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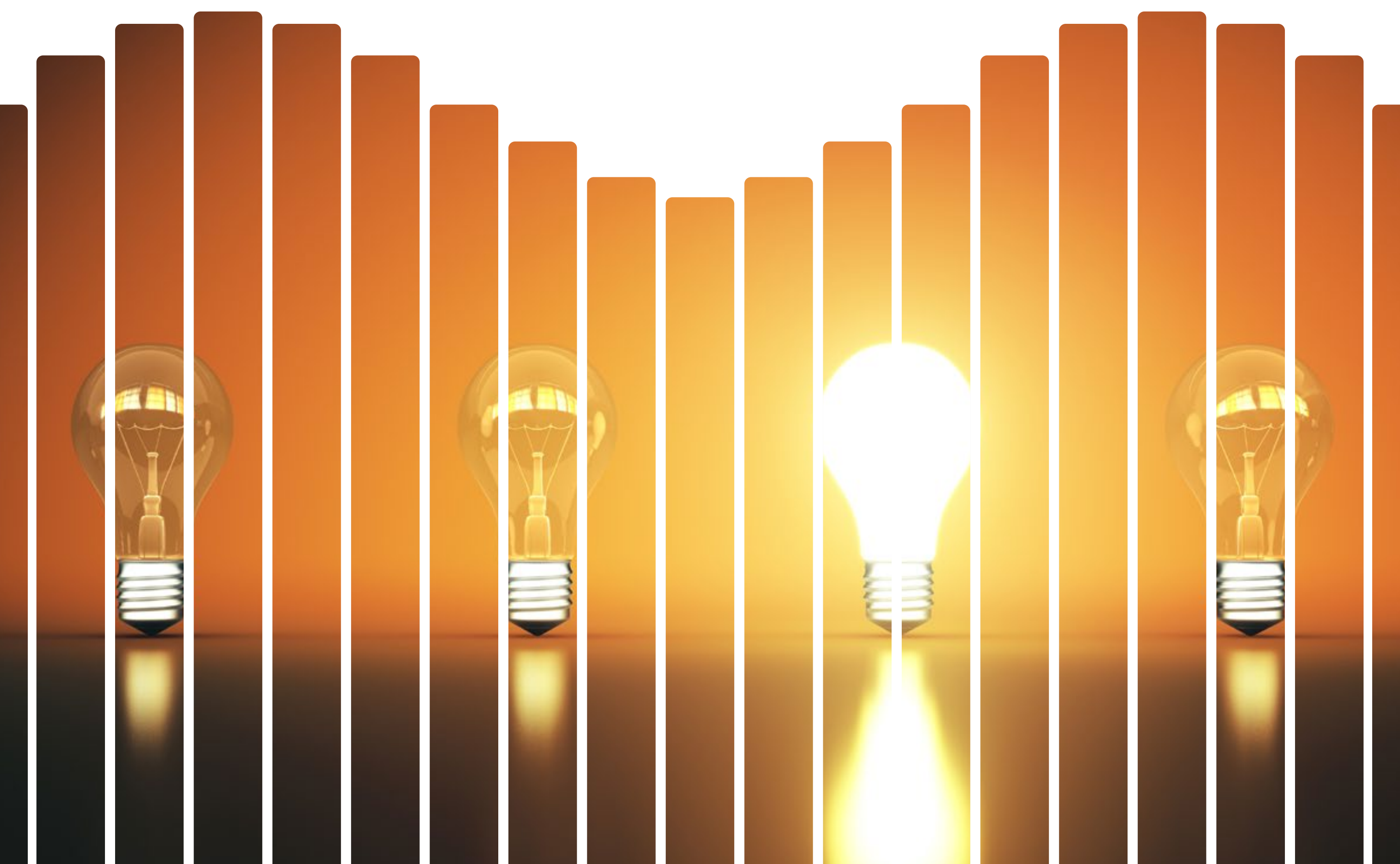
The Tax Institute

Taxation in Australia

Intangible integrity intensity
Chloe Burnett SC, ATI

Conditions of release
Julie Steed

The rules behind the NALI and NALE acronyms
Craig Day



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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.

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Tax News – at a glance

by TaxCounsel Pty Ltd

July – what happened in tax?

The following points highlight important federal tax developments that occurred during July 2023. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 62 (at the item number indicated).

Amendments now law

The *Treasury Laws Amendment (2022 Measures No. 4) Act 2023*, which received royal assent and became law on 23 June 2023, makes a number of significant amendments. **See item 1.**

Thin capitalisation and transparency amendments

An amending Bill, which was introduced into parliament on 22 June 2023, contains amendments to protect the integrity of the Australian tax system and improve tax transparency. **See item 2.**

Small business energy incentive

The government has released exposure draft legislation and explanatory materials in relation to the proposed Small Business Energy Incentive that is intended to help small and medium businesses electrify and save on their energy bills. **See item 3.**

Use of an individual's fame

The Commissioner has released a final determination in relation to arrangements where an individual with fame establishes an entity (the "related entity") and enters into an agreement with that entity for the use of their name, image, likeness, identity, reputation and signature (TD 2023/4). **See item 4.**

Travel and overtime meal allowances

The Commissioner has issued a determination that sets out the amounts that he considers are reasonable for the substantiation exception in Subdiv 900-B of the *Income Tax Assessment Act 1997* (Cth) for the 2023–24 income year (TD 2023/3). **See item 5.**

Diverting SMSF property development profits

The Commissioner has released a taxpayer alert in relation to arrangements under which profits of a property development project are diverted to a self-managed superannuation fund through the use of a special purpose vehicle involving non-arm's length arrangements (TA 2023/2). **See item 6.**

FBT: otherwise deductible rule

The Federal Court (Logan J) has held that travel expenses incurred by the taxpayer for fly in fly out employees did not, in the circumstances, satisfy the otherwise deductible rule and dismissed appeals against FBT assessments for the FBT years ended 31 March 2012 to 31 March 2019 (inclusive) which had assessed the taxpayer to FBT of $13m (*Bechtel Australia Pty Ltd v FCT* [2023] FCA 676). **See item 7.**

Project Wickenby: a rebound for the Commissioner

The Federal Court (Perry J) has, on the Commissioner's application, set aside the judgment of the Full Federal Court in *Rawson Finances Pty Ltd v FCT* ([2013] FCAFC 26) on the ground that it was obtained by fraud (*FCT v Rawson Finances Pty Ltd* [2023] FCA 617). **See item 8.**

Reimbursement agreement appeal

The Full Federal Court (Moshinsky, Colvin and Hespe JJ) has unanimously dismissed an appeal by the taxpayer from a decision of Thawley J in which his Honour held that an agreement to carry out various steps, including a buy-back of shares, constituted an agreement that fell within the reimbursement agreement provisions in s 100A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) (*B&F Investments Pty Ltd as trustee for the Illuka Park Trust v FCT* [2023] FCAFC 89). **See item 9.**

Rental property deductions

The AAT has held that a taxpayer was entitled to deductions in the 2017 income year for interest on a borrowing that was used to acquire a dwelling in the 2007 income year and for council rates, insurance premiums and land tax incurred in respect of the dwelling, where the dwelling had not been tenanted since 2012 (*DiStefano and FCT* [2023] AATA 1697). **See item 10.**

GST: was there a deposit?

In a recent decision, the AAT considered the question of whether an amount paid by a party to a contract for the supply of container homes was a security deposit for the purposes of Div 99 of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (*Container Homes Designer Domain Pty Ltd and FCT* [2023] AATA 1815). **See item 11.**

Benchmark interest rate: Div 7A

The Div 7A ITAA36 benchmark interest rate for the 2023–24 income year where a private company has a regular 30 June accounting period is 8.27%.

CGT improvement threshold

The CGT improvement threshold for the 2023–24 income year is $174,465.

President's Report

by Marg Marshall, CTA

Time to prioritise working well

President Marg Marshall on how efficiency, purpose and balance can help us to centre wellness in our busy professional lives.

Often repeated wisdom in offices around the world is to "work smarter and not harder". Valuable advice, but at a time when I know we are all busy, I want to encourage you to focus on working well.

By that, I mean working in a way that allows you to be and feel your best, both at work and outside of it. Working well is working with a mind toward your own wellbeing as well as professional outcomes.

"Wellness" is frequently talked about these days, and it can mean different things to different people. In the world of work, we are recognising more and more that wellness needs to factor into our professional spaces and plans. So, how do we "work well"?

Through my own experience, I can suggest three considerations that have helped me, and may help you too.

Efficiency

Working efficiently is about doing your best work, with an appropriate amount of effort – never cutting corners, but not exhausting yourself with busy-work either. In a profession where research, analysis and interpretation are a key part of our work, time can easily get away from us, especially when diving into a particularly thorny or interesting issue.

It's important to know when to say "enough". It's equally important to have the right tools at your disposal to facilitate efficient work. Time spent searching for resources is time you're not spending on growing your business, your career or on life's other important matters, like family, friends and self-care.

I hope that the resources, reports, papers and other analysis we share with you as a member assist you in working efficiently.

Purpose

In professional development conversations, we're often challenged to "find our why". I find that linking your work back to a purpose helps to maintain a clear focus and direction.

It may be a client goal, a personal goal such as a promotion or a personal best, or a larger goal – the betterment of the tax system, a benefit for your company, or a certain outcome for the community you live in. Your purpose may also be less tangible than this. Most of us like to feel we are having a positive impact on the world, and our work is one way we can do so.

A strong sense of purpose also allows you to clearly see your priorities. If the work you're doing is not aligned to your purpose, is it really necessary? Does it further the goals that truly matter to you? By keeping purpose at the centre of our work, we can feel good about the time we spend working.

Balance

We all know about work–life balance, but a reminder is always welcome.

Working from home especially can blur the lines between professional and personal life. Sometimes this is a benefit – I doubt any of us have ever before been so on top of laundry – but it can also be harmful. Working well means knowing when to switch off, knowing when to leave work behind in favour of family, friends and fun. It means dedicating time to the rest and recovery that is just as important (and crucial to) productivity.

I recognise that many of us have workloads that can make balance seem like a far-off dream sometimes. I hope that through the support and resources the Institute offers you, we can alleviate some of the time burden and help you to find more balance and work well.

Correction regarding recent letter

On Monday 3 July 2023, I wrote to you regarding recent updates in PwC's investigation into its handling of confidential Treasury information.

The Tax Institute holds itself and its members to the highest standard of professionalism and ethical conduct. We take these values and our professional obligations very seriously. We are the first to swiftly acknowledge and correct any mistakes that are brought to our attention and that we may make inadvertently.

In that letter, I made a comment that referred to the "removal" of four partners who were previously named by PwC. It was an error to use the word "removal" to describe those departures.

Both I personally, and The Tax Institute, sincerely apologise to those impacted by this misstatement for any hurt or distress caused.

We have also amended our website statement to reflect this.

Once again, we apologise to those who have been impacted by the misdescription and thank you for your continued support and understanding.

CEO's Report

by Chair and Acting CEO, Clare Mazzetti

You're at the heart of the Institute

Acting CEO, Clare Mazzetti, reflects on growing our membership and how your support is at the core of our organisation.

With a new financial year well underway, I trust you are on top of your client obligations and looking after your own needs as well. I echo Marg's sentiments about maintaining balance in your work and life, especially at this time of year.

If you have not yet done so, please take a look at our Tax Time hub where our Tax Policy and Advocacy team have put together quite comprehensive checklists and video guides on individual, company and trust tax returns. I hope these resources are useful and allow you to get your work done a little more efficiently this year.

Resources like this are part of our mission to ensure that you can work at your best, year-round. It has been so pleasing to see that nearly our entire membership has renewed for another year. That is perhaps the best endorsement of what we do and what we stand for.

We're glad to have you with us for another year. There are lots of exciting developments coming up over the next 12 months, and I'm glad to be able to share them with you. This includes further improvement to our website experience, continuing professional development events, and further advocacy on the issues that matter to you.

What lies ahead

Our dedicated members, like you, are the foundation of everything we do. Your ongoing support allows us to turn our sights to the future.

More than ever, in 2023–24, we are dedicated to the task of growing our member base and welcoming an increasingly diverse range of professional experience, ideas and individuals into our ranks. This benefits us all.

The Institute is a melting pot where tax professionals of all kinds – from accountants to legal practitioners, small business practitioners to in-house corporate advisers, sole traders to new graduates – come together to share their ideas and experience for the benefit of the entire tax community.

This breadth of thought improves our resources, many of which are driven by volunteer contributions. It also allows us to continue holding wonderful professional development events. The more tax professionals we can touch, the more we are able to secure expert speakers, hold events all around the country, and tailor programs to specific sectors of the industry. A large community also means a larger network for each member, as you can tap into fellow members for insights, opportunities and support.

Our advocacy also benefits from a wide and engaged membership. Understanding and representing your experiences in our advocacy work is vital to ensuring that we champion outcomes and processes that genuinely help you and your clients.

This is what we mean when we say our members are at the heart of everything we do: we would not be The Tax Institute, The *everything* Tax Institute, without you.

So, thank you for being here. Thank you for your continued support. We continue to work hard at supporting you in turn.

Senior Tax Counsel's Report

by Julie Abdalla, FTI

Design, consultation and time

Taking a step back and reflecting on the progress of the government's recent measures can assist in the design of a better taxation and superannuation system.

The government has announced, and is in the process of progressing, several key measures that will impact a broad range of taxpayers. These include: the proposed reform of the thin capitalisation regime; the denial of deductions for intangible assets located in low or no tax jurisdictions; the non-arm's length expense rules for superannuation funds; the proposed changes to several aspects of disclosure and reporting requirements; the implementation of the Organisation for Economic Co-operation and Development's Pillar 1 and Pillar 2; and the introduction of new integrity provisions, such as the franked distributions and capital raising measure.

The path of these measures towards enacted legislation provides some useful insights about the principles that should be kept in mind when designing taxation and superannuation law and policy.

Addressing complexity and cost

Australia's taxation and superannuation systems are complex. This complexity seems to be a constant feature that worsens rather than improves over time. In 2015, it was estimated that the taxation legislation ran to more than 14,000 pages — a number that seems to grow at an alarming pace every year. Making changes to existing provisions is a challenging task, with the potential for countless unintended consequences creating complexity for law and policy makers, and taxpayers alike.

One of the most concerning consequences is the ever-increasing compliance and administration costs imposed on taxpayers, and the administrator. The above measures, if not carefully designed and implemented, have the potential to place an even greater compliance burden on taxpayers and the administrator.

We need to move towards a system that is simpler, promotes efficiency, reduces the financial impact on taxpayers of compliance, and strives to be equitable to taxpayers. This starts at the initial policy stages and relies heavily on input from industry as to practical operation and impacts.

Collaborative policy development

Policy announcements can originate from the need to address a perceived problem or achieve an objective, for example, targeting a mischief in the system or increasing revenue receipts. By the time the policy parameters are determined, the scope of enabling legislation is often all but set in stone. From this point on, it can be extremely difficult to effect change and seek clarifications in the policy or proposed law. Ultimately, this can lead to law that creates disproportionate economic outcomes or compliance burdens, particularly for taxpayers who are inappropriately impacted by the particular measure.

Seeking input from the industry and professional associations at an earlier stage can mitigate this risk by providing a broader range of insights from a diverse pool of experience. A collaborative approach earlier in the process can better identify the intended policy outcome and balance it against the compliance burden and other impacts on taxpayers.

The need for time

Some of the measures are proposed to commence (now, retrospectively) on 1 July 2023. However, despite this date passing, enabling legislation has not yet been passed. This puts taxpayers in a difficult position. They lack certainty regarding their tax obligations, as well as guidance on how best to comply with them. Taxpayers need time to understand the position at law and ensure that their reporting and information systems are adequately prepared to allow them to meet their obligations.

Despite concerns raised by industry, professional associations including The Tax Institute, and other stakeholders, only the Country-by-Country reporting measure has had its commencement date delayed. It is imperative that law and policy design factor in inevitable delays and allow realistic time to adequately address complexities in what is proposed. Delaying the start of a major measure can reduce administration costs and ensure better compliance in the long term. It also increases the opportunity to identify and address potential issues at an early stage.

Looking ahead

Most importantly, significant changes need to be part of a broader vision. Changes are often announced and designed in the context of smaller projects or outcomes. This "tinkering" approach lends itself to a fragmented system, reinforcing the problems of complexity and compliance costs.

The Tax Institute continues to advocate for a system that is simple, fair and efficient. We acknowledge that reform is a lengthy process that takes time to design and implement. Measures designed and introduced by any government should be framed towards this overarching objective. Only then can we address systemic issues, ensuring that we are progressing towards a better taxation and superannuation system for all Australians.

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Tax News – the details

by TaxCounsel Pty Ltd

July – what happened in tax?

The following points highlight important federal tax developments that occurred during July 2023.

Government initiatives

1. Amendments now law

The *Treasury Laws Amendment (2022 Measures No. 4) Act 2023*, which received royal assent and became law on 23 June 2023, makes a number of significant amendments. The amendments that should be particularly noted are set out below.

Digital currency

Amendments to the *Income Tax Assessment Act 1997* (Cth) (ITAA97) and the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GSTA99) clarify that digital currencies (such as bitcoin) continue to be excluded from the income tax treatment of foreign currency. For the purpose of these amendments, the term "digital currency" does not include digital currencies issued by, or under the authority of, a government agency (government-issued digital currency) which continue to be taxed as foreign currency.

The amendments to the ITAA97 apply to income years that include 1 July 2021 and later income years. The amendments to the GSTA99 and the *A New Tax System (Goods and Services Tax) Regulations 2019* (Cth) apply in relation to supplies or payments made on or after 1 July 2021.

FBT record-keeping

Amendments to the *Fringe Benefits Tax Assessment Act 1986* (Cth) reduce compliance costs for employers finalising their FBT returns by empowering the Commissioner to allow them, where it is appropriate to do so, to rely on adequate alternative records holding all of the prescribed information instead of seeking that information again by way of statutory evidentiary documents, such as prescribed employee declarations.

These amendments apply to the FBT year starting on 1 April 2024 and subsequent FBT years.

Skills and training boost

Amendments made to the *Income Tax (Transitional Provisions) Act 1997* (Cth) provide small businesses (with an aggregated annual turnover of less than $50m) with access to a bonus deduction that is equal to 20% of eligible expenditure for external training provided to their employees.

This is a temporary measure to incentivise small businesses to train and upskill their employees, helping to build a more productive workforce.

The amendments apply to eligible expenditure incurred from 7:30 pm (by legal time in the Australian Capital Territory) on 29 March 2022 until 30 June 2024. The amendments apply to enrolments or arrangements for the provision of training made or entered into at or after 7.30pm (by ACT legal time) on 29 March 2022.

Technology investment boost

Amendments made to the *Income Tax (Transitional Provisions) Act 1997* provide small businesses (with an aggregated annual turnover of less than $50m) with access to a bonus deduction that is equal to 20% of their eligible expenditure on expenses and depreciating assets for the purposes of their digital operations or digitising their operations.

This is a temporary measure to support small businesses to operate digitally. The bonus deduction applies to the total of eligible expenditure of up to $100,000 per income year or specified time period, up to a maximum bonus deduction of $20,000 per income year or specified time period.

These amendments apply to eligible expenditure incurred from 7:30 pm (by ACT legal time) on 29 March 2022 until 30 June 2023.

2. Thin capitalisation and transparency amendments

The Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023, which was introduced into parliament on 22 June 2023, contains amendments to protect the integrity of the Australian tax system and improve tax transparency.

Thin capitalisation

Amendments in the amending Bill will limit the amount of debt deductions that multinational entities can claim in an income year. The new thin capitalisation rules seek to align with the OECD's earnings-based best practice model which allows an entity to deduct net interest expenses up to a benchmark earnings ratio.

The Bill also contains amendments to strengthen the thin capitalisation rules in Div 820 ITAA97. The amendments address risks to the domestic tax base arising from the excessive use of debt deductions, which amount to base erosion or profit shifting arrangements. The amendments introduce new thin capitalisation earnings-based tests for a certain class of entities, replacing the existing asset-based rules for those entities. The amendments also establish a new arm's length debt test in the form of a third party debt test.

A proposed new Subdiv 820-EAA ITAA97 contains provisions that will disallow deductions to the extent that they are incurred in relation to debt creation schemes.

These amendments are to apply to income years commencing on or after 1 July 2023.

Transparency

The amending Bill also contains amendments which will require, for each financial year commencing on or after 1 July 2023, Australian public companies, as part of their annual financial reporting obligations under Ch 2M of the *Corporations Act 2001* (Cth), to provide a "consolidated entity disclosure statement":

- if the accounting standards require the public company to prepare financial statements in relation to a consolidated entity – the "consolidated entity disclosure statement" will be a statement that includes disclosures about entities within the consolidated entity at the end of the financial year; or
- if the above does not apply – the "consolidated entity disclosure statement" will be a statement to that effect.

3. Small business energy incentive

The government has released exposure draft legislation and explanatory materials in relation to the proposed small business energy incentive that is intended to help small and medium businesses electrify and save on their energy bills.

Under the incentive, businesses with an aggregated annual turnover of less than $50m will have access to a bonus 20% tax deduction for the cost of eligible depreciating assets that support electrification and more efficient use of energy.

To be eligible for the bonus deduction:

- the expenditure must be eligible for a deduction under another provision of the tax law; and
- the asset must be first used or installed ready for use, or the improvement cost incurred, between 1 July 2023 and 30 June 2024.

Certain kinds of assets and improvements will not be eligible for the bonus deduction, including motor vehicles (including hybrid and electric vehicles) and where the asset or improvement uses a fossil fuel.

Up to $100,000 of total expenditure will be eligible for the incentive, with the maximum bonus tax deduction being $20,000.

The Commissioner's perspective

4. Use of an individual's fame

The Commissioner has released a final determination in relation to arrangements where an individual with fame establishes an entity (the "related entity"), typically a family trust or company, and enters into an agreement with that entity for the use of their name, image, likeness, identity, reputation and signature (referred to as "fame") (TD 2023/4).

The related entity then agrees with other entities for their authorised use of the individual's fame in return for a fee. TD 2023/4 explains the Commissioner's views on the application of s 6-5 ITAA97 (ordinary income) in these circumstances.

The common law of Australia does not recognise as a proprietary right an individual's ability to exploit their fame separately from an accompanying business. Consequently, there is no recognised proprietary right (common law or otherwise) in an individual's fame that is capable of transfer or assignment. This can be contrasted with copyright, trademarks, registered designs and other forms of intellectual property which have proprietary rights recognised under Australian common law and legislation. TD 2023/4 is about the general exploitation of an individual's fame separate from the exploitation of these recognised intellectual property rights.

TD 2023/4 is only concerned with income from the use of the individual's fame. It does not apply to income from the provision of services (such as where the individual is engaged by a related entity to provide their personal services to a third party), nor does it apply to fees earned by a related entity from exploiting copyright, trademarks or registered design rights licensed to the related entity.

TD 2023/4 acknowledges that the views on alienation set out in the determination differ to the practical compliance approach in allowing limited alienation of income taken in PCG 2017/D11 (tax treatment of payments for use and exploitation of a professional sportsperson's "public fame" or "image") which was withdrawn on 24 August 2018.

TD 2023/4 also acknowledges that individuals may have entered into arrangements on the basis of PCG 2017/D11. As a transitional compliance approach, the Commissioner will not devote compliance resources to apply the views expressed in TD 2023/4 to income derived before 1 July 2023 from arrangements entered into in good faith that are consistent with the principles outlined in PCG 2017/D11 where they were entered into before 28 June 2023 (the date of publication of TD 2023/4).

5. Travel and overtime meal allowances

The Commissioner has issued a determination that sets out the amounts that he considers are reasonable (reasonable amounts) for the substantiation exception in Subdiv 900-B ITAA97 for the 2023–24 income year (TD 2023/3).

