot with so-called "fighting" regulations.

In *Mayo Foundation for Medical Education & Research v United States* (2011), regulations were made after the revenue authority lost a previous case against the same party. The court extended *Chevron* deference to tax regulations and said, "we have found it immaterial to our analysis that a 'regulation was prompted by litigation'".

This demonstrates the danger of carte blanche delegated authority to the revenue authority and indicates that any power to grant relief on a change of interpretation given to the Commissioner in Australia must only be capable of exercise for the taxpayer's benefit.

Ruling regime

So, let's move on now to the power of rulings.

Where a particular interpretation or practice has been adopted in the past, estoppel (or an administrative law remedy to the same effect) is not available against the Commissioner.

The public ruling system provides a degree of relief from this problem, but it is necessarily limited to issues of sufficient importance that a ruling is made.

Since 1992, there have been formalised public and private ruling structures supported by legislation. They are generally binding on the Commissioner. However, a taxpayer can still take advantage of the law in a way that is inconsistent with a ruling if it is more favourable to the taxpayer.

The ruling system was, and is, an important mechanism for providing certainty to taxpayers and a valuable means of dealing with issues as they arise without having to resort to knee-jerk legislative fixes, which risk unintended consequences or, alternatively, drawn-out legislative reform.

As I have said previously, in the case of complex commercial transactions dealing with uncertain areas of the law, the only real way of achieving certainty in Australia is to obtain an early ruling. In that way, the Commissioner essentially acts as lawmaker.

If the taxpayer disagrees with the Commissioner's position, they must accept it or resort to protracted and expensive litigation. Of course, many taxpayers decide not to, or simply cannot afford to, pursue that avenue.

From a whole-of-system point of view, approaching the Commissioner for a private ruling for every potentially contentious transaction is not the most efficient way of giving certainty to taxpayers. And the Tax Office would likely be overwhelmed by private ruling applications if every taxpayer sought a ruling whenever they were uncertain.

At the same time, the tax law is so extensive that the Commissioner cannot reasonably be expected to have detailed public rulings on every area.

Despite the value of rulings, particularly public rulings, there is a temptation to deal with issues quickly through a ruling or some other form of non-legally binding guidance at the expense of a proper process of considered legislative reform.

The result is that deficient legislation is left untouched, and a complex web of rulings or administrative guidance is spun around it.

It is a lazy, timid way to avoid the real issue.

Even if rulings or administrative guidance are seen as only a temporary fix, when a long legislative reform agenda competes for parliamentary time, a temporary fix can easily become a permanent ersatz solution.

One recent example which could well have fallen into that category is the Commissioner's current interpretation of the non-arm's length income rules as they relate to outgoings incurred by superannuation funds.

In LCR 2021/2, the Commissioner states that outgoings incurred at less than arm's length rates that are not referrable to any one asset taint all the fund's income as non-arm's length income to be taxed at the top rate. The ruling recognises concerns over the severity of such an outcome.

In the case of large APRA-regulated superannuation funds, the Commissioner's solution to these concerns is to only apply compliance resources to reviewing documentation that evidences appropriate internal controls and that reasonable steps were taken in determining an arm's length expenditure amount, but not to determining whether an arm's length amount was *actually incurred*.

No doubt this is a commendable attempt to relieve the most onerous and inequitable results stemming from the Commissioner's interpretation. However, if that interpretation is correct, this is clearly a problem that can only be resolved by legislative reform.

And, indeed, only yesterday, after a year of political advocacy by the professional bodies led by The Tax Institute, the government committed to developing legislation to fix this issue.

The issue of change of interpretation and retrospectivity is particularly acute in the case of public rulings. Although rulings are usually stated to apply before and after the date of the ruling, in these cases, the Commissioner will often take a position to not commit resources to the issue for periods before the change of view.

However, many practitioners will be familiar with the approach in TR 2010/3 and PS LA 2010/4 in the context of Div 7A and the extended meaning of "loan" being applied to unpaid present entitlements from trusts, but only for UPEs arising after 16 December 2009.

Before that date, the Commissioner had publicly taken the position that UPEs were not loans within the meaning of the provisions, although not in a binding ruling.

The approach to the new ruling went one step further than not applying compliance resources. Rather than publishing the new view, applicable before and after the date of the ruling, with a policy not to apply compliance resources to UPEs arising before that date, the ruling explicitly stated that it applied only prospectively on this issue.

The ruling, together with PS LA 2010/4, purports to do precisely what *Macquarie* decided the Commissioner cannot do: apply a view of the law that the Commissioner thinks is wrong, based merely on timing.

Where there was an old ruling expressing the old view, taxpayers were protected by the binding nature of that old ruling. However, where there is no ruling, just an understood practice, the taxpayer is left with no assurances other than the resource allocation decision.

As we have seen, that is not satisfactory.

In the US, the IRS also publishes revenue rulings, distinct from the regulations discussed earlier, which are similar to public rulings in Australia. But unlike here, whilst they are not binding on courts in the same way as Treasury regulations, US courts afford a degree of deference to rulings, according to the quality of their reasoning and consistency with authority.