TD 2023/3 relates to claims made by employees for:

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

The approach outlined in TD 2023/3 can only be used where the taxpayer receives an allowance to cover the particular expenses that they are claiming, for example,

the taxpayer received an accommodation allowance and is claiming accommodation expenses.

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

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

6. Diverting SMSF property development profits

The Commissioner has released a taxpayer alert in relation to arrangements under which profits of a property development project are diverted to a self-managed superannuation fund (SMSF) through the use of a special purpose vehicle (SPV) involving non-arm's length arrangements (TA 2023/2).

More particularly, under the arrangements:

- one or more SMSFs have, or acquire, direct or indirect ownership of an SPV that undertakes a property development project; and
- because of the non-arm's length arrangements between the SPV and other entities, the SPV derives a profit that ultimately benefits the SMSFs which is more than what it would have been if all of the parties had dealt with each other at arm's length.

The non-arm's length arrangements have the effect of shifting what would otherwise be the profits of the related entities (taxed at the corporate rate, for example) to the SMSFs, being concessionally taxed entities. If the SPV is a company, the SMSFs may also receive tax offset refunds in relation to the dividends received.

The Commissioner will consider whether the dividends and other income received by the SMSFs are non-arm's length income as defined in s 295-550 ITAA97, and the application of the regulatory requirements in the *Superannuation Industry (Supervision) Act 1993* (Cth) and other relevant law in respect of these arrangements.

Recent case decisions

7. FBT: otherwise deductible rule

The Federal Court (Logan J) has held that travel expenses incurred by the taxpayer for fly in fly out (FIFO) employees did not, in the circumstances, satisfy the otherwise deductible rule and dismissed appeals against FBT assessments for the FBT years ended 31 March 2012 to 31 March 2019 (inclusive) which had assessed the taxpayer to FBT of $13m (*Bechtel Australia Pty Ltd v FCT*[1]).

Bechtel Australia Pty Ltd (Bechtel) was a member of the Bechtel group of companies. The ultimate parent company was Bechtel Group, Inc, which was incorporated in the United States.

In keeping with the business worldwide of the Bechtel group of companies, Bechtel carried on a business in Australia of providing contracting services in respect of large-scale construction projects. Such services included engineering, procurement, construction and project management services and design and build services.

One such project entailed the performance of engineering, procurement and construction (EPC) contracts awarded to Bechtel for the liquefied natural gas (LNG) projects on Curtis Island (the Curtis Island projects). The Curtis Island projects entailed the construction of three large LNG plants and related facilities on Curtis Island. Curtis Island is situated near Gladstone in Central Queensland. There were no bridges to Curtis Island. It is thus accessible only by sea or air. A ferry service operated between Curtis Island and the nearby mainland.

The Curtis Island projects exemplified features typical of many EPC contracts performed by the Bechtel group of companies. One such feature was that performance of the contracts required the gathering at a site (in this instance, Curtis Island) of a large number of employees with specialist skills and experience for a finite period. Another was that the local workforce had insufficient persons with such specialist skills and experience. Yet another was that the terms of the prevailing governmental approval prohibited the relocation to the immediate vicinity of the site (in this instance, Gladstone) of all but a small proportion of the required workforce as did not already reside there.

In combination, and in respect of the Curtis Island projects, these features meant that Bechtel was compelled to recruit its additionally required workforce from beyond the Gladstone area. It met the requirement by both Australia-wide and international recruitment. The exemplified features mentioned also meant that Bechtel was obliged to recruit and employ this non-Gladstone resident, additional workforce on a FIFO basis. Related to this, Bechtel was also obliged to construct, maintain and operate temporary accommodation (termed "camp accommodation") on Curtis Island for such employees.

The FIFO employees travelled from their respective home base airports to Gladstone in order to undertake duties at the Curtis Island projects site during the period in which they were rostered to perform duties there. Within Bechtel, a home base for an employee, be that a town or city in Australia or overseas, was known as a "point of origin" and such roster periods were known as "swings". These employees were required to live during a "swing" on Curtis Island in the temporary accommodation provided at or near the project site by Bechtel. At the end of a "swing", such employees returned to their respective point of origin

airports. Employees made their own arrangements in relation to travel to or from their residence to or from that airport.

A typical journey for an employee to commence rostered duty at one or the other of the sites on Curtis Island where the Curtis Island projects were being undertaken involved:

- a flight or flights from a point of origin airport to Brisbane airport, if not resident sufficiently close to Brisbane airport so as to commute there by car, bus or rail (or some combination thereof);
- a flight from Brisbane airport to Gladstone airport;
- a bus from Gladstone airport to the Gladstone ferry terminal at Gladstone Port;
- a ferry from the Gladstone ferry terminal to the relevant Curtis Island project ferry terminal; and
- a bus from the relevant Curtis Island project ferry terminal to the temporary accommodation on the island for the relevant LNG construction project forming part of the Curtis Island projects.

If the FIFO employee were resident overseas, their journey would commence and conclude with transit by some means from their point of origin to their point of origin airport. Bechtel neither arranged nor paid for such transport, in the same way that it did not for like transit for an Australian resident FIFO employee. Depending on available flights and destinations, an overseas employee might, for example, have to take an international flight from their point of origin airport to Sydney international airport and then transfer to Sydney domestic airport for a flight to Brisbane airport.

The FIFO employees fell into two broad classes: (1) craft employees; and (2) field non-manual employees (FNM). The FBT issue before the court was concerned only with travel expenses incurred by Bechtel in respect of air travel in respect of FNM FIFO employees who could not be accommodated on the mainland in or near Gladstone. In respect of these employees, Bechtel incurred travel expenses to take them:

- from the high-capacity airport nearest to such an employee's point of origin location (referred to within Bechtel as the "point of origin airport") to Gladstone airport to undertake work during the employee's "swing"; and
- from Gladstone airport back to the point of origin airport at the conclusion of each "swing".

The Commissioner included these travel expenses in deemed assessments of Bechtel to FBT for each of the FBT years in issue as being the taxable value of the residual fringe benefits. Bechtel accepted that these travel expenses were residual fringe benefits but objected to the assessments on the basis that the taxable value thereof should be reduced to nil because those expenses satisfied the "otherwise deductible" test. The Commissioner disallowed the objection and Bechtel's appeal to the Federal Court was dismissed by Logan J.

Logan J said that, effectively, the outcome of the appeal was dictated by the answer to the hypothetical question of whether the travel expenses, if incurred by an employee, would or would not be deductible in light of the reasoning of the majority of the High Court in *Lunney v FCT*[2] and the more recent decision of that court in *FCT v Payne*.[3]

Logan J said that he considered that he was bound by the decision in *Lunney* to hold that, in the circumstances of the present case, the travel expenses, had they been incurred by the employees, would not have been deductible. The expenses would, if incurred by the employees, be pre-requisites to the gaining or producing of assessable income, not incurred in the course of gaining or producing assessable income. On the authorities, that is the discrimen. Also on the authorities, it matters not to its characterisation whether the expense is, as in *Lunney*, an intra-urban bus fare or, as in the present case, a logistically complicated combination of international or interstate (or both) air fares, a bus fare and a ferry fare.

Importantly, Logan J said that the decision of the Full Federal Court in *John Holland Group Pty Ltd v FCT*[4] demonstrated how, if it so chose, Bechtel might, by a change in place of rostered start time, have made such expenses meet the "otherwise deductible" test in s 52 of the *Fringe Benefits Tax Assessment Act 1986* (Cth). But that was not the employment model it chose for its FIFO FNM workforce at the Curtis Island projects.

8. Project Wickenby: a rebound for the Commissioner

The Federal Court (Perry J) has, on the Commissioner's application, set aside the judgment of the Full Federal Court in *Rawson Finances Pty Ltd v FCT*[5] on the ground that it was obtained by fraud (*FCT v Rawson Finances Pty Ltd*[6]).

Rawson Finances Pty Ltd (Rawson), the respondent to the Commissioner's application, was one of a number of entities owned and controlled by members of the Binetter family.

Following an audit commenced in July 2006 as part of Project Wickenby, the Commissioner was not satisfied with Rawson's income tax returns, and issued notices of assessment for the 1997 to 2008 income years and penalty assessments for the 2001 to 2008 income years. Specifically, the Commissioner included in Rawson's assessable income three "loans" obtained by Rawson (totalling A$4.5m) from the Mercantile Discount Bank (the MDB), Israel, in 1997, and disallowed deductions for interest on the alleged loans.

Rawson objected to the Commissioner's assessments and, following the Commissioner's disallowance of the objections, applied to the AAT for a review of the Commissioner's objection decisions. The essence of Rawson's case before the tribunal was a "business practice" case, being that its former director, Erwin Binetter (Erwin), and his family had a business practice of obtaining loans from Israeli banks on the basis only of personal guarantees. Rawson submitted that the tribunal should infer that Rawson followed the same business practice as its related entities, and that its loans

from the MDB were not supported by any security beyond personal guarantees.

The AAT found that Rawson had established that the Commissioner's taxation assessments were excessive, and set aside the Commissioner's objection decision. On the Commissioner's appeal to the Federal Court, Edmonds J allowed the appeal on the ground that it was not open on the evidence for the tribunal to characterise the funds received by Rawson from the MDB as loans. On further appeal, the Full Federal Court allowed Rawson's appeal and set aside the orders of Edmonds J.

New evidence

Subsequently, the Commissioner obtained a very substantial body of new evidence, including from the liquidators of two of the Binetter family entities, banks in Israel, and evidence given on examination by bank officers in Israel. The Commissioner alleged that the new evidence established that the tribunal and Full Court decisions were obtained by fraud on the part of Rawson. The Commissioner specifically alleged that the new evidence established that the loans to the Binetter family entities, including Rawson, were secured by secret cash deposits, and in the case of Rawson and another Binetter family entity, Advance Finances Pty Ltd (Advance), those deposits were held by family members using a code name. On the basis of the new evidence, the Commissioner submitted that Rawson's case that its loans were secured only by personal guarantees was knowingly false and misleading and, on this basis, sought to set aside the Full Federal Court's decision on the ground of fraud.

Fraud established

Perry J held that the new evidence overwhelmingly established that the decisions of the tribunal and the Full Court were obtained by fraud on the part of Rawson through Andrew Binetter (Erwin's son) (but not on the part of the legal practitioners making submissions in the tribunal and Federal Court proceedings).

First, the new evidence contradicted Rawson's "business practice" case which relied on the conduct of other Binetter family entities, including BCI Finances Pty Ltd (BCI), Advance and other entities. This evidence established that the common "business practice" engaged in by the Binetter family was in fact to secure so-called loans from Israeli banks on the basis of back-to-back deposits and not as alleged by Rawson before the AAT on the basis of personal relationships and guarantees.

For example, in relation to BCI, new evidence emerged that, on 8 March 2006, Andrew signed a deed of pledge which pledged a deposit as security for BCI's loan with another Israeli bank, Bank Hapoalim. This unequivocally confirmed that the BCI loans were secured by a back-to-back deposit. Similarly, a plethora of new documents in relation to Advance, Rawson's sister company controlled by Andrew's cousin, established the existence of a deposit account securing the loan. Significantly, new evidence also emerged that, in 2007, Andrew arranged for the preparation of draft correspondence to be sent by the Israeli banks on their bank letterheads, which misrepresented the so-called "loan arrangements" by concealing the existence of the back-to-back deposits.

Second, the new evidence revealed that Rawson's loans with the MDB were in fact secured by a secret deposit account in the code name of "Arthur Belan". The evidence established that Andrew, whose knowledge was to be attributed to Rawson, knew of the Arthur Belan deposit account and the true nature of the arrangements between Rawson and the MDB from 1997 or shortly thereafter. Yet Rawson, through Andrew, ran a case now known to be false and misleading in the tribunal and pressed that case on appeal to the Federal Court and the Full Federal Court. Indeed, Andrew himself gave patently false evidence to the tribunal.

Perry J concluded that it was no overstatement to say that the evidence established highly egregious and fraudulent conduct by Rawson, through Andrew, in the case run before the AAT and in the Federal Court. The new evidence revealed that this was a case of extraordinary deceit and subterfuge involving a multitude of overseas accounts and highly suspicious and unexplained transactions of "labyrithal complexity".

Perry J held that the Commissioner had established that the fraud perpetrated by Rawson was material. The new evidence completely undermined critical findings by the AAT, including its acceptance of Andrew's evidence (now known to be false and misleading) that he had no knowledge of any security for the alleged loans. Furthermore, if the new evidence were before the tribunal on a rehearing and remained unanswered, it was almost inevitable that the AAT would have reached a different decision. In this regard, Rawson's submission that the new evidence demonstrated that the funds obtained from the MDB were "genuine loans at interest" was misconceived at every level.

Consequences

Perry J held that the decision of the Full Federal Court should be set aside on the ground that it was procured by fraud. However, her Honour held that the first instance decision of the Federal Court should not be set aside because the fraud was not material, given that Edmonds J had allowed the Commissioner's appeal and set aside the AAT's decision.

9. Reimbursement agreement appeal dismissed

The Full Federal Court (Moshinsky, Colvin and Hespe JJ) has unanimously dismissed an appeal by the taxpayer from a decision of Thawley J in which his Honour held that an agreement to carry out various steps, including a buy-back of shares, constituted an agreement that fell within the reimbursement agreement provisions in s 100A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) (*B&F Investments Pty Ltd as trustee for the Illuka Park Trust v FCT*[7]).

During the 2014 income year, a company with retained earnings (IP Co) bought back shares held in it by the trustee (the IP Trustee) of a discretionary trust (the IP Trust). The proceeds of the buy-back (about $10m) paid by IP Co to

the IP Trustee were deemed by s 159GZZZP ITAA36 to be a dividend for tax purposes. However, the share buy-back dividend constituted corpus of the trust for trust purposes. The deemed dividend was fully franked.

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

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

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

Thawley J held that s 100A ITAA36 applied to deem BE Co not to be presently entitled to the trust income and that the IP Trustee was taxable to the extent to which the Commissioner contended. Thawley J also held that, if s 100A ITAA36 did not apply, s 207-150 ITAA97 did apply because the deemed dividend was part of a "dividend stripping operation" as defined by s 207-155 ITAA97.

The Full Federal Court, in a joint judgment, held that, on the facts as found by Thawley J, s 100A applied. As a result, the IP Trustee was liable to tax on the net income of the IP Trust that was attributable to the deemed dividend. The IP Trustee had not discharged its onus of demonstrating that the assessment issued to it for the 2014 income year was excessive.

The Full Federal Court said that the examination of the facts and circumstances relevant to an investigation of the purpose of a party as required by s 100A(8) supported the conclusion that a party (and, in particular, Mr Buckley who was an adviser to the company group and an appointor of the IP Trust) entered into the reimbursement agreement for a purpose of ensuring that the retained earnings of IP Co could be distributed to and retained by the IP Trust without the IP Trustee being liable to tax. It was therefore to be concluded that the reimbursement agreement was entered into for a purpose of securing that the IP Trustee, who, if the agreement had not been entered into, would have been liable to pay income tax in respect of the 2014 income year, would not be liable to pay income tax in respect of that year of income.

This conclusion was not dependent on forming a view about the manner in which the IP Trustee might choose to distribute the buy-back proceeds in the future. Nor did it require a conclusion to be drawn about whether a distribution of those proceeds, as corpus of the IP Trust, would or would not be taxable to the recipient of such a distribution.

Although its conclusion in relation to the operation of s 100A ITAA36 meant that it was not necessary to decide whether the deemed dividend was made as part of a dividend stripping operation for the purposes of s 207-150(1) ITAA97, the Full Court did examine the question.

10. Rental property deductions

The AAT has held that a taxpayer was entitled to deductions in the 2017 income year for interest on a borrowing that was used to acquire a dwelling in the 2007 income year and for council rates, insurance premiums and land tax incurred in respect of the dwelling, where the dwelling had not been tenanted since 2012 (*DiStefano and FCT*[8]).

The taxpayer was an experienced businessman who worked in a senior management position at a large company. He had a long history of investing in rental properties. On 31 August 2006, he purchased a house located in Anna Bay, a coastal town north of Sydney. He funded the purchase with money borrowed from a bank, the borrowing being secured by a mortgage over the property.

The house was situated at a desirable location on the oceanfront. Occupants of the house could access the beach from the front yard.

The house only earned the anticipated very high rentals for a few weeks each year. In the years that immediately followed the purchase, the house proved difficult to rent outside these periods and was empty for long stretches. A long-term tenant moved into the property in 2010 and moved out in 2012. The taxpayer had not received rental income from the property since 2013. The property was vacant from that point.

The AAT said that there was no reason to doubt that the taxpayer purchased the property with the intention of renting it out, albeit that he also had it in mind to redevelop the property in due course.

When the long-term tenant moved out in 2012, she reported an extensive list of defects with the property. The taxpayer had a building inspection completed in January 2013 and the inspection report confirmed the property was in very poor condition. The report clearly put an end to the notion of the house being re-rented quickly.

In the first half of 2013, the taxpayer consulted his cousin, who was an architect, about options for the property and also spoke with another relative who was a qualified electrician and project manager/builder. These consultations considered various possibilities for renovating or redeveloping the property. The taxpayer said that he was focused on increasing the rental income that he had derived, but that he had made limited progress towards realising

any of these options because of distractions in his business and personal life. The taxpayer lodged a development application in respect of the property in the latter part of 2015 and the application was approved in February 2016.

The AAT said that the real issue was whether the holding costs of the property – the losses or outgoings in question – had lost their connection with the earning of assessable (in this case, rental) income.

The AAT said that the authorities made clear that each case must be judged on its particular facts. The authorities also made clear that intention was potentially relevant, and that personal circumstances might be considered where progress towards executing a plan to produce assessable income is delayed, but there were limits. Ultimately, one looks to facts and circumstances that evidence a commitment to the ends of income production.

The AAT said that, when regard was had to all of the circumstances, it was satisfied that the taxpayer had done just enough to demonstrate that he had retained his commitment in the relevant year to the project that would ultimately yield assessable income (or, perhaps more accurately, his behaviour did not demonstrate he had at that point lost his commitment to that end). He made clear that he originally acquired the property for rental purposes. While having limited success in attracting the sort of high-paying tenants he anticipated following the purchase, there was no reason to doubt that he was making genuine efforts to market the property during that earlier period and he did have a long-term tenant at one stage.

There was also no doubt that serious defects emerged in the property which made it practically uninhabitable. The taxpayer then took steps – slowly, but not so slowly as to invite questions about the genuineness of his purpose – towards lodging a development application. The application was approved in early 2016. It was clear that nothing had happened from then until before the end of the 2017 year of income. The taxpayer's explanation for that lull in activity was called into question but the AAT said that it had no reason to doubt that he was weighed down with carer responsibilities. Perhaps more importantly, he had experienced difficulties in the business he was running that distracted him and ultimately impacted on his ability to finance the project.

In short, the AAT was not satisfied that the slow progress towards realising the project – and the lull in activity between February 2016 and 30 June 2017 in particular – suggested a want of commitment given the activities that the taxpayer had been undertaking and the evident purpose of the original investment. It followed that the nexus between the outgoings and the production of assessable income remained.

The AAT accepted that the delay in execution of the project could become untenable at some point; at such a point, the taxpayer would no longer be said to be incurring outgoings in gaining or producing assessable income. But the taxpayer had not reached that point in the 2017 income year.

11. GST: was there a deposit?

In a recent decision, the AAT considered the question of whether an amount paid by a party to a contract for the supply of container homes was a security deposit for the purposes of Div 99 GSTA99 (*Container Homes Designer Domain Pty Ltd and FCT*[9]).

The applicant, Container Homes Designer Domain Pty Ltd (Container Homes), entered into an arrangement for King Island Links Pty Ltd (King Island Links) to be supplied with 20 customised container homes at $37,300 per unit. On entry into the arrangement, King Island Links paid $373,000 (the payment), being 50% of the agreed total price for the units, to Container Homes. Subsequently, King Island Links unilaterally withdrew from the arrangement without taking delivery of any of the homes but stated that Container Homes could retain the $373,000.

The issue to be decided was whether the payment was a deposit held by Container Homes as a security for the performance of King Island Links' obligations under the arrangement and whether it was forfeited for failure to perform those obligations. If the answer to each of those questions was "yes", Container Homes would be liable for GST attributed to the tax period under review. If not, Container Homes would not liable for GST attributed to that tax period.

The AAT said that the evidence, such as it was, pointed on balance to the nature of the deal, being that Container Homes would acquire the units and sell them to King Island Links, with title passing from Container Homes to King Island Links in accordance with the contract. At the least, the evidence was insufficient to persuade the AAT that Container Homes had discharged the burden of proving that it was a mere agent.

After referring to several decisions, the AAT said that it was persuaded that the payment was not properly characterised as a deposit. The conclusion that the evidence was sufficient to discharge Container Homes' burden of proof was reached by the AAT with some hesitation because of the potential for pages from the contract to be missing from the evidence. However, for several reasons, the AAT was persuaded that, on balance, that was not fatal to Contain Homes' case.

First, the use of the expression "advance" to refer to the time for the payment to be made, where it first and most prominently occurred in the payment schedule, suggested that it was more likely than not that any further pages would have been devoted to specifications and not contain a clause that would give an extraordinary and inconsistent meaning to the expression "advance" to encompass forfeiture. The language of the contract was otherwise conventional for a contract of this kind; there were no expressions giving meanings wholly inconsistent with their conventional usage, which seemed unlikely in an unsophisticated document adopted by a small business.

Second, this conclusion was also consistent with the conduct of Container Homes, which did not set aside the payment as a deposit to be retained, instead immediately transferring funds to the supplier in India. If the payment

were a security deposit, and particularly in view of the extraordinary percentage of the price, it would be expected that King Island Links would have required it be set aside, for example, in a lawyer's trust account.

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References

1 [2023] FCA 676.

2 [1958] HCA 5.

3 [2001] HCA 3.

4 [2015] FCAFC 82.

5 [2013] FCAFC 26.

6 [2023] FCA 617.

7 [2023] FCAFC 89. The decision of Thawley J at first instance is *BBlood Enterprises Pty Ltd v FCT* [2022] FCA 1112.

8 [2023] AATA 1697.

9 [2023] AATA 1815.

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Tax Tips

by TaxCounsel Pty Ltd

Connected entity issues

A recently released draft determination considers the Commissioner's discretion to disregard an entity's control under the connected entity rules in the *Income Tax Assessment Act 1997*.

Background

Whether an entity is connected with another entity is now relevant to the operation of a number of provisions of the *Income Tax Assessment Act 1936* (Cth) (ITAA36), the *Income Tax Assessment Act 1997* (Cth) (ITAA97), the *A New Tax System (Goods and Services Tax) Act 1999* (Cth), and the *Fringe Benefits Tax Assessment Act 1986* (Cth).

For example, in the case of the ITAA97, whether an entity is connected with another entity is relevant for the purposes of calculating the aggregated turnover of the entity which, in turn, is relevant for the purposes of determining whether the first entity is a small business entity.

Small business entity status is a prerequisite to eligibility for a range of tax concessions. These concessions include: the immediate deductibility for small business start-up expenses;[1] the CGT small business concessions;[2] the simpler depreciation rules;[3] the small business income tax offset;[4] and the immediate deduction for certain prepaid business expenses.[5] A small business entity also qualifies for a shorter period within which the Commissioner may amend an assessment.[6]

In the context of GST, small business entity status is relevant for an entity to be able to adopt a cash basis for accounting for GST.[7] There is an FBT car parking exemption that can be accessed by a small business entity.[8]

The relevance of the connected entity rules, however, extend beyond determining the aggregated turnover of an entity. The rules also apply, for example, for the purposes of the operation of the active asset test and the maximum net asset value test that are relevant to the operation of the CGT small business reliefs.[9]

Whether an entity is connected with another entity turns on whether the first entity controls the other entity. The concept of "control" for this purpose is defined in s 328-125 ITAA97. The provisions of that section require what may be called "control of 40%" but confers on the Commissioner a discretion to disregard a 40% control interest in certain circumstances. It is those circumstances that are considered in TD 2023/D2. This article considers the draft determination.

Aggregated turnover

The way the connected entity concept may become relevant can be illustrated by the aggregated turnover rules that apply for the purposes of determining whether an entity is a small business entity.

The expression "small business entity" is defined in s 328-110 ITAA97. The general rule that applies is that an entity will be a small business entity for an income year if the entity carries on a business and has an "aggregated turnover" that is less than $10m.[10]

The concept of aggregated turnover is defined in s 328-115 ITAA97. In broad terms, the general position is that an entity's aggregated turnover for an income year is the sum of the relevant annual turnovers. When the issue is whether entity A is a small business entity for an income year, the annual turnovers that are relevant are:[11]

1. entity A's annual turnover for the income year;
2. the annual turnover for the income year of any entity that is connected with entity A at any time during the income year; and
3. the annual turnover for the income year of any entity that is an affiliate of entity A at any time during the income year.

It is (2) above that is particularly relevant to this article and, more particularly, the circumstances in which an entity will be taken to be connected with another entity. Those circumstances are defined in s 328-125 ITAA97.

Connected entity definition

The provisions of s 328-125 ITAA97 that are primarily relevant for present purposes are as follows:

> "**328-125 Meaning of connected with an entity**
>
> (1) An entity is ***connected with*** another entity if:
>
> (a) either entity controls the other entity in a way described in this section; or
>
> (b) both entities are controlled in a way described in this section by the same third entity.
>
> …
>
> Direct control of an entity other than a discretionary trust
>
> (2) An entity (the ***first entity***) controls another entity if the first entity, its affiliates, or the first entity together with its affiliates:
>
> (a) except if the other entity is a discretionary trust – own, or have the right to acquire the ownership of, interests in the other entity that carry between them the right to receive a percentage (the ***control percentage***) that is at least 40% of:

(i) any distribution of income by the other entity; or

(ii) if the other entity is a partnership – the net income of the partnership; or

(iii) any distribution of capital by the other entity; or

(b) if the other entity is a company – own, or have the right to acquire the ownership of, equity interests in the company that carry between them the right to exercise, or control the exercise of, a percentage (the ***control percentage***) that is at least 40% of the voting power in the company.

Direct control of a discretionary trust

(3) An entity (the ***first entity***) controls a discretionary trust if a trustee of the trust acts, or could reasonably be expected to act, in accordance with the directions or wishes of the first entity, its affiliates, or the first entity together with its affiliates.

(4) An entity (the ***first entity***) controls a discretionary trust for an income year if, for any of the 4 income years before that year:

(a) the trustee of the trust paid to, or applied for the benefit of:

(i) the first entity; or

(ii) any of the first entity's affiliates; or

(iii) the first entity and any of its affiliates;

any of the income or capital of the trust; and

(b) the percentage (the ***control percentage***) of the income or capital paid or applied is at least 40% of the total amount of income or capital paid or applied by the trustee for that year.

Note: Section 328-112 of the *Income Tax (Transitional Provisions) Act 1997* affects the operation of this subsection in relation to the 2007–08, 2008–09, 2009–10 and 2010–11 income years.

(5) ...

Commissioner may determine that an entity does not control another entity

(6) If the control percentage referred to in subsection (2) or (4) is at least 40%, but less than 50%, the Commissioner may determine that the first entity does not control the other entity if the Commissioner thinks that the other entity is controlled by an entity other than, or by entities that do not include, the first entity or any of its affiliates.

Indirect control of an entity

(7) This section applies to an entity (the ***first entity***) that directly controls another entity (the ***second entity***) as if the first entity also controlled any other entity that is directly, or indirectly by any other application or applications of this section, controlled by the second entity.

(8) However, subsection (7) does not apply if the second entity is an entity of any of the following kinds:

...”

The draft determination

The draft determination (TD 2023/D2) that has been released by the Commissioner is particularly concerned with subs (6) of s 328-125 ITAA97 which confers on the Commissioner a discretion to, in effect, disregard a control percentage of 40% but less than 50% in an entity (referred to as the “test entity”) where the test entity is otherwise controlled by another entity.

TD 2023/D2 states that its principal concern is to provide guidance on the following specific issues relating to the concept of “control” which the ATO has had to consider when administering the Commissioner's discretion:

- requests for the Commissioner's discretion to be exercised where a third entity has sole or primary responsibility for day-to-day management of the affairs of the test entity, but holds relatively insignificant or no interests in the income or capital of the test entity, or in shares carrying voting rights (if the test entity is a company); and
- applicants suggesting that their control percentage interests of between 40% and 50% should be disregarded because the remaining holders of interests in the test entity will together necessarily control the entity, irrespective of their number or relationship to each other.

Concept of control

TD 2023/D2 does not seek to deal comprehensively with the concept of “control” for the purposes of considering the exercise of the Commissioner's discretion, nor the wide range of circumstances in which it will be relevant for the exercise of the Commissioner's discretion. The Commissioner's conclusion on control in a given case will turn on the specific facts and circumstances.

TD 2023/D2 states (in para 13) that, having regard to the statutory context, the nature of control relevant for the Commissioner's discretion is control over those matters typically associated with ownership of a business entity. That is, entitlements to income and capital of the entity, as well as participation in decision-making on key matters affecting the entity's constitution, funding, structure and management. The latter would ordinarily include matters such as:

- decision-making on the composition and oversight of the management team;
- amending the entity's constituent documents;
- deciding on capital and entity restructuring proposals, the issue of new ownership interests or winding-up; and
- authorising significant changes in the direction of the entity's business operations.

TD 2023/D2 states that other ways in which an entity may be said to be "controlled", such as the control exercised by managers with responsibility for the day-to-day conduct of the business of the entity, do not of themselves constitute control of the entity in the sense contemplated by the aggregation rules. It is necessary to distinguish control of *an entity* from powers in respect of the conduct of *an entity's business.*

Managers or directors with responsibility for the day-to-day conduct of a company's business may have considerable autonomy in making significant business decisions, but this of itself is not considered relevant "control" of the entity for the purposes of s 328-125(6) ITAA97.

TD 2023/D2 refers to an example in the relevant explanatory memorandum[12] which refers to a manager of the test entity with a 58% shareholding in that entity, and another person with a 42% shareholding who has no dealings at all with the manager. The ATO considers that, in these circumstances, the significance of who manages the business of the test entity stems from the relative ownership interests which dictate who has the power to determine who performs the managerial function. The identity of who actually performs the managerial function is generally of limited relevance to the question of control of the test entity. The manager in the explanatory memorandum with the 58% shareholding would not cease to control the test entity merely because they decided to appoint a new manager with full responsibility for the day-to-day conduct of the business of the entity.

The Commissioner would also consider that the example in the explanatory memorandum illustrates circumstances in which it would be likely for the Commissioner to conclude that the test entity was controlled by a third entity (the 58% shareholder) and exercise the discretion to disregard the 42% shareholding accordingly. The holding of interests carrying rights to more than 50% of the income, capital and voting power in a company is consistent with control of the company for the purposes of s 328-125(6) ITAA97. Assuming that the majority ordinary shareholding is sufficient to carry the vote on most or all of the fundamental matters relating to the test entity, the Commissioner would think that there was control by the third entity unless the third entity's control through its majority shareholding is in some way qualified or compromised by other circumstances or arrangements.

Third entity can hold less than 40% interest

TD 2023/D2 also states that ownership of a majority of interests carrying relevant rights is a likely basis for concluding that a third entity controls the test entity for the purposes of s 328-125(6) ITAA97. However, when considering the exercise of the discretion, the Commissioner is not confined to identifying a third entity with the requisite control percentage under the primary tests for control (that is, in s 328-125(2) to (4) ITAA97).

TD 2023/D2 states that the language of s 328-125(6), which requires the Commissioner to "think" that there is a controlling third entity (or entities), is consistent with the Commissioner needing to form a view on actual control by reference to all relevant circumstances. In providing for this enquiry, the subsection does not limit the Commissioner to a class of potential controllers having a control percentage interest of 40% or more under the primary tests. This view is supported by para 2.60 of the explanatory memorandum referred to which states:

> "The Commissioner may think that another entity controls the entity either based on fact or on a reasonable assumption or inference. Whether or not the third entity has a 40 per cent interest may assist in determining whether the third entity controls the other entity, but it is not decisive."

This does not mean, however, that a different concept of "control" than that contemplated by s 328-125(2) to (4) ITAA97 applies to determine that a third entity controls the test entity for the purposes of s 328-125(6) ITAA97. The focus remains on control of the test entity in the sense described in para 13 of TD 2023/D2. That is, control over those matters typically associated with ownership of a business entity.

It therefore may be possible to control an entity in the relevant sense by means other than formal ownership of interests carrying relevant rights. For example, an owner of shares carrying a certain percentage of the voting power in a company may effectively surrender those rights by legal agreement with a third entity.

While the Commissioner might readily infer that the third entity controls the test entity from legally enforceable arrangements of this kind, he would closely scrutinise assertions that a third entity controls the test entity on the basis of informal arrangements, practices or patterns of behaviour alone. This would especially be so if they appear inconsistent with the legal interests held by entities in the test entity.

Control by more than one "third" entity

TD 2023/D2 states that it is clear from the text of s 328-125(6) ITAA97 that the exercise of the Commissioner's discretion can be based on a conclusion that the test entity is controlled by a third entity (or entities) that does not include the first entity or any of its affiliates.

The Commissioner does not accept as correct that an entity's control percentage interest of between 40% and 50% should be disregarded on the basis that the remaining interest holders together necessarily control the test entity, irrespective of their number or relationship to each other. While the Commissioner may look beyond a single third entity for relevant control, the discretion would not be exercised merely on the basis of identifying a group of unrelated entities that, when individual control percentages are aggregated, holds interests in the test entity amounting to a control percentage of more than 50%.

For example, a pattern of consistent voting behaviour by a group of unrelated minority shareholders in a widely-held company would not constitute control of that company by those shareholders, even if collectively they held more than 50% of the total shares.

In order to form a view that a group of third entities controls the test entity, the Commissioner would expect to see that the group has agreed to operate, and does operate, as a single controlling mind when it comes to decision-making generally in respect of the test entity. This might be in accordance with proxy arrangements that put voting power in the hands of one member of the group, or other legal arrangements under which the entities are broadly bound to act jointly in respect of the affairs of the test entity.[13]

While control by a group of entities could be established without the existence of a formal agreement to act jointly, strong evidence would be required to support assertions that there is joint control in such circumstances. The Commissioner would closely scrutinise the nature of the relationship between the entities and ongoing patterns of behaviour in relation to the test entity to determine whether there is a sound evidentiary basis to think there is joint control.[14]

The conclusion that there is a single controlling mind is more readily reached in these circumstances if the group consists of associated entities in terms of common ownership or close familial relationships. Mere alignment of purpose or agreement to act cooperatively on certain issues by otherwise unrelated entities would rarely, if ever, be a sufficient basis to determine that there is control of the test entity by a group of third entities.

Examples

TD 2023/D2 gives a number of examples to illustrate the way the views set out in the draft determination apply. Several of these are given below (with the example number in TD 2023/D2 retained).

Example 2. Third entity owning more than 50% of shares

Tech Pty Ltd carries on a business of selling a software product it has developed. Mr W, who started Tech Pty Ltd, owns 56% of the shares in the company. The remaining 44% is owned by Ms Q, a passive investor who had provided capital for Tech Pty Ltd as a start-up entity. Mr W manages all aspects of the business of Tech Pty Ltd and his majority shareholding enables him to carry the vote on all matters concerning the company, apart from those where a special resolution is required by law. Tech Pty Ltd seeks an exercise of the Commissioner's discretion to ignore Ms Q's control percentage interest in the company for the purpose of calculating its aggregated turnover.

Example 2. Third entity owning more than 50% of shares (cont)

The Commissioner would conclude that Mr W controls Tech Pty Ltd in this case and exercise the discretion accordingly. Mr W's management of the day-to-day affairs of Tech Pty Ltd is relevant to the extent that it reflects his control of the company through his majority shareholding.

Example 3. Effect of shareholder agreement

Assume the same facts as for example 2, except the 44% interest is owned by Finance Co which has entered into a shareholders' agreement with Mr W. The agreement specifies many matters relating to the business affairs of Tech Pty Ltd that require a special resolution (approval by 75% of all shareholders). This includes matters relating to business funding, significant new transactions and changes in the nature of the existing business. Tech Pty Ltd seeks an exercise of the Commissioner's discretion to ignore Finance Co's control percentage interest for the purpose of calculating its aggregated turnover, on the basis that Mr W has actual control.

Depending on the nature and extent of matters to be dealt with by special resolution under the shareholders' agreement, the Commissioner may not think that Mr W actually controls Tech Pty Ltd for the purposes of s 328-125(6) ITAA97. This is notwithstanding his majority shareholding and responsibility for managing the business of Tech Pty Ltd. If his rights in respect of Tech Pty Ltd have been substantially compromised by the special resolution requirements, it is likely that the Commissioner will reach this conclusion and not exercise the discretion to ignore the control percentage interest of Finance Co. (Note that if this were the case, Tech Pty Ltd would work out its aggregated turnover by including the annual turnovers of Mr W and Finance Co. There is no scope for the exercise of the Commissioner's discretion to ignore Mr W's interest as his control percentage interest exceeds 50%.)

Example 4. Third entities with total shareholding of more than 50%

Cellnet Pty Ltd carries on a business of developing products to be used in connection with mobile phones. Cellnet Pty Ltd was originally started by Ms A and Mr B who now each own 28% of the company. The remaining 44% is owned by an unrelated company, MobTel Pty Ltd. Cellnet Pty Ltd has three directors, Ms A, Mr B and Mr C (a representative from MobTel Pty Ltd). Ms A and Mr B meet regularly to discuss operational and strategic matters relating to Cellnet Pty Ltd, and have a history of reaching agreement on decisions relating to Cellnet Pty Ltd. Ms A and Mr B are otherwise unrelated and

Example 4. Third entities with total shareholding of more than 50% (cont)

independent of each other. Cellnet Pty Ltd seeks an exercise of the Commissioner's discretion to ignore the control percentage interest of MobTel Pty Ltd for aggregated turnover purposes.

The Commissioner in this case would not exercise the discretion as it would not be concluded that Cellnet Pty Ltd is controlled by Ms A and Mr B. Although they have a history of agreement on issues relating to the company: (1) they are not bound to act jointly; and (2) each would require the support of MobTel Pty Ltd or its representative to prevail in decision-making if not supported by the other.

In the absence of arrangements or circumstances of the kind described in paras 27 or 28 of [TD 2023/D2],[15] it would not be concluded that Ms A and Mr B control Cellnet Pty Ltd for the purposes of s 328-125(6).

Example 5. More than one entity satisfies the control percentage interest test

Entity A and Entity B each hold 45% of the ordinary shares in ABC Co and each satisfies the test for control in s 328-125(2) ITAA97 for their respective interests. Entity C holds the remaining 10% of shares in ABC Co. ABC Co seeks the exercise of the Commissioner's discretion on the basis that either Entity A or Entity B controls ABC Co, but not both, because they have control percentage interests of more than 40% in ABC Co.

In the absence of further facts, the Commissioner would not conclude that Entity A nor Entity B actually controls ABC Co merely because they satisfy a primary test by having a control percentage interest of more than 40%. To exercise the discretion, the Commissioner must think that ABC Co is actually controlled by either Entity A or Entity B. It is possible in the circumstances that neither Entity A nor Entity B actually controls ABC Co, in which case both will be connected with ABC Co for aggregation purposes.

Some observations

TD 2023/D2 illustrates the difficulties that may arise in relation to the application of the discretion conferred on the Commissioner by s 328-125(6) ITAA97.

It is submitted that the meaning of the expression "is controlled by" in the context of s 328-125(6) ITAA97 is a question of statutory construction and does not depend on any subjective view of the Commissioner. Once that meaning is determined, it would then be a question of whether the facts fell within that meaning.

The view adopted in TD 2023/D2 is that the expression "is controlled by" in s 328-125(6) ITAA97 refers to "actual control", with the focus remaining on control of the test entity in the sense described in para 13 of the determination (see above under "Concept of control"). That is, control over those matters typically associated with ownership of a business entity.

Further, even if the "is controlled by" requirement is met, the Commissioner has a discretion as to whether or not to apply s 328-125(6) ITAA97. The subsection provides that "the Commissioner *may* determine …".

At a practical level, there are two basic situations that may confront a taxpayer. The first is where the circumstances are such that, unless s 328-125(6) ITAA97 is applied in the taxpayer's favour, the taxpayer will be unable to access a tax concession. The second situation is where the taxpayer may consider that there are good grounds for accessing some tax concession without the Commissioner applying s 328-125(5) ITAA97 in the taxpayer's favour but, if those grounds turn out to be flawed, s 328-125(6) ITAA97 will provide a possible solution.

It would seem that, in the first situation, the taxpayer should apply to the Commissioner for the exercise of the discretion before lodging the relevant income tax return. However, if this were not done, it would not preclude the Commissioner from exercising the discretion at a later point in time (for example, when deciding an objection against an assessment).

In the second situation, it would seem that the taxpayer would not need to apply to the Commissioner for an exercise of the discretion but, in the event of an unfavourable assessment, could, in addition to any other grounds, object on the basis that the Commissioner should exercise the discretion favourably.

Paragraph 6 of TD 2023/D2 states:

> "6. The statutory condition for exercising the Commissioner's discretion requires that the Commissioner positively conclude that there is actual control by a third entity or entities. It is not sufficient to merely show that the first entity is not a controller."

While the second sentence is clearly a correct statement, it is not clear that the first sentence is. The most relevant meanings of the word "think" given in the *Macquarie Dictionary* are: "4. To form or have an idea or conception of (a thing, fact, circumstance etc) … 7. To hold as an opinion; believe, suppose …".

It is suggested that para 6 of TD 2023/D2 would have the effect of imposing a too high standard of proof on a taxpayer in any challenge to the Commissioner's refusal to exercise the discretion.

When considering the views expressed in TD 2023/D2, it must be kept in mind that those views are at present in draft form.

TaxCounsel Pty Ltd

References

1 S 40-880(2A) ITAA97.

2 Div 152 ITAA97. For the purposes of the CGT small business reliefs, the aggregated turnover threshold is $2m (s 152-10(1AA) ITAA97).

3 Subdiv 328-D ITAA97.

4 Subdiv 328-F ITAA97.

5 Ss 82KZM and 82KZMD ITAA36.

6 S 170 ITAA36.

7 S 29-40 of the *A New Tax System (Goods and Services Tax) Act 1999.*

8 S 58GA of the *Fringe Benefits Tax Assessment Act 1986.*

9 Ss 152-15 and 152-40 ITAA97.

10 TD 2023/D2 points out that the connected entity issues have taken on added significance following the introduction of tax incentives with higher aggregated turnover thresholds, thereby extending their relevance beyond the small business market. This includes temporary measures introduced in 2020 in response to the COVID-19 pandemic, such as the full expensing of depreciating assets (Subdiv 40-BB of the *Income Tax (Transitional Provisions) Act 1997*) and the loss carry back rules (Div 160 ITAA97).

11 S 328-120(2) ITAA97.

12 Explanatory memorandum to the Tax Laws Amendment (Small Business) Bill 2007.

13 Para 27 of TD 2023/D2.

14 Para 28 of TD 2023/D2.

15 See above under the heading "Control by more than one 'third' entity".

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Mid Market Focus

by Peter Bembrick, CTA, HLB Mann Judd

CGT and the main residence exemption

The CGT main residence exemption can be restricted, sometimes reasonably and logically, sometimes in more complex ways that offer many traps for the unwary.

Introduction

When you think of capital gains tax (CGT) and residential properties, the two most common situations are the family home (where the sale is completely tax-free under the main residence exemption[1]) and an investment property (where CGT is payable on the entire gain on sale). What is not fully appreciated, however, is that this can be viewed as a spectrum on which lie various other scenarios where the tax treatment can be more complicated.

This article does not cover situations where properties are acquired from deceased estates,[2] which offer even more complexity. Other areas that have not been specifically addressed include moving into or changing main residences, and building, repairing or renovating a dwelling.[3] Also note that the CGT exemption may not necessarily be available for a sale of adjacent land or other structures.[4]

The family home becomes an investment property

One of the simplest variations is where the owner lives in their property initially before moving out and leasing it to tenants, typically because they have bought another property to live in and do not wish to apply the "absence rule" (discussed below).

The original residence will become an investment property from the date that it is first used to earn rental income and is treated as if it had been acquired for market value at that time, as long as this occurred after 20 August 1996.[5] The 50% CGT discount also applies to the capital gain, provided you hold the property for a further 12 months after that date.

Example 1

Mel and Tim buy an apartment for $850,000 in July 2023 and move in immediately after settlement.

Example 1 (cont)

After living there for three years, they buy a house and move in July 2026, renting out the apartment from that time, when it is valued at $1m. The apartment is eventually sold in July 2033 for $1.6m.

In this situation, Mel and Tim are deemed to acquire the apartment for $1m in July 2026, so their gross capital gain on sale is $600,000, which is reduced under the 50% CGT discount to $300,000, ie $150,000 each since it was in joint names.

The absence rule: domestic case

An alternative scenario is where the taxpayer does not acquire another property and chooses to continue to treat the property as their exempt main residence even though they no longer live there.[6] Assuming they are renting out the property, the absence period can last as long as six years without affecting the CGT exemption,[7] although there is no limit if the property is not used to earn rent (eg if it is left vacant or used by family and friends).

The absence rule may be used domestically by property owners at different stages, whether it be a first homeowner moving back in with Mum and Dad to pay down their mortgage, right up to a widow or widower moving into a retirement home. Note that the six-year limit can be "refreshed" by (genuinely) moving back in before moving out again later.

Example 2

In July 2023, Lizzy buys an apartment in Melbourne and, after two southern winters, she takes up a career opportunity in Sydney, moving back into her parents' home in Sydney's northern beaches. As she has tenants in her apartment, Lizzy will be subject to the six-year absence limit, meaning that she can hold the property until July 2031 and still sell it tax-free, provided she doesn't acquire another main residence during that period. If she holds the apartment for longer than that, there will be a partial exemption on a pro-rata basis.

Example 3

Brian has owned his split-level, five-bedroom house since the early 1990s and it has been his main residence for the entire time. He decides that the time has come to move into aged care but is not ready to sell the family home yet, instead allowing his son Charles to remain living in the house rent-free (on the understanding that Charles pays the holding costs, such as rates, maintenance and utilities) as long as he chooses to stay there or until Brian's death, whichever comes first. Charles lives in the house for a further 10 years before moving out and then Brian is able to sell it tax-free, claiming the full main residence exemption.

Property initially rented out and later used as a home

The situation is more difficult where a property is initially rented out and later used as a home, as it is necessary to calculate the total capital gain as if it had always been an investment property. The property will be taxed on the portion of the total capital gain relating to the period before it became the main residence, calculated pro-rata based on the number of days before that time divided by the total number of days that the property was owned.[8]

One saving grace is that the 12-month test for applying the CGT discount is measured from the original acquisition date. Another is that certain non-deductible holding costs attributable to the period when the property was not rented, such as council and water rates, land tax (if applicable) and mortgage interest,[9] as well as non-deductible repairs and renovation costs, can be added to the cost base, reducing the taxable capital gain. A major barrier to capturing such costs, especially when a long period of time has elapsed, is identifying the amounts involved and locating the relevant back-up documentation.