There is a statutory presumption that rulings are retrospective. However, the IRS can determine the extent of any retrospectivity, and its policy is not to make rulings retrospective if it would be harmful to taxpayers.

That said, it could change its policy at any time or make an exception in a particularly important case.

It has done precisely that in a number of cases where it has issued rulings during litigation in an attempt to influence the outcome.

Fortunately, US courts seem to have resisted those attempts and, because rulings are given less deference than regulations, have been able to give the ruling little weight.

However, the weight of authority in the US, as here, still appears to be that, apart from blatant cases of issuing rulings to affect ongoing litigation, the revenue authority can retrospectively change its view of the law, even where taxpayers have relied on its previous view to their detriment.

Of course, a degree of caution should be exercised when comparing the Australian and US ruling systems. Australian rulings are binding in a different way. They bind the Commissioner and, whatever the true state of the law, the Commissioner must apply the law in accordance with his rulings.

Presumably, once it is clear a ruling is wrong, public rulings will be withdrawn and private rulings will no longer be issued in those terms.

By way of contrast, in the US, rulings (and regulations) influence the positions taken by the courts. They shape the law in a fashion that is unfamiliar in Australia.

Remedial power

The remaining solution to the problem I'm canvassing with you this evening is for federal parliament to delegate remedial powers to the Commissioner for situations where gaps in the law are exposed, or where the letter of the law applies to the detriment of taxpayers in a way that is inconsistent with parliament's purpose. This might include cases where there has been a change of interpretation or practice.

One argument against any remedial power is that parliament can always amend the legislation. But the reality is that the process of legislative amendment and reform moves more slowly than one would wish, and the consequences of amendment are not always anticipated, particularly with such complex and interdependent tax legislation.

The current remedial power in Div 370 of Sch 1 to the *Taxation Administration Act 1953* (Cth) is the culmination of a long process of discussion and official review. It is intended to obviate:

> "… unintended consequences in the application of taxation laws which cannot otherwise be addressed by the general powers of administration …"

The current power allows the Commissioner to alter the law by legislative instrument where:

- the modification is not inconsistent with the intended purpose of the provision;
- the Commissioner considers the modification reasonable, having regard to that purpose and the costs of complying with the law; and
- the Commissioner has been advised by Treasury or the Finance Department that the modification would have only a negligible impact on the Budget.

Parliamentary oversight is maintained because parliament can disallow a legislative instrument within 15 sitting days of it being tabled in each House and there are restrictions on when and to whom the instrument applies.

However, the remedial power has been used on only five occasions.

Again, whilst this power is useful, it relies on a lengthy process of review and consultation and, in practice, has only been used to deal with minor matters.

Conclusion: a new tool

So, having explored three options to give taxpayers more certainty, and found each of them wanting, where do we land on this?

The conclusion I have reached is that the more fundamental issues which arise from a change in position on the part of the Commissioner, and the danger arising from action against taxpayers which is inconsistent with the objectives of clarity, consistency and fairness, can only be dealt with by broader protections grounded in legislation.

In order to protect the rule of law, and strike the necessary balance between collecting tax according to the letter of the law and the broader objectives underpinning a coherent tax system, taxpayers who reasonably rely on the practice of the Commissioner, in good faith, should be protected if the Commissioner changes course at a later date.

Taxpayers would have to prove an administrative practice, but this could be easily done where Tax Office publications existed or where the relevant administrative practice was well established.

One should expect that the statute would not set the bar to establishing an existing practice at an unreasonable level.

In such cases, it is necessary for continued clarity, confidence and trust in the tax system — ultimately for the rule of law — that taxpayers be relieved from tax shortfalls, penalties and interest.

By providing protection in legislation, there can be no question of the Commissioner exceeding his remit, unlike the so-called "dispensing power" once advocated for in the UK or the extra-statutory concessions there.

The provision could draw on existing learning in the UK regarding "legitimate expectation" and the protection against penalties for relying on administrative practice that already exists in s 284-224 of Sch 1 to the Administration Act.

The text of my suggested provision will be in the published version of this lecture, which I invite you to consider.

Without that protection, despite the Commissioner's power to allocate resources, issue rulings or provide minor relief by legislative instrument, taxpayers would be at the mercy of the Tax Office which could, perhaps even must, immediately issue assessments according to their current, albeit new, interpretation of the law, no matter the care taken by those taxpayers.

This serves no purpose to our society and is antithetical to the rule of law.

Whilst, for a time, the revenue take might be increased, the erosion of confidence and trust in the tax system would ultimately lead to a serious reduction in the willingness of taxpayers to voluntarily comply with their taxation obligations.

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Women in Tax – Purposeful Pursuits

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APRIL
27
Wed

WA
APRIL
29
Fri

VIC
MAY
6
Fri

1 CPD hour

National Infrastructure Conference

APRIL
28–29
Thu

NSW Online

12 CPD hours

Agribusiness Intensive

APRIL
28–29
Thu

QLD Online

12 CPD hours

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