One obvious outcome is that there is an underlying assumption of capital growth taking place uniformly throughout the ownership period, while it is more likely that property prices may have gone up and down or at least up at different rates in different periods. This also ignores the fact that major renovations may have materially enhanced the value of the property so the increase should reasonably be attributed more heavily to one period, which can work for or against the taxpayer, depending on the specific situation.

Example 4

Assume that Mel and Tim from example 1 flipped their situation around and rented their apartment out for the first seven years and then moved in for three years before selling it for $1.6m in July 2033. Ignoring incidental costs and other additions to the cost base, the total capital gain would be $750,000, of which 70% would be taxable, representing the period during which Mel and Tim did not actually live in the property, being $525,000.

After applying the CGT discount, this represents a taxable capital gain of $262,500, ie $131,250 each. As noted above, the actual capital gain will be lower once non-deductible holding costs are considered. Assume that the effect of this is to reduce the taxable capital gain for each of Mel and Tim to $118,000.

In this example, the taxable capital gain is $32,000 less for each of Mel and Tim than in example 1, but in many cases the outcome will be reversed, with this scenario resulting in a higher capital gain.

Property used as a holiday home or occupied only by other family members

Many people don't realise that CGT applies to a holiday home in much the same way as it does to an investment property, with one significant difference: as noted above for the partial exemption scenario, there will be holding costs to capture in the CGT cost base. This is because very few (if any) of the costs will have been claimed as tax-deductible, although the problem of identifying and substantiating the costs will be magnified as the property will never have been used as the owner's main residence, with the ownership period often stretching back many years.

Finding this out at the time of selling a property can cause great practical difficulties because, typically, records of such "private" expenses have not been kept, especially going back several years. Ideally, taxpayers should be aware of the cost base rules and keep records as they go along, otherwise reconstructing the cost base after the fact could be a painful exercise.

If the property was rented out for part of the ownership period, then naturally it is only the non-deductible costs relating to the non-rental period that are included in the cost base.

Example 5

Sam and Kitty live and work in Brisbane and have owned a "weekender" on the Sunshine Coast for the last 20 years that they are thinking of selling. Since the house has never been used to earn rent, they have not bothered to keep records of all of the holding costs incurred over the years, although they do have the original purchase documents, online banking records providing details of the interest costs on the loan for the last six years, and all of the details of a major renovation completed four years ago.

Carrying on a business versus working from home

Since the onset of COVID-19, an increasingly common scenario is where the taxpayer has been carrying on a business from home. Determining when this occurs is important as it will result in a partial loss of the main residence exemption on sale, which is generally calculated based on the period during which the home was used to carry on the business, as well as the percentage of the floor area of the residence used for business purposes.[10]

This can be contrasted with the more common situation of people working from home but they are not actually carrying on a business, which does not allow a deduction for property holding costs such as rates and interest (only specific working from home deductions such as a portion of heating, lighting and depreciation of furniture and equipment) but importantly has no effect on the taxpayer's main residence exemption.[11]

The ATO will generally seek to reduce a taxpayer's CGT exemption where it believes that the dwelling has the character of a place of business,[12] considering factors such as whether a part of the dwelling: is set aside exclusively as a place of business; is clearly identifiable as a place of business; and is not readily adaptable for private or domestic purposes.

Example 6

For five years, since buying his house, Ed has run a physiotherapy practice using the front two rooms which comprise approximately 20% of the total floor area, continuing to own the house for three years after ceasing his business before selling it. The area used for the practice has a separate entrance accessible directly from the street, there is clear signage directing people to a small reception/waiting area, and there is a consultation/treatment room for seeing patients that includes all of the equipment and office furniture that Ed needs to run his practice. Ed sells the house for $1.8m – $800,000 more than his total CGT cost base.

Starting with a total capital gain of $800,000, the first step is to identify the period that the house was used for business purposes, ie five years out of eight years, reducing the capital gain to $500,000. Next there is an apportionment for the portion of the house used for the business, typically based on floor area, producing a gross taxable capital gain of $100,000 (ie $500,000 x 20%). Finally, as the house was held for more than 12 months, Ed is eligible to claim the 50% CGT discount and would have a net discounted capital gain of $50,000. He may also be able to apply the small business CGT concessions to further improve his position, but that is a topic for another article and will not be discussed here.

In a similar way to properties that are used entirely as the main residence before being used to earn rent, when an existing main residence is converted to partial business use, the special rule in s 118-192 ITAA97 comes into play, deeming the taxpayer to acquire the property for its market value at the date of first business use (see example 1).

Example 7

Assume that Ed from example 6 had instead owned his house for three years before starting his practice, carrying on the business for five years before selling the house and moving the booming practice to larger, more suitable rented premises, while buying a larger house for his growing family. The market value at the time he started the practice was $1.5m, so the starting point will be a capital gain of $300,000, reduced to $60,000 for the 20% business floor area. The CGT discount still applies as the business has been carried on for more than 12 months, resulting in a net discounted capital gain of $30,000.

Effect of divorce on selling jointly acquired properties

Often, as part of a family law settlement, specific jointly held assets will be allocated to one party or the other so, where it is agreed that a jointly owned property is to be owned by one of the parties going forward, that party would be treated as acquiring their former spouse's share of the property. CGT roll-over relief applies to such a transfer, so no tax is payable at this point.[13]

The first party will be treated as having acquired the portion of the property being transferred to them at the same time and for the same cost as applied to their former spouse, ie in effect, they will be treated as having acquired 100% of the property at the original purchase date and as paying all relevant amounts that contribute to the CGT cost base. The same difficulties described above in examples 4, 5, 6 and 7 can arise depending on how the property has been used, with locating cost base data and records often being a major headache.

It is worth noting that, when negotiating the family law property settlement, all potential future tax liabilities on family assets should ideally be quantified. This is where the legal and tax advisers of both parties have an important role to play.

Example 8

Gloria and Javier bought a house jointly 15 years ago, initially using it as a holiday home for three years, living in it as a main residence for five years, before divorcing and finalising their property settlement under which Gloria's 50% share passed to Javier. Eight further years have passed, with Javier using the house as his main residence. He has recently signed a contract to sell it, seeking advice from his accountant as to the CGT treatment.

In this situation Javier will need to calculate the full capital gain using all available data and records to calculate and substantiate his CGT cost base, remembering that the CGT roll-over treats him as having acquired Gloria's 50% share at the same time and for the same cost base amounts as would have applied to Gloria if they had not divorced, ie the position is the same as if Javier had originally acquired the entire house.

Javier calculates that the total capital gain was $1.5m, although, if he been able to locate all of the cost base data and records, it is likely that the actual capital gain would have been much lower. The pro-rata calculation of the taxable capital gain for the period that the house was used as a holiday home is $300,000, which is reduced to $150,000 by the 50% CGT discount.

Implications for foreign residents

There have always been complexities associated with applying the main residence exemption to individuals who were not, or ceased to be, tax residents of Australia.

This relatively manageable landscape was, however, turned on its head by changes which were originally announced in the 2017 Federal Budget and subsequently legislated, subject to certain transitional arrangements that finished on 30 June 2020, to deny the main residence exemption to property disposals by non-resident individuals[14] in quite a dramatic manner.

An exception to the changes was introduced for certain "life events" occurring within six years of their change in residency. A life event includes the taxpayer, their spouse or child under 18 having a terminal medical condition or passing away.[15]

In the absence of such events, any disposal of the property while the taxpayer remains a non-resident will not be eligible for even a partial application of the main residence exemption. Even worse, there are no rules allowing a "deemed market value cost base" along the lines of the special rule in s 118-192 ITAA97, which would seem to have been a simple, equitable measure to include in the amendments and the failure to do so is regrettable, to say the least. Many would say it renders the changes grossly unfair.

This leaves the entire capital gain where the property is sold while the taxpayer is a non-resident subject to CGT, taxed at non-resident rates and with a reduced CGT discount, calculated with reference to the relative periods of residency and non-residency.[16] This can be contrasted with the situation prior to the changes, when the six-year absence rule in s 118-145 ITAA97 allowed taxpayers to live outside Australia for a period of up to six years (or indefinitely, if the property was not rented out) and sell within this period with the full CGT exemption intact.

The only silver lining is that s 118-110(3) ITAA97 applies only to sales by non-residents, so the situation has not changed for property sales made after returning to Australia, in which case, the absence rule in s 118-145 ITAA97 is still available.

Example 9

Tony and his family bought their house 20 years ago for $1m before relocating to Spain and becoming non-residents, when the house was valued at $2.5m. After five years, Tony decides that he is likely to stay overseas for an indefinite period, selling for $3m. After identifying additional cost base elements, Tony calculates a total CGT cost base of $1.5m.

Under the new rules, Tony's total capital gain will be $1.5m, with a partial discount available using the formula in s 115-115 ITAA97 that allows for his non-resident days, ie five years out of 25 years = 20% x 50% = 10%, so that the CGT discount available is reduced from 50% to 40%, and the net discounted taxable gain will be $900,000.

If instead Tony had moved back to Australia after five years and sold the property immediately, s 118-145 ITAA97 would ensure that no CGT was payable. If Tony was able to use the market value of $2.5m as his

Example 9 (cont)

deemed cost base, with no additional cost base elements, the gross capital gain would be $500,000 and no discount would be available as the gain would relate entirely to the non-resident period. This is clearly preferable to the actual outcome and is also a much easier rule to apply.

In summary

The CGT treatment of selling residential property can be more complicated than many people think. At times, this will involve partial CGT according to the usage of the property for different purposes. While there are many opportunities to maximise the CGT cost base and minimise the tax payable, the most common practical hurdle is the ability to locate the required records.

Peter Bembrick, CTA
Tax Partner
HLB Mann Judd Sydney

References

1 S 118-110 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).
2 Ss 118-195 to 118-210 ITAA97.
3 Ss 118-135, 118-140 and 118-150 ITAA97.
4 S 118-165 ITAA97.
5 S 118-192 ITAA97.
6 S 118-145 ITAA97.
7 S 118-145(2) ITAA97.
8 S 118-185 ITAA97.
9 S 110-25(4) ITAA97.
10 S 118-190 ITAA97 and TD 1999/66.
11 PBR 1051593007881.
12 IT 2673.
13 S 126-5 ITAA97.
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15 S 118-110(4) and (5) ITAA97.
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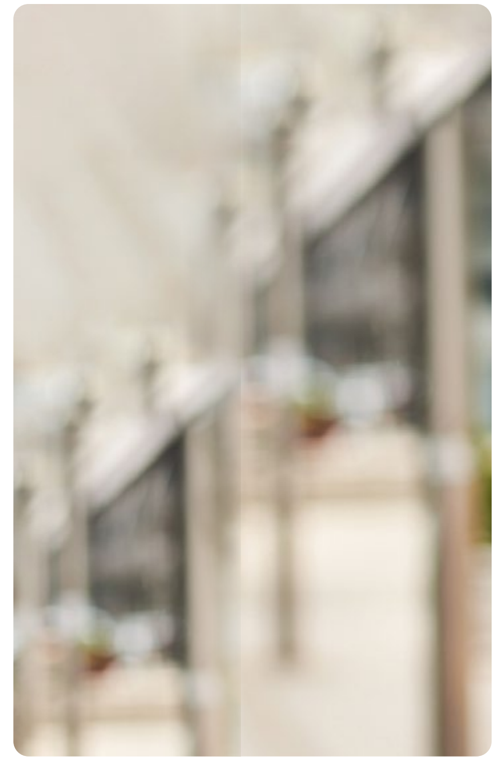

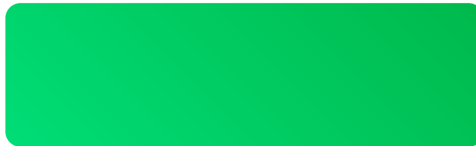

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Bryan Hartanto
Accounting and Tax Graduate
HLB Mann Judd, NSW

What got you started in tax?

I started off my career in tax as a vacationer at KPMG within the corporate tax (financial services) division. Then, in my last semester of university, I worked part-time as a business services accountant at a boutique firm. Once graduated, I moved to my current place of employment at HLB Mann Judd as an accounting and tax graduate working in the corporate tax team.

Why did you take CTA2A Advanced?

I am working towards the CTA designation. The material in the program is directly related and relevant to my work. I do have plans to study for the CA program in the future, but I will be able to apply for recognition for prior learning for the tax units. Thus, the amount of time I have to study does not significantly increase.

What content in the subject has proven to be the most valuable?

The subject that has proven to be the most valuable is small business concessions and taxation of different entities, eg partnerships, trusts and superannuation funds. I have learned how to apply the law step-by-step to determine whether an entity or individual can access the small business concessions and how to calculate tax positions for the different entities. I have applied what I have learned from the CTA2A program to my role, specifically from Module 6 – Trusts. I find the area of trust law complex; however, CTA2A did a great job covering this topic and explaining difficult concepts comprehensibly. After completing CTA2A, I have a better understanding of trust law and am better equipped in completing trust returns.

How did you manage the workload?

Juggling study, full-time work, hobbies and maintaining a healthy social life was challenging but definitely doable. Unfortunately, there is no magic pill to performing well, it just requires good-old fashion discipline and effective time-management skills. Best practice is to stay on top of the content by studying a few hours consistently every week. That way you can manage your other commitments better and not have to cram a semester of content within a few weeks, making your life miserable during that time. My employer, HLB Mann Judd, is also understanding and generous with my study requirements as they offer study and exam leave and allow me to take up additional annual leave near the exam period.

Any words of wisdom for other tax professionals considering studying?

Do it. It will be highly beneficial for your career and you will learn so much. Many employers prefer accountants with further postgraduate studies so don't limit yourself professionally by choosing not to study. I would recommend doing further study as early in your career as possible as you are likely to take on more responsibilities and work longer hours the more senior you are.

Intangible integrity intensity

by Chloe Burnett SC, ATI, Barrister, Sixth Floor Selborne & Wentworth Chambers

A new measure has come into effect, denying certain deductions for intangible-related payments. The measure, to be contained in new s 26-110 of the *Income Tax Assessment Act 1997* (Cth), is in exposure draft form but has a start date of 1 July 2023. The payments that it applies to are those made by a significant global entity, of which there are about 10,000 in Australia, to an associate where the payment is attributable to the right to exploit an intangible asset and results in an associate deriving income in a jurisdiction where the corporate tax rate is less than 15% and the income is in fact taxed at less than 15%. The measure is wide in scope and raises a number of issues, both as to its terms and as to its relationship with the OECD/G20 Pillar Two minimum tax measures that Australia plans to implement from 2024.

Introduction

On 1 July 2023, the "intangible integrity measure" in s 26-110 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) came into effect. The section is not yet law; it is exposure draft legislation only.[1] However, tax professionals need to be aware of it as its start date of 1 July 2023 was recently confirmed by Treasury.[2]

In a nutshell, the measure denies a deduction for a payment to an associate in a significant global entity (SGE) group, to the extent that it is attributable to a "right to exploit an intangible asset" and results, directly or indirectly, in an associate deriving income in a "low corporate tax jurisdiction" (with a corporate tax rate of less than 15%) and where the income is itself subject to foreign tax at less than 15%.

Australia is a net importer of intellectual property (IP) and goods and services which rely on IP.[3] The demand of Australian consumers and businesses for technology, branded goods, medical inventions and culture far exceeds the rate at which we develop these things domestically. As a result, large amounts of money are paid out of Australia each year for rights relating to IP and other intangibles. These amounts are, absent this measure, typically deductible for Australian income tax purposes, subject to anti-avoidance and transfer pricing rules. They are often also subject to royalty withholding tax.

The intangible integrity measure has wide-ranging significance for Australian taxpayers. Although it only applies to SGEs, the Australian arm of an SGE does not have to be large. About 10,000 entities lodged their most recent tax returns indicating that they were members of an SGE.[4] The wide scope of the measure stems from the ubiquity of intangible-related payments out of Australia, from the breadth of the drafted concepts of "exploit" and "intangible asset" and from the nexus and apportionment elements.

It is an "intense" time for affected taxpayers as they navigate and seek to comply with this draft measure, in addition to the other moving parts in the cross-border intangibles space. These include the draft software royalties ruling,[5] the draft practical compliance guideline on intangibles arrangements,[6] the implementation of the OECD/G20's "two-pillar solution" (Pillar Two is discussed in more detail below),[7] as well as the existing, but not predictable, rules in the areas of anti-avoidance, treaty anti-abuse and transfer pricing.

New ss 26-110 and 960-258 ITAA97

The exposure draft proposes the insertion of a new section at the end of Div 26 ITAA97, s 26-110, as well as a new s 960-258. The key components of the draft legislative scheme are as follows.

The object provision

Section 26-110(1) states that "[t]he object of this section is to deter significant global entities from avoiding corporate income tax by structuring their arrangements so that income from exploiting intangible assets is derived in low corporate tax jurisdictions".

However, the provision's application is not limited to SGEs which, after this legislation was announced, move or consider moving their intangibles to low tax jurisdictions. That is, it does not apply only to those who are capable of being "deterred" by it. It applies regardless of when, or whether, intangibles were moved to a low corporate tax jurisdiction. This suggests that part of the object is to encourage SGEs to restructure their existing intangible supply chains out of low tax jurisdictions. However, restructures that are done in anticipation of an incoming measure can raise the question of Pt IVA of the *Income Tax Assessment Act 1936* (Cth) (ITAA36).

The objects clause refers to "avoiding corporate income tax", but the legislation has no avoidance purpose element. Also, there is not an exception for structures with "sufficient economic substance". That term is picked up in the new s 960-258(4) — but only in the negative, as a hallmark of a patent box regime ripe for scheduling. The term is not asterisked, and it is not clear how it corresponds to the diverted profits tax's sufficient economic substance carve-out in s 177M ITAA36. The draft explanatory materials also only refer to the sufficient economic substance concept in relation to patent box regimes.

Payments to associate

Only payments that a taxpayer makes to its "associate" are caught by the section (s 26-110(2)(b) ITAA97). The payment

need not be made directly to an associate, it can be made "directly or indirectly", and it "it does not matter where the associate is located" (s 26-110(2)(b)).

"Associate" is asterisked and it takes its definition in s 318 ITAA36, as the draft explanatory materials confirm.

There is no carve-out for arrangements that are on terms equivalent to those which would be agreed between unrelated parties. It is the fact of association that matters, not any arm's length yardstick.

Attributable to

The key operative provision in the opening words to s 26-110(2) states: "An entity (the ***payer***) cannot deduct under this Act, for an income year, an amount for a payment it makes, to the extent that the payment is attributable to a right to exploit an intangible asset".

The phrase "to the extent that the payment is attributable to" is the language of apportionment. Apportionment is likely to be a major issue with this rule. It is already an issue with royalties, but it is supercharged here because the concept of a payment for the exploitation of an intangible asset is broader than the "royalty" definition, as discussed below. Such payments will often be made under a contract which relates to other things as well, such as the provision of goods, services or financial arrangements. In contracts where the potential "intangibles" component is outside the "royalty" definition, there may not have previously been any need to consider apportionment. Apportionment can involve costly and contestable valuation and industry expert evidence.

Intangible asset

The term "intangible asset" is not defined. Its meaning is informed by s 26-110(6) and (7), but these provisions do not supply an exhaustive definition. The draft explanatory materials state that it takes its "ordinary meaning".

While the composite phrase "intangible asset" perhaps has entered the lexicon as a loose synonym for IP, it is more likely that the ordinary meaning would be construed more broadly as any asset which is non-physical. This is broader than just IP. Interpreted as any non-physical asset, "intangible asset" covers an enormous spectrum of valuable things that businesses use. Any contractual right is an intangible asset. As is any statutory licence. Goodwill would probably be covered. Note 1 to s 26-110 expressly states that information, algorithms and data are intangible assets. Mere information is not an asset in the legal sense.[8] Its express inclusion in the draft legislation does not sit comfortably with the statement at para 1.47 of the draft explanatory materials that the provision:

> "… is not intended for this term to adopt a definition specifically used for accounting or transfer pricing purposes. For example, workforce synergies and other intangible assets recognised for accounting purposes that are not relevant assets are not intended to be captured by these amendments."

Items that are expressly not "intangible assets" are rights in relation to tangible assets or in relation to land, Div 230 ITAA97 financial arrangements and equity interests, and anything else prescribed by regulations (s 26-110(7)). The use of, or right to use, industrial, commercial or scientific equipment appears not to be covered because of the exclusion of para (b) of the s 6(1) ITAA36 "royalty" definition in s 26-110(6)(a) — and because those are tangible assets (s 26-110(7)(a)).

The exclusion for land and land-related rights in s 26-110(7)(b) ("an estate, interest or right in or over land" or a "right in respect" thereof) may not foreclose debate about whether certain mining and infrastructure rights and assets fall within it or not. The fertile disputation around taxable Australian real property and land rich duties makes this clear. Mining and infrastructure corporate structures may be less likely to hold these rights outside Australia. However, s 26-110 does not require the "intangible asset" to be held outside Australia.

Section 26-110(6) provides that the items mentioned in the s 6(1) "royalty" definition, apart from paras (b) and (f) thereof, are within the notion of an "intangible asset". This covers:

- copyrights, patents, designs or models, plans, secret formulae or processes, trade marks, or other like property or rights;
- scientific, technical, industrial or commercial knowledge or information;
- assistance ancillary to the above;
- visual images or sounds, or both, transmitted to the public by satellite, cable, optic fibre or similar technology;
- all or part of the spectrum specified in the *Radiocommunications Act 1992* (Cth); and
- motion picture films, films or video tapes used in connection with television or radio tapes.

Some of these are classic IP items, whereas others are more remote from that notion. Some of these are not even "assets" at all but are effectively deemed to be "intangible assets" by s 26-110(6). For example, services would not generally be understood as part of the ordinary meaning of "asset", but s 26-110(6)(b) effectively deems ancillary assistance services, as defined in para (d) of the s 6(1) "royalty" definition, to be an intangible asset.

Beyond that deeming, there is a broader question about the extent to which intragroup payments for services will be caught by this measure. Services can be intangible, but they are not usually thought of as an asset. However, a contractual right to receive services is an asset. It is also intangible. Intragroup cross-border service contracts are very common. They do not appear to be the target of this measure. However, it is not possible to exclude them from its theoretical scope. Further, even if they were excluded, apportionment issues would remain. The conceptual borderline between an "intangible asset" and services is likely to be even more difficult to demarcate than the already difficult royalties/services border.[9]

A right to exploit

Just as "intangible asset" is broad, so too is "a right to exploit" an intangible asset.

"Exploit" is defined at s 26-110(10) by reference to its ordinary meaning, and also as including using, marketing, selling, licensing or distributing the intangible asset, certain forbearances and, extraordinarily, to "do anything else in respect of the intangible asset" (s 26-110(10)(e)). It is hard to draft more broadly than that.

"Permission" to exploit an intangible asset is treated the same way as a "right" to exploit, so it appears that a legal entitlement is not required (s 26-110(5)(b)).

Results in, directly or indirectly

A precondition for the deduction being denied is that the arrangement "results" in the associated recipient of the payment, or another associate, deriving income in a "low corporate tax jurisdiction" (s 26-110(2)(c)(ii)). This income may be derived by them "directly or indirectly" but it must be "from exploiting the intangible asset or a related intangible asset". The amounts do not need to meet any kind of direct tracing test, nor do they need to be paid in any temporal order (s 26-110(3)(b)).

It is novel to see the unadorned word "income" in the ITAA97. It is unclear whether the legislature intends by this word that the entity derive income according to ordinary concepts (the s 6-5(1) concept), or amounts that would be assessable income if they were derived in Australia, or income in an accounting sense, or income according to the tax laws of the foreign jurisdiction, and so on.

The amount of income derived does not need to be the same as the amount of the payment. However, a significant disproportion in these amounts may suggest that the payment or arrangement did not "result" in the income being derived, or that the income is not derived "from exploiting the intangible asset, or a related intangible asset". This causation question appears to be a factual one, informed by the contracts and the wider context. It could be quite a contestable and uncertain issue on certain fact patterns.

The recipient does not need to make a profit in the low corporate tax jurisdiction, or pay any amount of tax. It is enough that they derive "income" there. If Associate A in a low corporate tax jurisdiction receives a relevant amount, but then pays a corresponding amount to Associate B in a jurisdiction where it is taxed at rates exceeding 15%, the result under the measure is unclear. Section 26-110(4)(b)(i) turns off the deduction denial if "the income is or will be subject to foreign income tax at a rate of 15% or more", as discussed below. The question is whether the tax on Associate B can be regarded as a tax on "the income" derived by Associate A.

Royalty withholding tax reconciliation

A new provision added to the second exposure draft aims to prevent an aspect of double taxation that would result from denying a deduction while imposing royalty withholding tax. Subsections (8) and (9) of s 26-110 reduce the amount of the deduction denial to the extent of royalty withholding tax paid on the amount. It is a complete carve-out for amounts bearing royalty withholding tax at a 30% rate, and a pro-rated reduction of the deduction denial for lesser withholding tax rates.

Low corporate tax jurisdiction

"Low corporate tax jurisdiction" is defined in proposed new s 960-258(1) as a foreign country where the corporate income tax rate is less than 15%, or nil. There are further guidance rules for working this out in s 950-258(2).

Countries with a corporate tax rate that is less than 15% include Ireland (12.5%), Liechtenstein (12.5%), Chile (10%), Hungary (9%) and Barbados (5.5%).[10] Countries with no corporate income tax or a nil rate include Bermuda, Belize, the British Virgin Islands, the Cayman Islands, Guernsey, Jersey, the Isle of Man and the United Arab Emirates.[10]

There is scope for a country with a corporate tax rate of 15% or more to be determined to be a low corporate tax jurisdiction by regulation where it has a patent box regime "without sufficient economic substance" (s 960-258(4) and (5)).

There is a form of "sufficient foreign tax" carve-out from the measure. This is a new exception in the second exposure draft. It provides that, even if the associate derives the relevant income in a low corporate tax jurisdiction, the deduction is not denied if "the income is or will be subject to foreign income tax at a rate of 15% or more" (s 26-110(4)(b)(i)). This applies where the payee jurisdiction has a corporate tax rate below 15% (including as deemed under s 960-258(2)), but nonetheless taxes this particular item at 15% or more. The draft explanatory materials, at paras 1.72 and 1.73, give the addition of state and municipal taxes to those at the federal level as an example of this. This would also appear to apply where a third country's controlled foreign company (CFC) regime attributes the income to a controller in a higher tax jurisdiction (the draft explanatory materials state this at para 1.68). As noted above, it is unclear if this applies if the associate in the low corporate tax jurisdiction on-pays the same or a similar amount to an associate in a higher corporate tax jurisdiction. The deduction is also not denied if the income is picked up under Australia's CFC regime (s 26-110(4)(b)(ii)) or by the foreign hybrid mismatch rules of another country (s 26-110(4)(b)(iii)).

The interesting and difficult question is what happens where the payee jurisdiction has a headline rate below 15% but implements a qualified domestic minimum top-up tax (QDMTT) under Pillar Two, or other similar Pillar Two measures. A QDMTT allows a low corporate tax country to tax the "gap" to 15%, rather than yield it to another country. Countries which have announced that they intend to introduce a QDMTT include Ireland, Liechtenstein and Switzerland. The QDMTT is generally not designed to affect the corporate tax rate. Whether it counts as "foreign income tax" for s 26-110(4)(b)(i) purposes may come down to the drafting in the foreign jurisdiction. But the main issue is that Pillar Two uses a per jurisdiction average. That is, its "minimum tax" requirement is that a ratio of 15% or more must be achieved when one divides total income tax in the jurisdiction by total financial statement income in the jurisdiction. The actual tax on a particular item is not the yardstick for Pillar Two, but it is for the intangible integrity measure. So, in the future, these two regimes could apply in quite an uncoordinated fashion, which does not seem consistent with policy or the multilateral consensus as to Pillar Two.

In addition, on the current drafting, those two regimes do not "switch on" at the same turnover threshold. There may be some multinational groups that are subject to the intangible integrity measure but not Pillar Two. The turnover threshold for s 26-110 is the same as the turnover threshold for SGE status, which is global income of A$1b or more.[11] For Pillar Two, it is global income of EUR 750m or more, currently about A$1.2b.

Comparison to rules in other countries

The recently released explanatory memorandum in respect of the thin capitalisation changes[12] also includes some discussion of the intangible integrity measure. It states that "jurisdictions such as the United States, the United Kingdom, the Netherlands and Germany have implemented measures to address similar issues".[13] Those countries each have different regimes. None of the regimes deny the entire deduction. Each has other requirements additional to those in s 26-110, making them more complex and less blunt than s 26-110.

The US kicked off the minimum tax trend with its global intangible low-taxed income and base erosion anti-abuse tax (BEAT) in 2017. This was introduced at the same time that the US cut its corporate tax rate from 35% to 21% and brought in other measures encouraging the return to the US of intangibles and intangible-related income, such as the foreign derived intangible income concession. The BEAT denies deductions, but in a way that is different from s 26-110. The August 2022 Treasury consultation paper in relation to the intangible integrity measure noted that the US will replace the BEAT with Pillar Two from 2024.[14]

In 2019, the UK introduced the offshore receipts in respect of intangible property (ORIP) rule. It is an income inclusion rule, not a deduction denial. It works by deeming certain low-taxed (under 10%, rather than s 26-110's 15%) offshore intangible income derived in a non-treaty jurisdiction to have a UK source. Section 26-110, by contrast, does not exclude treaty countries. The UK's ORIP has a carve-out along the lines of sufficient economic substance.

The Netherlands' rule is a withholding tax top-up for royalties. It applies where the payment is to a jurisdiction with a corporate tax rate below 9%. Its effect is to top up the Dutch royalty withholding tax rate to the highest Dutch corporate tax rate (25%). This deals with treaty shopping for royalties, but only for very low tax jurisdictions. It does not extend beyond royalties and does not deny deductions.

Germany's royalty barrier rule is perhaps the closest model to s 26-110, but it is narrower. It denies part or all of a deduction where a payment is made to a country with an OECD "harmful tax regime" patent box regime. It applies to a direct payment, not indirect payments. It only applies where the residence state taxes intangible income in a manner that is different from how it taxes other income. It also has a "sufficient economic substance" type carve-out, in line with the OECD's "substantial business activity" test for patent box regimes. It does not necessarily deny all of the deduction, but rather the part corresponding to the ratio between the actual tax rate paid and the 25% low tax rate. If the foreign tax is paid at, for example, 12.5% and the other requirements of the rule are met, half of the deduction (12.5 divided by 25) is disallowed.

Conclusion

The proposed new s 26-110 is a blunt measure in that it denies all of the deduction, and doubles penalties,[15] even where the transaction meets arm's length principles and does not attract any anti-avoidance rules. The deduction denial and the penalty hike kick in if there is a link, which can be indirect, to an amount being derived by an associate in a country with a corporate tax rate under 15% and it is taxed at less than that rate. If it is 14.9%, the entire deduction is denied; if it is 15%, it is not. It is unfortunate that the measure has effectively commenced operation at a time when it is only in draft form and when significant matters relating to it are still in flux.

The announcements about the measure as it developed over the last 18 months referred to a number of policy concerns.[16] These were, variously, treaty shopping, erosion of the global tax base, erosion of the Australian tax base, undue technicalities in the "royalty" definition, and the issue of "embedded" royalties. The rule in its current format appears to pursue one policy above others, that is, discouraging SGEs from using low tax jurisdictions. This is because the unclear boundaries of the "intangible asset", "exploit", causation and apportionment elements of the measure mean that the clearest path to achieving comfort that the rule will not apply will typically be ensuring that low corporate tax jurisdictions are not in the supply chain or, if they are, that any amounts in issue are nonetheless taxed at 15% or more.

It would be useful to understand the economic incidence of s 26-110's deduction denial, if that is possible. It may be similar to the economic incidence of Australia's royalty withholding tax. Because the value of intangibles and IP is often in their monopoly-like features, it is plausible that many SGEs will raise the prices that are charged to Australian consumers and businesses in order to partly or wholly absorb increased Australian tax resulting from the measure. To the extent that this happens, it would cut across the measure's general purpose of discouraging SGEs from exploiting their economic status at Australia's expense.

The long-view question is how this measure will sit with Pillar Two. The government stated on 23 June 2023 that it is "further considering interactions of the intangibles measure with global minimum taxes and domestic minimum taxes".[17] More can be expected on this, certainly when Australia's Pillar Two draft legislation is released, but ideally sooner. Apart from the numerous technical issues and the different turnover thresholds, the main disconnect is the basis on which these two regimes apply. The intangibles integrity measure operates at the level of an individual payment and the foreign tax on the income resulting from that particular payment. However, in the Pillar Two design process, a concerted decision was made to focus on overall per country averages rather than individual payments or any other level of granularity.

Tax professionals need to be across the new intangibles integrity measure because it has already, in a sense, commenced, and should also monitor Australia's Pillar Two implementation as it will impact on the measure and may come to replace it.

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This article is based on the "Intangibles and Royalties" session presented at The Tax Institute's International Masterclass held in Sydney on 22 June 2023.

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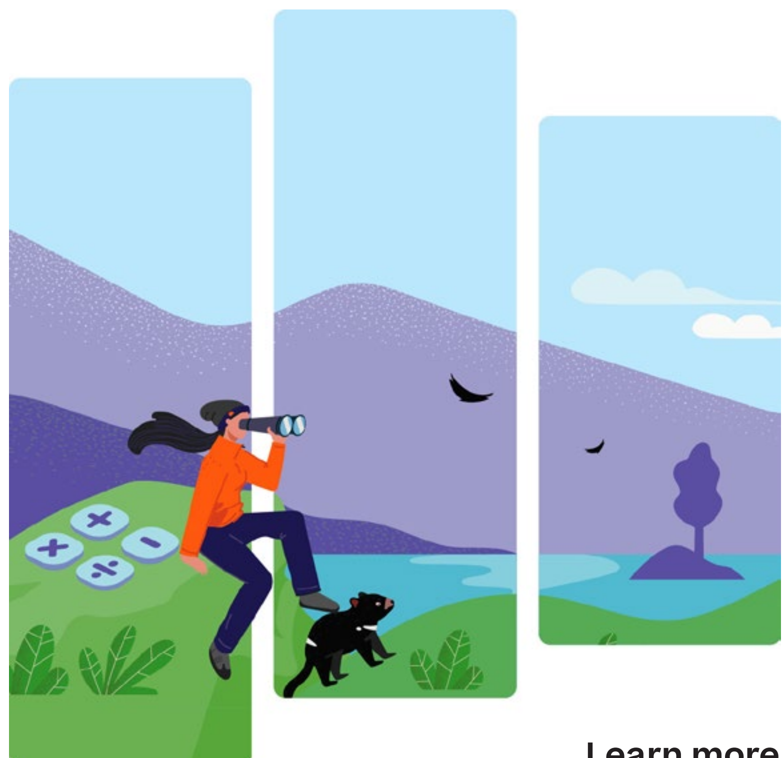

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Conditions of release

by Julie Steed, Senior Technical Services Manager, Insignia Financial

Superannuation conditions of release refer to the circumstances under which superannuation fund members can access their accumulated retirement savings. This abstract provides a concise overview of the key conditions governing the release of superannuation benefits. The eligibility criteria for accessing superannuation benefits vary depending on a member's age, employment status, and certain health conditions. Generally, members can access their superannuation on reaching age 65, retiring from employment after reaching preservation age, being diagnosed with a terminal illness, or suffering permanent incapacity. Many aspects of the conditions of release are technical in nature and may not always align with the plain English understanding of the terms, particularly retirement. However, their importance is significant as accessing superannuation without having met a condition of release is illegal early access. This is one of the most serious breaches of superannuation law which can result in heavy penalties for SMSF trustees and tax consequences for members.

Overview

Most of the conditions of release that provide fund members with access to their superannuation have not changed substantially for many years. However, there remain several areas that still cause confusion.

In this article, areas that can be unclear or seem contradictory, including the retirement definitions of release and dealing with terminal illness benefits, are reviewed. Also reviewed are some of the practical issues that arise, including managing a previous condition of release and the documentation requirements to substantiate that a condition of release has been met.

Preservation components

There are three types of preservation components:

1. the unrestricted non-preserved benefit;
2. the restricted non-preserved benefit; and
3. the preserved benefit.

The unrestricted non-preserved benefit can be paid at any time, and the restricted non-preserved benefit can be paid on termination of employment with an employer, or an associate of an employer who contributed to the fund. Preserved benefits cannot be paid until a condition of release is met.

There were major changes to the preservation rules from 1 July 1999. All future growth in accumulation phase since then is preserved until a condition of release is met. The unrestricted non-preserved benefits and the restricted non-preserved benefits as at 30 June 1999 were calculated and recorded. The preserved benefit is then calculated as the total benefit less any unrestricted non-preserved benefit and any restricted non-preserved benefit.

Unrestricted non-preserved benefits generally arose from pre-1999 member contributions. Restricted non-preserved benefits arose from certain pre-1999 employer benefits.

Unrestricted non-preserved benefits

If a member satisfies a condition of release with a nil cashing restriction, all of the member's preserved benefits in the fund at that time cease to be preserved benefits and can become unrestricted non-preserved benefits. Unrestricted non-preserved benefits may be cashed at any time, in whole or in part and as one or more lump sums or pensions. As with all things SMSF, the payment of any benefit is subject to the SMSF trust deed rules.

Restricted non-preserved benefits

If a member has a restricted non-preserved benefit in a retail fund, care needs to be taken if the member is considering rolling over to an SMSF. Unless an employer or an associate of an employer makes contributions to the SMSF, the restricted non-preserved benefit will not become unrestricted on termination of employment. The member will then need to meet a condition of release with a nil cashing restriction to access any restricted non-preserved benefit.

Preservation components are not like tax components that are required to be applied proportionally to any partial roll-over. A member could elect to roll over all of their preserved benefit and retain the restricted non-preserved benefit in the retail fund.

Nil cashing restriction

Conditions of release with a nil cashing restriction include:

- reaching age 65;
- retirement;
- death;
- a terminal medical condition; and
- permanent incapacity.

Documentation

The restriction on paying member benefits unless a condition of release has been met is an operating standard. This means that the SMSF auditors need to review compliance with the payment standards and they will require proof that a condition of release has been met.

Inheriting a fund

When an SMSF is transitioned from one service provider to another, preservation component information is often missing or inaccurate. In the absence of proof that a member has met a condition of release, all benefits invariably must be allocated as preserved.

Likewise, it is common to see part of a member's benefits classified as unrestricted non-preserved, although the member is under preservation age and has an eligible service date after 1 July 1999, ie they could not have made contributions prior to 1999.

Retirement conditions of release

Turning age 65

When a member reaches age 65, all benefits are accessible at any future time. The member can be working full-time and there is no requirement to terminate employment.

Turning age 65 is the only retirement-related condition of release that can be applied to a person who has never been gainfully employed, as they have no ability to have terminated an employment arrangement.

Retirement

The definition of "retirement" is contained in reg 6.01 of the *Superannuation Industry (Supervision) Regulations 1994* (Cth) (SISR) and has two limbs, based on a member's age.

For a person who has reached preservation age but is under age 60, their retirement is taken to have occurred if:

- an arrangement under which the member was gainfully employed has come to an end; and
- the person has no intention of being gainfully employed on a full-time or part-time basis

For a person who is age 60 or over, their retirement is taken to have occurred if an arrangement under which the member was gainfully employed has come to an end and either:

- the person was age 60 or over before the employment ended; or
- the person has no intention of being gainfully employed on a full-time or part-time basis.

Preservation age

Prior to 1 July 1998, preservation age was age 55 for all members. The preservation age is increasing to age 60. The preservation age depends on a member's date of birth (see Table 1).

Gainfully employed

"Gainfully employed" is defined in reg 1.03 SISR as being employed or self-employed for gain or reward in any business, trade, profession, vocation, calling, occupation or employment.

The definition is broken up into two components:

1. employed or self-employed; and
2. receipt of gain or reward.

Employed or self-employed

While "self-employed" is not defined in superannuation law, s 15A of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA) defines "employee" and "employer" which can be used to help determine whether a person is employed for superannuation purposes. These definitions align with the expanded meaning of these words used for superannuation guarantee purposes.

Common indicators that a person is employed are an employment contract, the receipt of salary from an employer which includes the deduction of PAYG tax, the payment of superannuation guarantee contributions, and entitlement to leave payments.

A person who is self-employed must generally be carrying on a business. A business includes any profession, trade, employment, vocation or calling other than an occupation performed as an employee.

Practitioners are often asked if volunteering constitutes employment, which it rarely does as there is invariably no employer/employee relationship for volunteers. Likewise, activities that are of a personal or domestic nature (such as babysitting family members) will generally not qualify.

Employment or self-employment is not confined to Australian activities. However, if relying on foreign employment or self-employment, the maintenance of robust documentation is recommended (particularly if translation is required!).

Table 1. Preservation age*

Date of birth	Preservation age	Access to benefits
Before 1 July 1960	55	Currently eligible
1 July 1960 – 30 June 1961	56	Currently eligible
1 July 1961 – 30 June 1962	57	Currently eligible
1 July 1962 – 30 June 1963	58	Currently eligible
1 July 1963 – 30 June 1964	59	1 July 2022 – 30 June 2023
From 1 July 1964	60	From 1 July 2024

* Source: *MLC Facts and Figures 2023/24*, p 37. Available at https://online.flippingbook.com/view/981906264.

Receipt of gain or reward

The receipt of gain or reward in respect of gainful employment requires the gain or reward to be in return for personal exertion. The gain or reward may include the receipt of remuneration, such as salary or wages, business income, bonuses, commissions, fees or gratuities.

The receipt of passive income (for example, from an investment portfolio) will not constitute gain or reward from gainful employment.

The concept of gain or reward is broad enough to encompass payments other than salary or wages, such as free housing and payment of utilities associated with the housing. However, the gain or reward must be directly related to employment activities and be commensurate with the personal exertion undertaken.

Expense reimbursements do not constitute gain or reward as they reflect compensation for expenditure incurred, rather than a payment for personal exertion.

Company directors

Company directors are generally office holders rather than employees. However, there is a provision in s 15A SISA that potentially enables a director to be considered as an employee. The requirements are that the director is entitled to be paid for their directorship. Directors are not generally entitled to be paid so it is important to ensure that the company constitution permits a director to be paid.

If a director is entitled to be paid and does receive a gain or reward payment, the resignation as a director after age 60 or after preservation age if they intend to permanently retire may trigger a retirement condition of release.

The ATO is likely to review arrangements involving the retirement of directors to ensure that there is no ongoing involvement in directing the business. The ATO website provides the Crackle case study example of establishing whether gainful employment has ceased for a director and employee.[1] This case study shows that merely terminating the arrangement "on paper" is not sufficient if the person continues to receive some form of reward for their personal exertion.

Termination

The retirement conditions of release require that an arrangement under which the member was gainfully employed has come to an end. This requires the arrangement to have terminated, rather than merely changed, even if the change is significant.

This is a particularly important concept for practitioners as members and SMSF trustees regularly do not appreciate the technical importance of the termination — in their mind, they have retired or are working less than 10 hours per week and therefore believe that they have met a retirement condition of release.

While members often intend to fully retire, they are frequently encouraged by their employer to remain on the books and fulfil casual or relief roles or work in an ongoing part-time capacity. If this occurs, the employment arrangement may not have terminated and therefore a retirement condition of release is not met.

Termination of gainful employment is an important consideration because, if the member has not terminated employment and therefore a condition of release has not been met, the payment will be in breach of the payment standards and constitute illegal early access. This can result in penalties to the SMSF trustees of 20 penalty units (currently $6,260) for a breach of an operating standard. In addition, the amount would be included in the member's personal income and taxed at their marginal tax rate, plus personal tax penalties.

The ATO expects trustees to obtain and retain evidence and documentation regarding a termination of gainful employment (further information is provided below).

Termination: case study

Sharmi worked full-time for 30 years with Medium Company. Sharmi retired at age 60 and commenced taking all her accrued leave. Prior to her accrued leave expiring, she was convinced to accept a casual role with Medium Company, working one day per week. Although Sharmi's hours have changed dramatically, she did not terminate employment with Medium Company and has therefore not met a retirement condition of release.

Termination from age 60

Where a member has multiple employment arrangements, terminating one of the arrangements after age 60 satisfies the retirement condition of release for all superannuation accrued to that date.

Multiple job termination: case study

Philip is age 62 and employed full-time with RBA Pty Ltd. In May 2022, he was employed as an electoral assistant and that employment terminated on 30 May 2022.

All of his superannuation accrued to 30 May 2022 can become unrestricted non-preserved.

Permanently retired

Permanently retired requires the member to never intend to be gainfully employed on a part-time or full-time basis. For this purpose, reg 1.03 SISR defines "part-time" gainful employment as being gainfully employed for at least 10 hours, and less than 30 hours, each week. "Full-time" gainful employment is defined as being gainfully employed for at least 30 hours each week.

When considering the permanent retirement after preservation condition of release, the termination of employment can have occurred at any time in the past. Unlike the termination of employment after age 60 retirement definition, the termination does not need to occur after reaching preservation age.

Practitioners are often asked what happens if a member genuinely intended to permanently retire but returns to the workforce after they have accessed their superannuation

or started a retirement phase pension. Provided that the intention to permanently retire was genuine and not a contrived arrangement, there is no requirement for the unrestricted benefits to return to a preserved status. However, any future contributions and investment return in accumulation phase will be preserved.

Permanently retired: case study one

Dhoa is 59 when she sells her florist shop in February 2023. Prior to selling, she accepts a position with a local events management company to work for six hours each Friday preparing floral arrangements. She has no intention of doing any other work. Although Doha has future employment, she meets the retirement condition of release by terminating her self-employment and having no intention of working 10 or more hours per week.

Permanently retired: case study two

Hai is 59 when, in February 2023, he agrees with his employer Big Pty Ltd that he will reduce his working hours to one day per week (7.5 hours per week). Hai does not terminate his employment with Big Pty Ltd. However, over his working life he has terminated employment with a variety of employers. Hai meets the retirement condition of release as he has reached his preservation age, has terminated a gainful employment arrangement in the past, and does not intend to be gainfully employed for 10 hours or more in the future.

Nil cashing and limited recourse borrowing arrangements

Where a member of an SMSF has a limited recourse borrowing arrangement (LRBA) and they meet a condition of release, their total superannuation balance may be amended. The outstanding LRBA amount is added to the total superannuation balance if:

- the LRBA commenced on or after 1 July 2018 and:
  - the LRBA is a related party loan; or
  - the member has met a condition of release with a nil cashing restriction; and
- the LRBA is over an asset which is supporting the member's interest in the fund.

While the related party loan aspect of the addition of the LRBA amount to the total superannuation balance is generally well understood, the meeting of a nil cashing restriction is often missed.

LRBA: case study

Chu acquired a property with an LRBA from Lender Bank on 1 July 2018 at age 55. Ill health causes Chu to terminate employment on 1 June 2023 at age 60. Chu immediately gets a full-time sedentary position with another employer. The termination of employment after age 60 is a nil cashing restriction condition of release and the outstanding LRBA amount will be added to Chu's total superannuation balance at 30 June 2023:

Cash and shares	**$750,000**
Plus property	$1,200,000
Less LRBA	$300,000
Account balance	$1,650,000
Plus LRBA	$300,000
Total superannuation balance	**$1,950,000**

Chu will not be eligible to make non-concessional contributions to the SMSF in 2023–24 as their adjusted total superannuation balance at 30 June 2023 is above $1.9m.

Timing of access

When a member reaches age 65, all benefits are accessible at any future time.

When a member reaches preservation age and permanently retires from the workforce, all benefits are accessible at any future time. If the member returns to gainful employment, all future benefits become preserved.

When a member terminates employment after age 60, only the benefits accrued to the date of termination become accessible. All future growth is preserved. A common strategy for members who intend to continue with gainful employment is to start a retirement phase pension. This solidifies the unrestricted non-preserved nature of the pension interest and any earnings in the pension will also be unrestricted non-preserved. Withdrawals can be made from the pension at any time and future preserved benefit can grow in accumulation phase.

The member can apply for the benefit amount accrued to the date of termination of employment after age 60 at any future time. However, there may be practical difficulties in calculating the value of a benefit at the relevant historic date. If the SMSF uses a professional administration system, the calculation may be able to be readily determined and proven to an auditor or the ATO. Even then, some administration systems may not enable a calculation in a prior financial year once the SMFS accounts have been finalised for the year. SMSFs that do not use professional administration systems may need to have interim accounts prepared.

Retirement documentation

Where a member has permanently retired after preservation age, it is important to ensure that the termination of employment is documented and the member attests to their intention to permanently retire. These documents should be retained on file. Given the mutuality of the member and the trustee in an SMSF, documentation of retirement is often overlooked. However, if the member subsequently returns to employment and is not retired at the time of audit, there may be difficulties in demonstrating that the benefits are legitimately unrestricted non-preserved.

Termination documentation

If a member was an employee of an unrelated employer, evidence of termination of employment can be relatively easy to obtain. Documentation may include a letter/email of resignation and acceptance by the employer, a termination notice, a statement of payment of final leave entitlements, or a PAYG payment summary with a non-30 June end date.

If a member was employed as a casual, proof may be more difficult and written confirmation that the member is terminating employment is recommended.

Where a member is self-employed or employed by a related employer, whether a termination of gainful employment has occurred will be a question of fact. However, documentation of termination can be problematic. Robust documentation can include documentation of the sale of the business and/or the assets required to run the business. These could include the business premises, goodwill and tools of the trade. Cancellation of the business name and ABN are helpful, but there may be valid reasons for retaining a trust or company and therefore not cancelling the ABN. Lodgment of final tax returns and notification to service providers (such as accountants or auditors) that their services will not be required in the future could also assist.

It is also important for members to appreciate that the ATO has sophisticated data-matching capabilities. They can readily identify inconsistencies such as declaring permanent retirement while receiving JobSeeker payments or receiving employment-related income.

Health-related conditions of release

Death

Death is the only compulsory cashing event. On the death of a member, their death benefit must be paid as soon as practicable.

If a death benefit is paid as a pension, the pension is unrestricted non-preserved and the beneficiary can access the benefit at any time.

Permanent incapacity

The permanent incapacity condition of release requires the trustee to be satisfied that the member is unlikely, because of ill-health (physical or mental), to engage in gainful employment for which the member is reasonably qualified by education, training or experience (reg 1.03C SISR).

In an SMSF, given the mutuality between the trustee and the member, the trustee may be satisfied based on the member's health condition and/or the member's current treating doctor's medical opinion.

There are tax concessions that apply to disability superannuation benefits which are defined as a superannuation benefit (s 995-1 of the *Income Tax Assessment Act 1997* (Cth)) if:

- the benefit is paid to a person because they suffer from ill-health (whether physical or mental); and
- two legally qualified medical practitioners have certified that, because of the ill-health, it is unlikely that the person can ever be gainfully employed in a capacity for which they are reasonably qualified by education, experience or training.

The difference between the condition of release definition and the tax concession definition is the requirement for two legally qualified medical practitioners to certify rather than the trustee to be reasonably satisfied.

Documentation

To demonstrate compliance with the condition of release, trustees should retain the evidence on which they have satisfied themselves that the member meets the "permanent incapacity" definition.

If the trustee is applying the tax concessions available for a disability superannuation benefit, they must retain the two certificates from the legally qualified medical practitioners.

Insurance

If the member has disability insurance, it is important to review the policy definition of "disability". Since 1 July 2014, superannuation insurance policy definitions must align with the permanent incapacity condition of release definition. However, policies held prior to 1 July 2014 are grandfathered. An SMSF may hold a policy for a member which is "own occupation" where the disability definition is that the member is unlikely to engage in gainful employment in their *usual* occupation (rather than the "any occupation" definition). This could result in the insurance proceeds being paid to the SMSF, but the condition of release is not met so the insurance proceeds cannot be paid to the member.

> "… the documentation requirements for this condition of release are often overlooked."

The insurance policy definition may also be narrower than the condition of release. For example, many policies will include the requirement for the member to be unable to undertake activities of daily living (feeding, bathing, dressing). Other policies may include the requirement for the member to be unable to engage in gainful employment for which the member is reasonably qualified by education, training, *retraining* or experience.

Terminal medical condition

A member who has a terminal medical condition can access their superannuation benefits as a tax-free lump sum. Fortunately, both the tax definition (reg 995-1.06 of the *Income Tax Assessment (1997 Act) Regulations 2021* (Cth)) and the superannuation definition (reg 6.01A SISR) are the same and require:

- two registered medical practitioners to certify, jointly or separately, that the member suffers from an illness, or has incurred an injury, that is likely to result in the member's death within 24 months or less (the certification period);
- at least one of the medical practitioners is a specialist practicing in an area related to the illness or injury; and
- the certification period has not ended (the shorter of the certification periods if there are two certificates with different certification periods).

The member benefits accrued at the time of meeting the condition of release, or which accrue during the certification period, become unrestricted non-preserved. However, if the member survives beyond the certification period, all future growth is preserved.

It is important to ensure that the SMSF trust deed permits the payment of a benefit under the terminal illness condition of release. The terminal illness condition of release was introduced in 2008 and the certification period was originally 12 months but was increased to 24 months from 1 July 2015. Many older trust deeds do not include the ability to pay a terminal illness benefit or may still have the 12-month certification period stated in the deed.

Complying pensions

Superannuation law does not permit the commutation of a lifetime, life expectancy or market-linked income stream because of a member's terminal medical condition.

Terminal medical condition documentation

Given the mutuality between the member and the trustee in an SMSF, the documentation requirements for this condition of release are often overlooked. While the member/trustee may be well aware that they have a terminal illness and their longevity is expected to be less than 24 months, the medical practitioner's certificates must be obtained and retained on file.

Terminal medical condition strategies

Where a member expects a death benefit to be paid to adult children, the withdrawal of a tax-free terminal medical condition benefit payment can save the 17% (including Medicare levy) tax that would be paid on the taxable component of a death benefit from the SMSF. The member can then gift the proceeds to their children, or the non-superannuation monies can be distributed via the estate without the superannuation death benefit tax.

Alternatively, if a tax-free death benefit pension payable to a spouse provides a better outcome, the benefit could be retained in the SMSF or only a partial withdrawal made. A withdrawal and recontribution strategy may also improve the tax position of a future death benefit pension if both spouses are under age 60.

If the member has life insurance, many policies allow the insurance amount to be paid as a terminal illness benefit. Some older policies may still require the life expectancy prognosis to be limited to 12 months. If the policy only pays on death, members will generally want to ensure that sufficient benefit is retained in the SMSF to cover ongoing premium payments.

A terminal illness benefit can be rolled over to another fund; however, such roll-overs are not roll-over superannuation benefits under tax law. This means that, if a terminal illness benefit is rolled over, the transfer is not treated as a roll-over but as a withdrawal and then a personal member contribution. The amount will therefore count towards the member's concessional and/or non-concessional contributions cap, depending on whether they may have been eligible to claim a tax deduction for some of the contribution.

If the member chooses to receive a pension benefit, the benefit is taxed as a normal superannuation pension, that is, there are no tax concessions for a terminal illness pension.

A terminal medical condition benefit is tax-free, even if the benefit contains an untaxed element of the taxable component, which would otherwise be taxed at 17% if withdrawn. This can provide a tax benefit to members of untaxed superannuation funds.

Temporary incapacity

An SMSF can pay a non-commutable income stream to a member who meets the temporary incapacity condition of release. Temporary incapacity requires a member to have ceased to be gainfully employed (including a member who has ceased temporarily to receive any gain or reward under a continuing arrangement for the member to be gainfully employed) and suffers ill-health (whether physical or mental) that caused the member to cease to be gainfully employed but does not constitute permanent incapacity (reg 6.01(2) SISR).

The non-commutable income stream must be for the purpose of continuing (in whole or in part) the gain or reward which the member was receiving before the temporary incapacity. This means that the member cannot receive temporary incapacity benefits that exceed the pre-disability income. When a member is in receipt of any form of paid leave, they are likely to be receiving the leave payments at their pre-disability income level. Therefore, the paid leave will generally need to be exhausted before a temporary incapacity benefit can commence.

The income stream cannot be paid for a period exceeding the period of incapacity from employment of the kind engaged in immediately before the temporary incapacity. However, if the member returned to gainful employment in a different capacity, the benefits could continue. The income from the new employment plus the temporary incapacity benefit must still not be greater than the pre-disability income. Likewise, the member could return to their usual gainful employment on a reduced basis and continue to receive payments that, together with employment income, do not exceed the pre-disability income.

Temporary incapacity benefits are generally payments from the proceeds paid from an income protection policy held within the SMSF. The income stream must not be paid from the member-financed benefit or the

mandated employer-financed benefit, which is generally all member and employer mandated contributions plus earnings. However, it may be possible to make payments from voluntary employer or salary sacrifice contributions (reg 5.08(3) SISR).

Insurance policies typically insure up to 75% of a member's pre-disability income. The ability to fund the temporary incapacity from salary sacrifice contributions may provide the opportunity to augment any insurance amounts. This would require the trustee to have maintained a separate record of salary sacrifice contributions and investment returns.

Temporary incapacity documentation

Given the mutuality between the member and the trustee in an SMSF, the documentation requirements for this condition of release are often overlooked, particularly if the SMSF is receiving proceeds from an insurance policy. It is still important for the trustee to document how they are satisfied that the member has met the temporary incapacity condition of release.

The non-commutable temporary incapacity income stream is an income replacement benefit rather than a superannuation benefit, and the SMSF trustee is required to calculate, deduct and remit PAYG tax as ordinary income. The SMSF is also required to produce an annual PAYG payment summary by 21 July each year.

Transition to retirement pension

When a member reaches preservation age, they can commence a non-commutable transition to retirement pension. The pension payments are the member's age based minimum and a maximum of 10%. The 10% maximum pension payment is not pro-rated if the transition to retirement pension commences during the year. The minimum pension payments are pro-rated and no pension payment is required if the pension commences in June.

A member can commence a transition to retirement pension with preserved, restricted non-preserved, and unrestricted non-preserved benefits. However, once the pension has commenced, the pension payments must be drawn from the preservation components in the following order:

- unrestricted non-preserved;
- restricted non-preserved; and
- preserved.

Preservation components are not like tax components that are required to be applied proportionally to any partial roll-over. A member could elect to commence the transition to retirement pension with all of their preserved benefit, and retain any unrestricted non-preserved benefit or restricted non-preserved benefit in the accumulation account.

Preservation components: case study

Jack is 59, has reduced his working hours, and is looking to supplement his employment income. His account balance is $800,000, of which $300,000 is the unrestricted non-preserved component. Jack's personal circumstances are such that receiving an income stream is more tax-effective than accessing his unrestricted non-preserved component as a lump sum benefit.

Jack commences a transition to retirement pension with $400,000 which is fully preserved. He retains his accumulation account with a $300,000 unrestricted non-preserved component and a $100,000 preserved component. Jack can withdraw up to $40,000 of income from his transition to retirement pension. His unrestricted non-preserved component is maintained for when he intends to access it tax-free after age 60.

Transfer balance account credit

Since 1 July 2017, transition to retirement pensions are not retirement phase pensions and do not benefit from exempt current pension income. However, when a member meets a nil cashing restriction condition of release, the pension balance is a credit in the member's transfer balance account. Given the mutuality of the SMSF member and trustee, the trustee will be expected to be aware that a member has met a relevant condition of release and report the transfer balance event.

SMSF members should review their transition to retirement pension account balance on meeting a nil cashing restriction condition of release to ensure that they do not exceed their transfer balance cap.

Other conditions of release

There are several other conditions of release that may be relevant to SMSFs but are less common than the nil cashing restrictions and transition to retirement.

Compassionate grounds

Members may apply to the ATO to approve the release of benefits on compassionate grounds (reg 6.19A SISR). Members can apply via their MyGov account. There are only very limited circumstances where benefits may be released on specified grounds. They are defined in legislation and cover expenses in respect of the following:

- medical treatment for the member or their dependant where the treatment is necessary to treat a life-threatening illness or injury, or to alleviate acute or chronic pain or an acute or chronic mental disturbance, and where such treatment is not readily available through the public health system;
- medical transport for the member or their dependant to access treatment necessary to treat a life-threatening illness or injury, or to alleviate acute or chronic pain or an acute or chronic mental disturbance;
- modifications to the family home and/or vehicle to meet the special needs of a disabled member or their disabled dependant;
- palliative care or death, funeral or burial expenses for the member or their dependant; and
- preventing foreclosure of a mortgage of the member's principal place of residence.

The amount that can be released to prevent foreclosure of a mortgage is defined in the legislation as an amount, in each 12-month period (beginning on the date of first payment), that does not exceed an amount equal to the sum of:

- three months' repayments; and
- 12 months' interest on the outstanding balance of the loan.

When applying to the ATO, it is necessary to provide a written statement from the mortgagee which states that:

- payment of an amount is overdue; and
- if the person fails to pay the amount, the mortgagee will:
  - foreclose the mortgage on the person's principal place of residence; or
  - exercise its express, or statutory, power of sale over the person's principal place of residence.

The statement must also include information to calculate the amount of three months' repayments and 12 months' interest.

Complying pensions

Superannuation law does not permit the commutation of a lifetime, life expectancy or market-linked income stream because a member meets the compassionate grounds condition of release.

Severe financial hardship

For members who wish to access their benefits on the grounds of severe financial hardship under preservation age (reg 6.01(5) SISR), there are two tests that must be met before a trustee is able to release a benefit:

1. the member must be in receipt of a Commonwealth income support payment and have been so continuously for the last 26 weeks; and
2. the member must satisfy the trustee that they are unable to meet reasonable and immediate family living expenses.

Commonwealth income support payments

As it is not negotiable that the member be in receipt of Commonwealth income support payments for the required period, difficulties will often arise as many members defer applying for Centrelink payments until they have exhausted all other avenues. Some members may also not be eligible for Centrelink payments.

Members need to obtain a letter from a relevant government department confirming that they have been on income support payments for 26 consecutive weeks. The letter is only valid for 21 days. Commonwealth income support payments include social security or service pensions, certain social security benefits, and income support supplements.

Reasonable and immediate family living expenses

There are three components to this test:

1. reasonable;
2. immediate; and
3. family.

The interpretation of "reasonable" is the most subjective component and will depend on a member's personal circumstances. "Reasonable" refers to both the nature and the amount of the expense, while "immediate" requires that the expenses are currently due and payable, ie the expense has already been incurred.

Importantly, business expenses do not qualify. This can be problematic where the financial difficulty has arisen because of a failing family business.

Other criteria

The maximum payment that can be paid is $10,000 gross. PAYG tax is deducted from payments for members under age 60. The minimum payment is $1,000 (unless the account balance is below $1,000, in which case, the whole account balance may be released).

Funds cannot pay more than is necessary to relieve the member from their severe financial hardship.

Only one payment can be made in any 12-month period.

Alternative test

For members aged at least preservation age plus 39 weeks, an application may be made under an alternative test. The client must:

- have received a Commonwealth income support payment for a cumulative period of 39 weeks after reaching preservation age; and
- not be gainfully employed (full-time or part-time) on the date of application.

If members satisfy this test, the trustee may release the entire benefit as there are no cashing restrictions under this test.

Complying pensions

Superannuation law does not permit the commutation of a lifetime, life expectancy or market-linked income stream because a member meets the severe financial hardship condition of release.

First home super saver scheme

The first home super saver (FHSS) scheme allows eligible members to access voluntary superannuation contributions to purchase their first home. A maximum of $15,000 of voluntary contributions made in any one financial year, subject to a total of $50,000, may be released. Voluntary contributions include salary sacrifice contributions, member non-concessional contributions and member concessional contributions made since 1 July 2017. In addition, associated earnings may also be released.

A member requests a FHSS determination from the ATO prior to entering into a contract for the purchase of a home. The ATO will determine a member's eligibility and calculate the amount of contributions and associated earnings that can be released.

The member then requests the ATO to issue a release authority to the SMSF trustee who can then make the payment.

Spouse contribution splitting

Contribution splitting of concessional contributions (reg 6.44 SISR) is available where the receiving spouse is under preservation age.

Where the receiving spouse is between preservation age and age 65, they must not have met a retirement condition of release. For the application to be valid, it must include a statement that the receiving spouse:

- is currently gainfully employed for 10 or more hours per week;
- is not currently employed for 10 or more hours per week but has not yet determined that they have no intention to ever resume gainful employment of 10 or more hours per week (ie they are not permanently retired); or
- has never been gainfully employed for 10 or more hours per week.

Contribution splitting is not available for spouses over age 65.

Conclusion

Although the conditions of release have not changed substantially for many years, there are still areas that cause confusion. Understanding the details and technicalities of the rules will allow practitioners to respond to more complex questions regarding conditions of release, and to be alert to areas of member confusion, particularly in relation to termination of gainful employment.

Identifying the practical impediments to accessing historic conditions of release can assist practitioners to manage member and trustee expectations and/or highlight the value of accessing benefits at the time a condition of release is met.

Understanding the documentation requirements for demonstrating that a condition of release has been met (and the differences in tax documentation rules) will also assist in the SMSF audit process.

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This article is an edited and updated version of “Conditions of release” presented at The Tax Institute’s Superannuation Intensive held on 30 to 31 March 2023.

Reference

1 Australian Taxation Office, *Establishing whether gainful employment has ceased*, QC 48668, 6 April 2016. Available at www.ato.gov.au/misc/downloads/pdf/qc48668.pdf.

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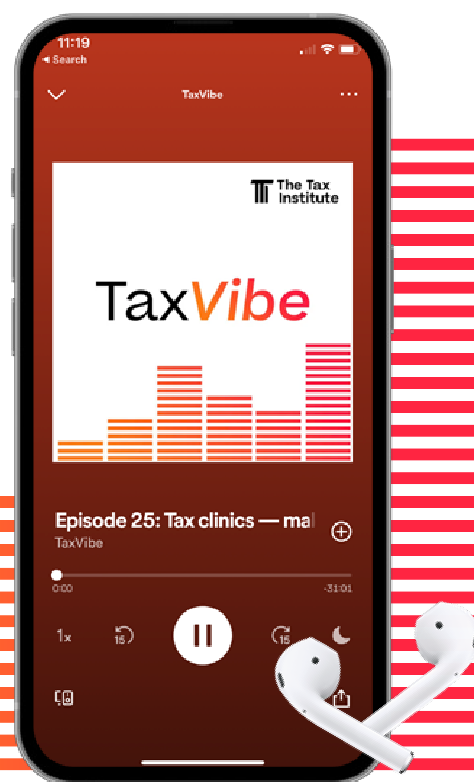

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The rules behind the NALI and NALE acronyms

by Craig Day, Head of Technical Services, Colonial First State

This article examines the circumstances in which a non-arm's length expense (NALE) may result in the derivation of non-arm's length income (NALI) for superannuation funds in Australia. It summarises the ATO's views as outlined in LCR 2021/2 and their implications for self-managed superannuation funds (SMSFs). The NALI rules were designed to prevent income diversion through non-arm's length dealings, leading to tax advantages for superannuation funds. LCR 2021/2 provides guidance on the application of these provisions in a range of scenarios, including for specific and general fund expenses. The government's proposed changes to the NALI provisions in relation to general fund expenses for SMSFs and large APRA-regulated funds are also discussed. Professional advisers must understand these rules to ensure compliance and effective tax planning for their SMSF clients, considering the potential impact on tax liabilities for SMSFs acquiring assets or services from related parties below market value.

Overview

In 2021, the ATO released LCR 2021/2 which outlines the ATO's views on when a complying superannuation fund will derive non-arm's length income (NALI) where it has incurred a non-arm's length expense (NALE).

However, in response to industry concerns in relation to how the rules apply to general fund expenses, the government announced that it would amend the rules to ensure that they were operating as intended. As a result, the government has released an exposure draft[1] which intends to enact changes regarding how the rules will operate for self-managed superannuation funds (SMSFs) and large APRA-regulated funds.

It is important to note that these changes are only proposed to apply for general fund expenses, and that the ATO's views in relation to how it will administer the NALI provisions in relation to a specific expense are not changing. Therefore, it is extremely important that professional advisers with SMSF clients understand how the existing rules in relation to specific expenses will be administered, as well as what changes are being proposed.

What is non-arm's length income?

The NALI rules are designed to stop income from being artificially diverted into the low tax superannuation environment via the use of schemes. The rules are contained in s 295-550 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) and, prior to 2018–19, captured amounts of both ordinary and statutory income of a superannuation fund that were:

- derived from a scheme where the parties to the scheme are not dealing with each other on an arm's length basis, and the amount of income received by the fund is more than it would have been if the parties were dealing at arm's length;
- a dividend from a private company where the amount is not consistent with an arm's length dealing having regard to a range of factors;[2]
- a distribution from a non-fixed trust, such as a discretionary trust; or
- a distribution from a fixed trust, such as a unit trust, where the income was derived under a scheme where the parties were not dealing at arm's length and the amount of income is more than the amount that the superannuation fund would have received if they were dealing on an arm's length basis.

Where a fund was deemed to derive NALI from a scheme or private company/trust investment, the whole amount (less any deductions to the extent that they are attributable to that income) will be NALI and taxed at 45%, ie not just the income above an arm's length amount.

For example, if an SMSF entered a scheme to lease a business real property to a related party for double the market rate of rent, all of the rent derived from the property would be NALI taxed at 45% — not just the 50% of the rent that exceeds a commercial arm's length amount.

Non-arm's length expense amendments

In 2019, the government amended s 295-550 ITAA97[3] to expand the definition of NALI to specifically include income derived via a non-arm's length dealing where a NALE was incurred. The government stated that these amendments were necessary to remove any ambiguity that the NALI provisions apply in these situations. The legislation also confirmed that the expanded NALI definition applies from 2018–19 onwards.

Scheme amendments

Under the 2019 changes, an amount of ordinary or statutory income will also be NALI where it is derived from a scheme involving a non-arm's length dealing and, as a result, the fund incurs a loss, an outgoing or expenditure that is less

than the amount that the fund might have been expected to incur had the parties been dealing at arm's length. This includes situations where no loss, outgoing or expenditure was incurred but might otherwise have been expected to have been incurred if the transaction was on arm's length terms.

Fixed trust amendments

Income derived by a fund as a beneficiary of a fixed trust, such as a unit trust, will also be NALI where it is derived from a scheme involving a non-arm's length dealing and:

- the fund incurs a loss, an outgoing or expenditure in acquiring its fixed entitlement or in gaining or producing the income; and
- the amount is less than the amount that the fund might have been expected to incur had the parties been dealing at arm's length.

As with the scheme amendments, the NALE amendments also capture situations where the fund does not incur a loss, an outgoing or expenditure that it may have been expected to incur had the parties been dealing at arm's length.

Why no NALE amendments for private companies or non-fixed trusts?

Similar NALE amendments were not made to the private company and non-fixed trusts provisions in s 295-550 as:

- the private company provisions are already broad enough to capture situations where a fund incurred a NALE in acquiring shares in, or deriving income from, a private company; and
- income derived from a non-fixed trust, such as a discretionary trust, will automatically be NALI regardless of any schemes or NALE arrangements.

ATO releases LCR 2021/2

Following the changes to s 295-550, the ATO issued LCR 2021/2 to outline its views on how the amendments would operate and in what circumstances a fund would, and would not, derive NALI due to incurring a NALE.

LCR 2021/2 is effective from 1 July 2018 and applies to income derived from 2018–19 onwards, regardless of whether the scheme was entered into prior to 1 July 2018.

NALE relating to specific assets

LCR 2021/2 confirms that the NALI provisions will apply to any income derived from a specific asset where there is a sufficient nexus between a NALE and in gaining or producing the relevant income or in acquiring the relevant interest.

Importantly, while LCR 2021/2 confirms that guidance can be obtained from general legal concepts relating to whether an expense would be deductible under s 8-1 ITAA97 to determine whether there is a sufficient nexus between a NALE and the relevant income, an expense does not need to be deductible under s 8-1 for the NALE provisions to apply. For example, the ruling confirms that a NALE may be of a revenue or capital nature or may be deductible under a different specific provision.

Expenses of a recurrent nature not relating to the acquisition of an asset

Where a fund incurs a NALE of a revenue or recurrent nature that does not relate to the acquisition of an asset,[4] the NALE will have a sufficient nexus to all of the income derived from that asset in the relevant year (excluding any realised capital gains).[5] For example, if a fund incurred a NALE of a revenue nature in relation to an asset that was a residential investment property in one year but not in any future years, only the rent received by the fund in that relevant year would be assessed as NALI.

Expenses relating to the acquisition of an asset

Where a fund incurs a NALE to acquire an asset, or it incurs a NALE of a recurrent nature that relates to the acquisition of an asset (such as financing costs), the NALE will have a sufficient nexus to all income derived by the fund in respect of the asset, both in the year of acquisition as well as in all future years.

For example, where a fund acquired units in a private unit trust for less than market value, or it borrowed on non-arm's length terms (eg nil interest rate) from a related party to acquire a property from a third party at market value, the NALI provisions would apply to all future income (including any future realised capital gains) derived from the asset.

> "If they were acting with their 'trustee hat' on, they will not be required (or permitted) to charge the fund."

In this case, LCR 2021/2 also confirms that, where an SMSF borrowed on non-arm's length terms to acquire an asset (such as the property in the above paragraph), there will still be a sufficient nexus between the initial NALE to acquire the property and any future capital gain, even where the trustee subsequently refinanced the borrowing on arm's length terms.[6]

In addition, it is important to note LCR 2021/2 indicates that a NALE of a capital nature incurred in a year in relation to an existing asset, such as for renovations to an existing property, could permanently taint all of the income in that year and all future years, including 100% of any future capital gains, derived from the property, even though the property was originally acquired on arm's length terms.[7]

Purchasing assets and in-specie contributions

Where a fund purchases an asset for less than its market value under a scheme where the parties were not dealing

at arm's length, the fund will have incurred a NALE to acquire an asset. In this case, LCR 2021/2 makes it clear that the difference between what the fund paid for the asset and its market value cannot be treated as an in-specie contribution.[8]

However, the ruling does confirm that a fund can acquire an asset via an arrangement that involves both a purchase and a separate in-specie contribution without triggering the NALE rules where the contract makes it clear that the fund is only purchasing part of the asset at market value.[9]

For example, this could occur where a fund purchased 80% of a business real property with a market value of $1m from a related party for $800,000, with the remaining 20% of the property being transferred to the fund by the member as a $200,000 in-specie non-concessional contribution.

However, where an asset is transferred via two separate transactions, ie via a purchase/in-specie contribution or via two separate purchase contracts at different times, it will be critical to ensure that each separate purchase is undertaken at market value as LCR 2021/2 confirms that a consequence of the NALE rules applying to the purchase of either all, or a part, of an asset, is that all of the income derived from that asset will be NALI (including any future capital gains).

As a result, it will be extremely important to retain all of the required documents, such as the purchase contract and transfer forms, to evidence that the asset was acquired via two separate transactions, with each occurring at market value.[10]

In-specie contribution value and NALE

While LCR 2021/2 does not refer to the NALE provisions applying to in-specie contributions, para 25B (draft updated) of TR 2010/1 confirms that in-specie contributions are required to be reflected at the asset's market value in the fund's accounts. Therefore, it seems that transferring an asset to the fund as an in-specie contribution will not trigger the NALE rules as the trustee is required to use the asset's market value when recording the value of the contribution in the fund's accounts.

Note that TR 2010/1 was still being updated at the time of writing to take into account issues such as the change to the definition of NALI to include income derived via a non-arm's length dealing where a NALE was incurred.

NALE relating to general fund expenses

LCR 2021/2 also confirmed that a NALE may also have a sufficient nexus to all of the ordinary and/or statutory income derived by the fund. For example, this may occur where a fund incurs a NALE that does not specifically relate to any particular amount being derived by the fund but instead to a generally deductible fund expense.[11]

These general fund operating expenses may include:

- actuarial costs;
- accountancy and administration costs;
- cost of pre-retirement financial advice provided to members; and
- audit and legal costs.

For example, where a fund incurred a NALE in relation to administration costs, the NALI provisions would apply to all of the fund's income in that year. Therefore, even a minor transgression via a small underpayment could result in adverse tax consequences for a fund as it could result in 100% of the fund's income in that year being taxed at 45%.

However, it is important to note that LCR 2021/2 also confirms that the NALE provisions do not apply to any actuarial or accountancy fees incurred when complying with, or managing, the fund's income tax affairs and obligations which are ordinarily deductible under s 25-5 ITAA97.[12]

For example, the NALE rules will not apply to the fee charged by an accountant to calculate the fund's exempt income where the fund is paying retirement phase pensions. However, where an accountant (or actuary) charges a fund one overall fee in relation to a number of services, such as tax and administration services, and they do not split their fee into different components, it may be prudent to assume that the NALE rules will apply to the overall fee.

Transitional compliance approach

In response to concerns raised about the ATO's approach to general fund expenses in the draft version of LCR 2021/2, the ATO announced (in PCG 2020/5) that it will not allocate any compliance resources to determine whether the income of a superannuation fund is NALI where the fund incurred NALE of a general nature that has a sufficient nexus to all ordinary and/or statutory income derived by the fund from 1 July 2018 to 30 June 2023.

The exposure draft of the Bill (the Treasury Laws Amendment (Measures for Consultation) Bill 2023) released by the government indicates that the NALE rules relating to general fund expenses will effectively apply from 1 July 2023 and will not be retrospective.

Proposed changes to general fund expenses provisions

Responding to industry concerns in relation to the application of LCR 2021/2 to general fund expenses, the government confirmed in March 2022 that the government would make legislative changes to ensure that the NALE provisions operate as intended.

Subsequent to this, the government released a consultation paper, *Non-arm's length expense rules for superannuation funds*,[13] in January 2023, and an exposure draft of the Bill[1] in June 2023 which intends to enact changes to the treatment of general expenses which have a sufficient nexus to all ordinary and statutory income derived by the fund.

Specifically, the draft exposure Bill suggested the potential amendments as follows:[14]

> "1.6 For specific expenses the existing treatment will continue to apply, and the amount of income that will be taxed as non-arm's length income will be the amount of income derived from the scheme in which the parties were not dealing at arm's length.
>
> 1.7 For general expenses the amount of income that will be taxed as non-arm's length income will be twice the difference between the amount of the expense that might have been expected to be incurred had the parties been dealing at arm's length, and the amount the entity did incur. Where the entity did not incur any expense, the amount of income that will be taxed as non-arm's length income will be twice the amount that might have been expected to be incurred had the parties been dealing at arm's length.
>
> 1.8 The total amount of a small complying superannuation fund's non-arm's length component will be capped at an entity's taxable income for the year not including any assessable contributions or any deductions against assessable contributions."
>
> "1.3 … the Bill will exempt large APRA-regulated funds, including exempt public sector superannuation funds, from the non-arm's length income rules related to non-arm's length expenses, although these funds will still be subject to the remaining non-arm's length income rules for income derived on a non-arm's length basis."

For SMSFs, this would result in an effective tax rate of 90% (2 x 45%) on the difference between what the fund should have paid (ie market rate) and the amount that it actually paid. For example, assuming that a fund incurred a NALE where the difference between what it should have paid (ie market rate) for a general fund expense and what it actually paid was $1,000, the fund's tax liability would be calculated as follows:

- $1,000 x 2 = $2,000
- $2,000 x .45 = $900

Assessable superannuation contributions will not be subject to the NALI rules under the proposed changes. The amount treated as NALI would reduce the fund's other assessable income that is not assessable superannuation contributions.

Services provided in capacity of trustee

LCR 2021/2 confirms that the NALE rules will not apply where a trustee (or a director of a corporate trustee) provides services (which may relate to a specific asset or the fund in general) in the capacity of trustee, as trustees and directors of a corporate trustee are prohibited from being remunerated for any duties or services they provide in that capacity.[15]

However, it is important to note that the *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA) provides an exemption which allows a person who is an individual trustee or a director of a fund's corporate trustee to receive remuneration for any services they provide to the fund in a different capacity where they satisfy the requirements under s 17B SISA.

Specifically, s 17B allows a person to charge their fund for any work or services they provide to the fund where:

- they are not acting as a trustee or as a director of the fund's corporate trustee when they undertake the work or services;
- they are appropriately qualified and licensed to perform the work;
- they operate a business of providing the services to the public, ie they are not just an employee; and
- the amount charged is on arm's length terms.

Therefore, where a person does any work for, or provides any services to, their fund, it will be critical to understand in what capacity the person was acting when they undertook the work. If they were acting with their "trustee hat" on, they will not be required (or permitted) to charge the fund a market rate for their services. However, if they were instead acting in their personal capacity, and they meet the requirements in s 17B, they will need to charge the fund an arm's length commercial rate for the provision of those services otherwise the fund will have incurred a NALE and the NALI provisions will apply to the relevant income.

In this case, LCR 2021/2 confirms that it will be appropriate to presume that an individual is acting in their capacity as a trustee, or a director of a corporate trustee, where their actions are consistent with a duty, obligation or power imposed on them by:[16]

- a specific law, such as the SISA or the *Corporations Act 2001* (Cth);
- the fund's trust deed; and
- their fiduciary obligations under general law,

and there are no factors to suggest they are acting in a different capacity.

In this case, LCR 2021/2 confirms that where a trustee/director uses any skills or knowledge obtained through their business, profession or employment to assist them in performing their trustee duties, that, on its own, would be insufficient to conclude that the person was not acting in their capacity as trustee.[17]

For example, the ruling confirms that a financial adviser could still be acting as trustee where they utilise their professional skills and knowledge to formulate, implement and regularly review their fund's investment strategy.

Conversely, LCR 2021/2 confirms that the factors that may indicate a trustee/director is acting in a different capacity include:

- they charge the fund for their services;
- they use the equipment and other assets of their business, or the equipment or other assts used in their in their profession or employment in a material manner,

when providing the services, ie minor, infrequent or irregular use may not result in the trustee/director being deemed to be acting in a different capacity;

- the service is of a type that can only be performed by a person who holds the relevant licence and/or qualification; and
- the activity is covered by an insurance policy relating to their business, or their profession or employment (for example, professional indemnity insurance).

For example, the NALE rules could apply to a financial adviser formulating an investment strategy for their fund for no charge where the adviser:

- was acting as a licensed financial adviser when formulating the investment strategy;
- undertook the work during normal office hours using their firm's financial planning software to prepare a statement of advice which included a recommendation to the trustee to adopt a specific investment strategy; and
- would be covered by their professional indemnity insurance policy in relation to their advice.

In contrast, LCR 2021/2 does outline that an SMSF may receive discounted prices without the NALE rules being triggered where the arrangement is consistent with normal commercial practices. For example, this could include an individual trustee who is an employee of an SMSF administration business being entitled to discounted SMSF administration fees under their employer's employee benefits policy where the same discount is available to all employees.

The ruling also confirms that services provided to a fund on a pro bono basis will be on arm's length terms where the trustee of the fund is not able to influence the service provider's decision to supply the services on a pro bono basis.

Case study: Trang

The following case study is based on example 9 in LCR 2021/2.

Trang is the trustee of her SMSF of which she is the sole member. She is also a plumber by trade and runs her own business as a sole trader in which she also employs an apprentice.

Trang's SMSF has two investment properties which are leased for a commercial rate of rent.

Property one

After finishing work for the day, Trang stops by one of the SMSF's investment properties to connect a stand-alone water filter provided (and to be taken away at lease end) by the tenant. She uses some of her tools of trade to complete the installation.

Trang performs this activity as trustee of her SMSF and does not charge the SMSF for this work.

Relevant factors

Trang undertook the work in her own time and the use of her tools of trade was minor, infrequent or irregular in nature.

Outcome

Trang was acting as trustee when she undertook the work and therefore there was no NALE.

Property two

Trang undertakes a complete renovation of the bathroom and kitchen in property two. She schedules time in her work calendar to undertake the work and uses the tools of her trade to undertake all plumbing work on the renovations. She also engages her apprentice in all works.

Trang does not charge the SMSF for the work undertaken in respect of the second property.

Relevant factors

The works were carried out during normal business hours using Trang's tools of trade in a way that is not minor, infrequent or irregular, and involved one of her paid employees. Trang, as a plumber, is also required to be licensed to undertake plumbing work.

Outcome

The circumstances indicate that Trang is providing the plumbing services in her individual capacity, rather than as trustee for her SMSF. Trang not charging her SMSF therefore results in her fund incurring a NALE in gaining or producing the rental income. The rental income from the property will therefore be NALI. As the works involve making capital improvements, the NALE will also result in any future capital gains realised on the sale of the asset being NALI.

It should be noted that, had the work Trang undertook in her individual capacity been of a revenue rather than a capital nature, ie it involved repairs and maintenance rather than renovations, only the rent derived from the property in that year would be NALI as there would not be a sufficient nexus between the NALE and any future capital gain made on the disposal of property two.[18]

NALE arrangements within private companies and trusts

While the new NALE amendments apply to treat income from a fixed trust as NALI where an SMSF incurred a NALE to acquire an interest in the trust, ie it acquired the units for less than market value, the new rules do not specifically apply at the trust level.

However, it is important to note that the pre-existing NALI provisions are thought to be broad enough to capture income derived from private companies or trusts where the company or trust entered into a non-arm's length dealing and incurred a NALE as this would then result in an SMSF deriving more income (via dividends or distributions) than it might have expected to receive had the company or trust dealt with the other party on arm's length terms.

For example, in 2020, the ATO issued SMSFRB 2020/1 which outlined the ATO's views in relation to SMSFs entering into property development activities. In that bulletin, the ATO confirmed that the dividends paid to an SMSF by a private company would be NALI due to a series of non-arm's length transactions occurring at the company level, including the company directors providing personal guarantees for loans taken out by the company.[19]

Therefore, where an SMSF holds an interest in a private company or fixed trust, the trustees of the SMSF need to be aware that where those entities enter into a scheme with another party, including a director of the company or a trustee of the trust, that results in the company incurring a NALE, that could result in any income received by the fund from holding an interest in that company or trust being assessed as NALI.

Conclusion

In conclusion, the recent changes to the NALI provisions and the release of LCR 2021/2 have the potential to significantly affect the tax liabilities of SMSFs that acquire assets or services from related parties at below market value. It is crucial for professional advisers to understand both the rules and practical implications to ensure compliance and effective tax planning for their SMSF clients. Being well-informed will enable trustees to navigate these complex rules.

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This article is an edited and updated version of "The practical behind the acronyms – NALI/NALE" presented at The Tax Institute's Superannuation Intensive held on 30 to 31 March 2023.

Disclaimer

The material and opinions in this article are those of the author and not those of Colonial First State Investments Limited. The material and opinions in the article should not be used or treated as professional advice and readers should rely on their own enquiries when making any decisions concerning their own interests.

References

1 Treasury Laws Amendment (Measures for Consultation) Bill 2023. The consultation for this draft Bill closed on 7 July 2023. The Bill is yet to be introduced to parliament.

2 When determining whether a private company dividend is consistent with an arm's length dealing, regard is required to be given to: the value of the fund's shares in the company; the cost to the fund of the shares; the rate of dividends received by the fund; whether the company has paid a dividend on other shares in the company and, if so, the rate of that dividend; whether the company has issued any shares to the entity in satisfaction of a dividend paid by the company (or part of it) and, if so, the circumstances of the issue; and any other relevant matters.

3 See Treasury Laws Amendment (2018 Superannuation Measures No. 1) Act 2019.

4 See below under the heading "Expenses relating to the acquisition of an asset" for more information on the treatment of recurrent expenses that relate to the acquisition of an asset.

5 See example 11 (specifically para 75) of LCR 2021/2.

6 See para 18 of LCR 2021/2. Note that the ATO has confirmed this will not apply where a fund refinanced a pre-existing non-arm's length limited recourse borrowing arrangement (LRBA) to comply with the introduction of the LRBA safe harbour requirements.

7 See example 9 (specifically para 69) in LCR 2021/2.

8 It should be noted that, where the asset is acquired from a related party, the fund would breach the prohibition on trustees acquiring an asset from a related party even where the asset was covered by an exemption, such as for listed shares, as the asset would not have been acquired at market value.

9 See para 29 of LCR 2021/2.

10 An in-specie contribution is required to be reflected at its market value in the fund's accounts as per para 25B of the draft update version of TR 2010/1.

11 See para 19 of LCR 2021/2.

12 See para 19 of LCR 2021/2.

13 Treasury, *Non-arm's length expense rules for superannuation funds*, consultation paper, January 2023. Available at https://treasury.gov.au/consultation/c2023-323132.

14 Exposure draft explanatory materials to the Treasury Laws Amendment (Measures for Consultation) Bill 2023. Available at https://treasury.gov.au/sites/default/files/2023-06/c2023-408585-explanatory-materials.docx.

15 S 17A(1)(f) and (g), and (2)(c) and (d) SISA.

16 See para 44 of LCR 2021/2.

17 See para 46 of LCR 2021/2.

18 See example 11 (specifically para 75) of LCR 2021/2.

19 See example 3 (specifically paras 66–70) of SMSFRB 2020/1.

A Matter of Trusts

by Thomas Abraham, Sladen Legal

State trust surcharges invalid?

Revenue NSW has determined that foreign surcharges breach international tax treaties. Will other revenue offices follow suit? How do you ensure that your trust is not a foreign trust?

In this article, we explore Revenue NSW's announcement that New South Wales surcharge purchaser duty and surcharge land tax, including trust surcharges, are inconsistent with international tax treaties entered into by the Australian federal government with certain foreign countries. In addition, this article examines the position of the Victorian State Revenue Office (SRO), and what trustees of discretionary trusts can do in each state and territory to ensure that they don't fall foul of the respective foreign surcharge provisions.

On 21 February 2023, Revenue NSW announced that it has been determined that NSW surcharge purchaser duty and surcharge land tax (the surcharge provisions) are inconsistent with international tax treaties entered into by the Australian federal government with New Zealand, Finland, Germany and South Africa.[1]

On 29 May 2023, Revenue NSW updated its list of countries to include India, Japan, Norway and Switzerland.

Arising from the update on 29 May 2023, the citizens (or related non-individuals, such as corporations and trusts) of the following countries (the treaty countries) will not be liable to the surcharge provisions in NSW: New Zealand, Finland, Germany, South Africa, India, Japan, Norway, Switzerland, Chile, Turkey, UK and Israel.

In essence, the announcement and further update sets out Revenue NSW's position that the surcharge provisions were incorrectly charged on the basis that they infringed the requirements of international tax treaties entered into with the treaty countries.

Trust surcharge provisions in NSW and Victoria

Up until the announcement on 21 February 2023, all foreign purchasers (ie foreign natural persons, foreign corporations and foreign trusts) of residential land in NSW had to pay an 8% duty surcharge on the taxable value of any residential land bought. Additionally, all foreign persons had to pay a land tax surcharge of 4% on the taxable value of all residential land held in NSW, payable on 31 December of each year.

In Victoria, the additional duty payable for foreign persons is also 8%, and the additional land tax surcharge (ie the absentee owner surcharge) payable has been 2% from the 2020 land tax year and is now going up to 4% from the 2024 land tax year onwards.

International tax treaties

Revenue NSW has conceded that the surcharge provisions are inconsistent with the non-discrimination clauses present in the international tax treaties between Australia and the treaty countries. For example, art 23 of the *Agreement between the Government of Australia and the Government of Finland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion* states:

> "1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected. This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States."

Similar clauses are found in art 23A of the South African equivalent treaty, and art 24 of both the German and New Zealand treaties. It is also further clarified in these treaties that these articles apply to "taxes of every kind and description imposed on behalf of the Contracting States".

Presumably, Revenue NSW's concession in relation to the surcharge provisions stems from the High Court's decision in *Addy v FCT*,[2] where it was found that the imposition of the more burdensome income tax on a backpacker (owing to her nationality as a national of the United Kingdom) contravened international tax treaties entered into by the Australian federal government and the UK which contained a non-discrimination clause.

Implications of Revenue NSW's announcement

There are a number of direct implications as a result of Revenue NSW's announcement, including:

- effective immediately, citizens of the treaty countries will no longer be liable to pay surcharge duty and surcharge land tax under the surcharge provisions in NSW;
- surcharge duty or surcharge land tax liability for non-individuals, such as corporations, trusts or partnerships, that arises because of an entity's affiliation with these treaty countries may also be affected by these international tax treaties;
- refunds may be available for purchasers/transferees and landowners from the treaty countries who have paid surcharge duty or surcharge land tax under the surcharge provisions;

- Revenue NSW's website currently states that refunds may be available for surcharge duty or surcharge land tax paid on or after 1 January 2021. It is unclear at this stage whether surcharge duty or surcharge land tax paid before this date will be eligible for a refund or if it is just for the purposes of processing refunds up to this date; and
- refunds of interest and penalty tax may also be available in relation to the surcharge provisions.

What about Victoria and other states/territories?

As these international tax treaties are entered into by the Australian federal government with treaty countries, it is expected/hoped that Revenue NSW's position would soon be adopted by the various states and territories which have provisions similar to the surcharge provisions.

Unfortunately, however, while the Victorian SRO has acknowledged the announcement by Revenue NSW, it has stated on its website that the position in Victoria has not changed and the SRO will continue to apply the surcharge provisions to all foreign purchasers and absentee owners:[3]

> "The SRO is aware of the announcement made by Revenue NSW in February 2023 regarding the imposition of the NSW foreign owner surcharge and surcharge purchaser duty for residents of South Africa, New Zealand, Finland and Germany.
>
> The position in Victoria has not changed and the SRO will continue to apply the Victorian provisions to all foreign purchasers and absentee owners."

The surcharge provisions in NSW and Victoria

NSW

If surcharge duty or surcharge land tax has been imposed on a foreign natural person, a foreign corporation or a foreign trust relating to one of the treaty countries, based on Revenue NSW's announcement, the surcharge provisions will not apply to such foreign persons and a refund of duty, land tax, penalties and interest may be claimed.

While the treaty countries now only include the eight listed foreign countries, it is possible that the list will also include Chile, Turkey, Israel and the UK. However, until such time that any additional countries are added to Revenue NSW's list, it is important to ensure that any trusts, particularly discretionary trusts, are correctly amended or varied to irrevocably restrict trust provisions so that the surcharge provisions do not apply.

Separately, advisers who have already made amendments to discretionary trust deeds from the treaty countries to irrevocably restrict relevant trust provisions so that the surcharge provisions do not apply should consider further the effect of such variations already made or to be made, particularly in light of Revenue NSW's announcement and the High Court's decision in *Addy*.

Victoria

As noted above, as the respective international tax treaties were entered into by the Australian federal government as opposed to an Australian state or territory government, it is difficult to foresee how the High Court's decision in *Addy* would apply any differently to a particular state or territory.

Nevertheless, advisers should still continue to make the necessary amendments to trust deeds, particularly discretionary trust deeds, to ensure that the foreign purchaser additional duty is not imposed on a transaction and absentee owner surcharge is not imposed annually in Victoria.

What non-foreign trust amendments are required?

Notwithstanding the above exemptions of certain countries from the foreign surcharge regimes, the surcharge will continue to apply to other countries and, for the moment, in states/territories (excluding the Northern Territory) other than NSW.

The surcharge regimes generally apply not only to trusts set up by, and for, foreign persons, but also to Australian discretionary trusts that just happen to have foreign beneficiaries. Therefore, if the trustee of an Australian discretionary trust acquires land that will be subject to the foreign surcharge, the trust deed should be amended such that it does not trigger the provisions in the relevant state or territory.

Each state and territory's provisions are different in this regard and therefore different discretionary trust deed exclusions are required (see Table 1).

Table 1. Non-foreign trust amendments (discretionary trusts)

Victoria	
Non-foreign trust for the Victorian *Duties Act 2000*	No more than 50% of the capital can be distributed to the following persons (as defined in the *Duties Act 2000* (Vic)): a foreign corporation; a foreign natural person; a person who is the trustee of a foreign trust; or any associated person.
Non-absentee trust for the Victorian *Land Tax Act 2005*	The trust must not have an "absentee beneficiary" (as that term is defined in the *Land Tax Act 2005* (Vic)) who is a "specified beneficiary" (as that term is defined in the *Land Tax Act 2005* (Vic)), which means an absentee beneficiary must not be specifically named in the trust deed.

cont …

Table 1. Non-foreign trust amendments (discretionary trusts) (cont)

New South Wales	
Non-foreign trust for the NSW *Duties Act 1997* and the NSW *Land Tax Act 1956*	All “foreign persons” (as that term is defined in the *Duties Act 1997* (NSW)) are prohibited from being or becoming a beneficiary of the trust. Any amendments made to this effect must be irrevocable.
Queensland	
Non-foreign trust for the Queensland *Duties Act 2001* and the Queensland *Land Tax Act 2010*	No more than 49% of the income or capital of the trust may be distributed to a “taker in default” (as that term is referred to in the *Duties Act 2001* (Qld) and the *Land Tax Act 2010* (Qld)) who holds a “foreign interest” (as that term is defined in the *Duties Act 2001* and the *Land Tax Act 2010*) in the trust.
South Australia	
Non-foreign trust for the South Australian *Stamp Duties Act 1923*	Any person who is a “foreign person” (as that term is defined in the *Stamp Duties Act 1923* (SA)) is excluded from holding the position of trustee or appointor of the trust, in addition to being excluded from being given a power to appoint under the trust, from being an identified object (beneficiary) of the trust, and from becoming a person who takes capital of the trust property of the trust in default.
Tasmania	
Non-foreign trust for the Tasmanian *Duties Act 2001*	No more than 49% of the capital of the trust may be distributed to a “foreign person” (as that term is defined in the *Duties Act 2001* (Tas)) (either alone or together with another foreign person) or to a foreign person generally (either alone or together with another foreign person).
Western Australia	
Non-foreign trust for the Western Australian *Duties Act 2008*	No more than 49% of the income or capital of the trust may be distributed to a “foreign person” (as that term is defined in the *Duties Act 2008* (WA)), either alone or in combination and/or together with one or more “associates” (as that term is defined in the *Duties Act 2008*), including in circumstances where the foreign person is a “taker in default” (as that term is defined in the *Duties Act 2008*). Foreign persons are also excluded from holding a position that would enable the person to influence (directly or indirectly) the vesting of the whole/part of any capital or income of the trust property if such a position would cause the trustee to become a foreign person.
Australian Capital Territory	
Non-foreign trust for the Australian Capital Territory *Land Tax Act 2004*	No foreign person can be a “beneficiary” (as that term is defined in the *Land Tax Act 2004* (ACT)).

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Superannuation

by Daniel Butler, CTA, and William Fettes, DBA Lawyers

SMSFs and voluntary disclosure to the ATO

Significant advantages can result from making a voluntary disclosure, including the potential to rectify and minimise penalties and other adverse consequences.

This article provides important background context on why SMSF trustees may wish to consider using the ATO's early engagement and voluntary disclosure service to notify the ATO regarding contraventions of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA) or the *Superannuation Industry (Supervision) Regulations 1994* (Cth) (SISR).

Should I make a voluntary disclosure?

Some SMSF trustees may, on first blush and without the benefit of obtaining expert advice, not be immediately attracted to the idea of proactively approaching the ATO regarding a fund's compliance issues. However, there can be numerous advantages in making a timely voluntary disclosure to the ATO, and it is worth noting that many contraventions are detected and reported via various means in any event. Thus, approaches based on trying to "fly under the radar" or hoping that the problem will go away are generally not a prudent course. Indeed, in many situations, timely action can minimise being placed in a significantly riskier position if things are left to fester.

How will the ATO find out?

Most contraventions are reported to the ATO by SMSF auditors lodging an auditor contravention report (ACR). For example, in FY2020, there were 13,800 SMSFs with 40,000 contraventions reported (an average of nearly three contraventions per SMSF).

Where an SMSF auditor forms the opinion that it is likely that a contravention of the SISA or the SISR:

- may have occurred;
- may be occurring; or
- may occur,

they are required under s 129 SISA to report the contravention or potential contravention to the ATO via the ACR system.

It is compulsory for each SMSF, in addition to having the accounts and administration of the fund maintained each financial year, to have the financial statements, investments and operations of the fund audited by an independent auditor to determine whether the financial statements are correct and to check compliance with various provisions in the SISA, the SISR and the *Income Tax Assessment Act 1997* (Cth).

In addition, there a range of other surveillance methods used by the ATO to collect information, including undertaking reviews or audits of SMSFs, especially where the ATO's systems or intelligence-gathering mechanisms determine that a contravention has occurred.

Thus, SMSF trustees must be mindful that, if there is any contravention, including any potential contravention that is yet to occur, there is a significant risk that it will be notified to the ATO or detected by the ATO in due course, so early engagement and voluntary disclosure is generally wise.

Are there any advantages with voluntary disclosures?

The ATO's voluntary disclosure process is designed to encourage funds to proactively engage with the regulator to achieve better compliance, reduce the ATO's use of resources, and typically result in lower penalties and adverse consequences. Therefore by disclosing contraventions upfront, SMSF trustees should be in a better position. The ATO states that it will:[1]

> "… take your voluntary disclosure and your willingness to engage with us at an early stage and throughout the review process into account when:
>
> - determining the level of enforcement action that is required
> - making a decision about the remission of any administrative penalties that may be applicable."

How do I prepare an appropriate submission?

Those preparing to disclose a contravention of superannuation law to the ATO should ensure that the submission includes all relevant material facts and supporting documents, as well as the details of any rectification plan that has been put in place or contemplated. It is best to have an experienced SMSF adviser or SMSF lawyer assisting when preparing the submission.

In certain cases, a proposed enforceable undertaking may also be appropriate. This is where the SMSF trustee still has to rectify the breach and proposes the steps that the trustee will take to do so.

The submission should be carefully worded and prepared, and ideally be lodged prior to any ATO audit or compliance

action. If the SMSF auditor is proposing to lodge an ACR, timely action should be taken to lodge a voluntary disclosure prior to the auditor lodging any ACR.

Moreover, the submission must be checked to ensure that it is true and correct and supported by appropriate evidence as any false or misleading statement can be subject to serious consequences. The ATO may, and in many cases will, ask further questions or request further supporting information or evidence to verify some or all of the content in the submission. Thus, we reiterate that having a lawyer involved to prepare, or at least review and check, the draft submission and to assist as and when needed, is highly recommended.

What is the ATO's process?

Further details on the ATO's early engagement and voluntary disclosure process can be found on the ATO's website.[1]

In theory, the voluntary disclosure process is relatively simple: use the prescribed form to describe the situation, the contravention and the rectification plan. However, as noted above, the submission should be appropriately worded and supported, and is best prepared by an experienced SMSF adviser or SMSF lawyer.

Note, that the ATO's webpage, among other things, states:[1]

> "We expect you to:
>
> - engage with your SMSF professional to devise a proposed plan of action to rectify the contravention
> - provide the proposed plan for rectifying the contravention and relevant supporting documentation with your voluntary disclosure
> - provide information that demonstrates that measures have been put in place to mitigate the risk of similar contraventions occurring in the future
> - actively engage with us throughout the review process
> - bring any outstanding SMSF annual return lodgments immediately up to date
> - make any necessary amendments to SMSF annual returns and/or individual members' income tax and pay any outstanding income tax liabilities that may arise."

What about a disclosure for tax purposes?

This article focuses on voluntary disclosures to the ATO for regulatory (ie the SISA and the SISR) purposes, rather than tax-related disclosures (including income tax, CGT or other federal or state tax issues).

However, it is worth noting that a voluntary disclosure for tax purposes can also prove beneficial and may result in a potential reduction of up to 80% in certain tax liabilities. Again, the ATO seeks to encourage voluntary compliance by taxpayers, and a stricter approach is applied if the ATO uncovers matters as a result of its ongoing audit and surveillance activities.

Are there any risks?

An experienced adviser should be in a position to provide some guidance on the risks and penalties that might be involved as result of going through a disclosure process, ie after assessing the particular background facts and circumstances of the matter. However, given the nature of the process, there are no guarantees regarding the outcome as the ATO makes the final determination.

In any event, SMSF trustees and members should be ready for a range of penalties and compliance actions being taken by the ATO, including administrative penalties, rectification and education directions, a notice of non-compliance, being rendered a disqualified person, and other sanctions. The administrative penalties alone can be significant. Currently, several administrative penalties are $13,200 per breach and, as noted above, in FY2020, an average of three contraventions per SMSF were reported to the ATO via the ACR system. If there are individual trustees, this penalty is multiplied by the number of trustees. Naturally, a corporate trustee can result in a substantial saving if appointed prior to the relevant breach occurring.

Thus, even where a voluntary disclosure is made, an SMSF still faces the risk of being rendered non-complying, the disqualification of trustees, and significant penalties being imposed. The total potential cost and severity of the range of penalties and sanctions that can be imposed means that it is vital to obtain expert assistance and representation.

For further discussion on the possible compliance action and penalties that the ATO can impose on SMSF trustees, see the article "ATO compliance action penalties for SMSFs".[2]

Conclusion

It is recommended that SMSF trustees obtain advice on their particular facts and circumstances to assess what would be involved in making a voluntary disclosure and to obtain feedback on the potential expected outcomes. Broadly, the benefits typically outweigh the risks and it is best to be proactive and not defer as the outcome is likely to be worse.

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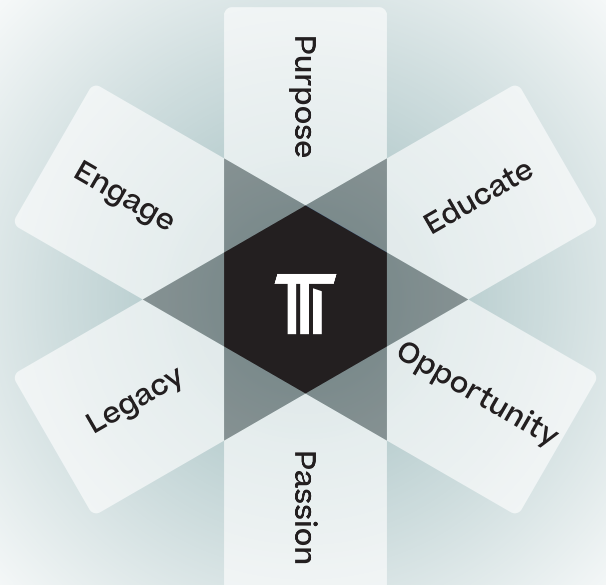

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Successful Succession

by Tim Donlan, ATI, Donlan Lawyers

Gifts made by an attorney

When, if ever, is it appropriate for an attorney, who is entrusted to manage a principal's financial affairs, to make gifts from the principal's funds?

Introduction

A recent example of an "enduring" attorney abusing their position highlights the vulnerability of a donor of a power of attorney after a loss of capacity.

It is well known that an attorney sits in a fiduciary role. As an agent of the principal or "donor", the attorney must at general law act in good faith in the best interests of the donor. The attorney's duties further include exercising their powers for proper purposes and not acting in a position where their personal interests conflict with those of the donor.

Until the introduction of legislation in each state of Australia permitting the establishment of an "enduring" power of attorney[1] and enabling the appointment of the attorney to continue to operate beyond the donor's loss of capacity, a power of attorney at common law would cease to operate if the donor died or lost capacity.[2] The logic behind that, although it might be considered hugely inconvenient,[3] is that historically a power of attorney as a form of agency allowed that an attorney could do anything that the donor could lawfully do for themselves, and consequently, if the donor could no longer act themselves, the attorney could not act for them either.[4]

At general law, the very nature of the attorney being in a fiduciary position with respect to the donor would prevent a gift being made by the attorney (on behalf of the donor) whereby the attorney would receive the gift or benefit in some other way from it.

However, there are some circumstances where a "conflict transaction" by an attorney may be permissible. That may apply where the instrument creating the power of attorney expressly authorises that the attorney can enter into conflict transactions, such as the authorisation of the making of gifts.

Legislation in some jurisdictions expressly allows the making of gifts by an attorney on behalf of a donor but only "limited reasonable gifts of a seasonal nature or in relation to a special event" (for example, birthdays and weddings) or where the gift is a donation that "the principal would be reasonably expected to make provided the gift or donation is not more than was reasonable having regard to the circumstances and the principal's finances".[5]

What then constitutes a gift[6] and what might be considered "reasonable in the circumstances and the principal's finances"? Is it the case that the greater the financial resources of the donor, the greater the gifts that can be made or splashed about by the attorney?

The concept of "reasonableness" is one that is prevalent in legislation and common law jurisprudence. The starting point when considering whether a gift or other conflict transaction is reasonable in all of the circumstances might be that it is difficult to see how anything other than a minor depletion of the capital of the donor (without the donor receiving some corresponding financial benefit) could be in the interests of the donor.

In circumstances where conflict transactions are authorised by the donor when creating the power of attorney, the courts will still closely guard the interests of the donor.

Where a breach of an attorney's duty occurs, the remedies for the donor may typically include an accounting for profits, setting aside a particular transaction, and usually the removal of the attorney.

Often matters involving alleged conflicts of interest and breaches of duty by attorneys come before the courts well after an impugned transaction occurs. They are often raised by third parties whose own interests have been adversely affected by the action of the attorney.

In 2020, the Supreme Court of New South Wales was called on to consider the application of an interested party in relation to certain conduct of an attorney primarily relating to the transfer of real property by the attorney to her daughter.[7]

The brief facts of the case are as follows:

- Dr Alan Grant died in 2019 aged 99 years. His wife Gwynneth Grant died in 2017 aged 87 years;
- they had five children, being Nerez, Seth, Ryven, Miles and Tansin;
- during Alan and Gwynneth's lifetimes, Alan worked as a radiologist and they held various interest in properties together with significant value;
- during his lifetime, Alan had granted an enduring power of attorney to Nerez which she operated between 2011 and 2017 when it was revoked by Alan and a new power of attorney appointing Seth was executed;
- after Seth was appointed as Alan's attorney, he discovered transactions conducted by Nerez in her capacity as Alan's attorney, including the transfer of a property to Nerez's daughter Kashaya for nil consideration, together with a reservation to Nerez of a personal right of occupation of that property; and
- Seth also discovered significant unexplained withdrawals of funds from Alan's bank accounts that had all but depleted his entire wealth.

In his then capacity as attorney for Alan, Seth sought orders in Alan's favour for the recovery of the property and funds transferred by Nerez.

The other associated litigation involving the family was extensive and not otherwise specifically considered in this article.[8]

Facts

In 2017, after Gwnneth's death, Seth discussed with Alan concern as to Nerez's financial management of his affairs. At around that time, Nerez transferred a property known as "Killcare", which was valued at around $900,000 and registered in Alan's sole name, to her daughter Kashaya for nil consideration.

Shortly prior to the transfer, Nerez purported to enter into a residential tenancy agreement as tenant, with her daughter Kashaya as landlord. It provided for nil rent to be paid by Nerez and purported to be a tenancy agreement that existed for the tenant's (her) lifetime. Given that, at the time it was entered into, Kashaya was not the registered proprietor of the property, it was not legally effective in any event. However, it stood as evidence as to Nerez's breaches of her duties.

It was further noted that, in the years prior to 2017 while Alan had been a resident in aged care facilities, Nerez had withdrawn over $4m in unexplained funds from his bank accounts for her own use. It was significant that, in withdrawing the funds and transferring the property from Alan's ownership, Nerez left Alan with only approximately $24,000. That amount was insufficient to meet payment of the assessed refundable accommodation at his aged care residence.

The specific relief sought by Seth on behalf of Alan was based on breach of a fiduciary duty by Nerez, the transactions being unconscionable, and the transactions involving gifts being beyond the authority conferred on Nerez by the relevant power of attorney. The relevant power of attorney document did not include any specific power to make gifts.

By the time of the trial of the action in 2020, both of Alan and Gwynneth had died.

Nerez defended the recovery action. She did so on the basis that the transactions, particularly the transfer of the Killcare property to Kashaya, were done merely to give effect to Alan's stated wishes. Nerez and Kashaya (who was named as a defendant in the proceedings) represented themselves in the proceedings.

In evidence, Nerez and Kashaya tendered a photocopy of a letter purported to be written by Alan in 2016 that stated:

> "10/4/2016
> Dear Nerez
> I want to give the Killcare house to Kashaya.
> I want you to live there for the rest of your life.
> I give you a life time tenancy.
> I will pay for the transfer.
> Please transfer the property to Kashaya.
> Thank you for all the care of me.
> Love
> Alan"

Findings

The letter was found by the court to be a fabrication.

With respect to the breach of fiduciary duty by Nerez, the court commented that:

> "359. … It was a breach on Nerez's part to use the power of attorney to execute a transfer of the Killcare property to Kashaya. Nerez knew that the Killcare property was Dr Grant's last substantial asset, the deprivation of which would leave him without any means of support for his future medical care and accommodation and that the transaction was therefore grossly improvident and could never be justified as in his interests. She knew this from her knowledge and use of Dr Grant's bank accounts and from the amount of money that she had already taken from Dr Grant over the years. She knew that Dr Grant was wholly dependent upon her and was in no position to stop her using the power of attorney and indeed that he did not know that she was using it to transfer the Killcare property (there is no accepted evidence that he had knowledge of it). She knew that as a fiduciary she was dealing with her principal, Dr Grant and he did not have independent legal advice in a transaction which was plainly for her benefit (through the lease that she would take of the Killcare property from Kashaya)."

Nerez was ordered to pay equitable compensation to Alan's estate in relation to monies withdrawn by her and for stamp duty and other associated costs incurred by Alan relating to the transfer of the property to Kashaya.

Kashaya did not escape liability either. The court found that:

> "352. … Kashaya, although not a fiduciary herself, agreed in a dishonest and fraudulent scheme with Nerez to take a transfer of the property by Nerez's misuse of the power of attorney."

The court commented that Kashaya was well aware that Nerez held the power of attorney, that Nerez had ascendancy over Alan and complete control of his financial affairs, and that, by transferring the property to her, it would be detrimental to Alan's financial position.

Further, the court found that, in the circumstances of the transfer of the property to Kashaya, she could not have had any genuine and well-founded belief that Alan's power of attorney authorised the transfer to her. She could have taken steps to ensure that Alan obtained independent legal advice as to the transfer but she did not.

The enduring power of attorney

In 1975, the Law Reform Commission of New South Wales stated:[9]

> "2.14 … What is needed is a means whereby a man, forseeing the possibility of mental incapacity, might make his own arrangements for the management of his

> property in that event, and for its application for such purposes (for example the maintenance of himself and his family) as he thinks fit …"

Such reform led to the introduction across all jurisdictions of the enduring power of attorney as referred to herein. The reasoning behind and desirability for donors of an enduring power is sound. The scope for abuse, however, is obvious and increasingly prevalent in an ageing population.

Following the introduction of the enduring power of attorney legislation, subsequent reviews of the laws have identified the potential for abuse of the office by an attorney acting without any oversight.[10]

Perhaps the name "power" of attorney falsely represents the position of the attorney, giving some attorneys a misplaced sense of unlimited authority.[11] Moreover, the description of the principal as a "donor" may be interpreted by some as akin to a "gifter".[12]

If nothing else, cases such as *Grant* highlight the importance of donors planning carefully for loss of capacity by selecting an appropriate attorney or attorneys, and properly documenting all applicable powers including, if appropriate, conflict powers that the attorney may exercise.

It may be that donors would be better protected with a greater level of routine scrutiny or supervision by the courts during the operation of an enduring power of attorney subsequent to the loss of capacity of the donor. In addition, persons appointed pursuant to an enduring power of attorney should perhaps be required to undergo training as to what may or may not constitute an appropriate use of the power.

Some commentators have noted that the concept of a power of attorney that devolved from early relationships of master and servant primarily for commercial purposes (involving appropriate supervision) might not be appropriate in the modern world with an ageing population to effectively empower unscrupulous attorneys to do "anything that can be lawfully done by the donor" in the event of their lack of capacity.[13]

The circumstances of *Grant v Grant* are merely one example of the need to balance the convenience of enabling a donor to appoint a person of their choice to manage their affairs on loss of capacity against the risks of an abuse of the associated power.

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1 *Powers of Attorney Act 2003* (NSW); *Powers of Attorney Act 2014* (Vic); *Powers of Attorney Act 1998* (Qld); *Powers of Attorney and Agency Act 1984* (SA); *Property Law Act 1969* (WA); *Powers of Attorney Act 2000* (Tas); *Powers of Attorney Act 1980* (NT); *Powers of Attorney Act 2006* (ACT).

2 *Drew v Nunn* (1879) 4 QBD 661.

3 C Bielanska and D Lush, *Cretney & Lush on lasting and enduring powers of attorney*, 9th ed, LexisNexis, 2022, para 1.3.

4 J Story, *Commentaries on the law of agency*, 6th ed (E Bennett (ed)), Little, Brown and Co, 1863.

5 See, for example, s 67 of the *Powers of Attorney Act 2014* (Vic).

6 For example, the purchase of property from the donor at under-value would likely be considered a gift of a financial benefit. The making of a binding death benefit nomination by an attorney has also been considered in terms of whether it constitutes a conflict transaction in the circumstances of a particular case (see *Re Narumon Pty Ltd* [2018] QSC 185 at [87]–[92] per Bowskill J).

7 *Grant v Grant; Grant v Grant (No. 2)* [2020] NSWSC 1288.

8 It could be said that this matter had it all. It included a claim brought by Nerez for provision from Gwynneth's estate. Those proceedings involved allegations and findings of disentitling conduct on Nerez' behalf. It also involved probate proceedings in relation to Alan's wills. Nerez also challenged Alan's capacity to make a new power of attorney in 2017, appointing Seth as his attorney and to remove her as his attorney.

9 New South Wales Law Reform Commission, *Report 20 (1975) – Powers of attorney and unsoundness of body and mind.*

10 Australian Law Reform Commission, *Elder abuse – a national legal response*, ALRC report 131, May 2017. See also, for example, South Australian Law Reform Institute, *Valuable instrument or the single most abused legal document in our judicial system? A review of the role and operation of enduring powers of attorney in South Australia*, report 15, 2020.

11 G Dal Pont, *Powers of attorney*, 3rd ed, LexisNexis, 2019, para 2.22. A "power" is defined at law as an authority to dispose of real or personal property whether or not any existing estate or interest in that property vests in the holder of the power. See also *Webb v McCracken* (1906) 3 CLR 1018 at 1023.

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Giving back to the profession

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