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The Tax Institute

Taxation in Australia

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Shirley Schaefer

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Invitation to write

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Tax News – at a glance

by TaxCounsel Pty Ltd

August – what happened in tax?

The following points highlight important federal tax developments that occurred during August 2023. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 124 (at the item number indicated).

Tax adviser misconduct

In a joint media release on 6 August 2023, the Treasurer, the Minister of Finance, the Attorney-General and the Assistant Treasurer announced action that is proposed to be taken to crackdown on tax adviser misconduct in light of the PwC tax leaks scandal. **See item 1.**

Individual residence rules

The Treasury has released a consultation paper, *Modernising individual tax residency*, with a view to developing a new, modernised individual tax residency framework based on recommendations made by the Board of Taxation in its 2019 report, *Individual tax residency rules – a model for modernisation*. **See item 2.**

Proposed technical amendments

The government has released exposure draft legislation and supporting explanatory materials relating to proposed miscellaneous amendments that seek to ensure that the law operates as intended by correcting technical or drafting defects, removing anomalies, and addressing unintended outcomes in legislation that is under the regulatory stewardship of the Treasury. **See item 3.**

Correcting GST errors

The Commissioner has released a draft legislative instrument which will allow a taxpayer to correct GST errors that were made when working out their net amount for an earlier tax period in a later tax period in specified circumstances (LI 2023/D13). **See item 4.**

Retiring partner: CGT issues

The Full Federal Court, in dismissing an appeal by a taxpayer from a decision of Cheeseman J, has unanimously held that the capital proceeds from the disposal by the taxpayer of his interest in the goodwill of a partnership from which he retired was not reduced for CGT purposes by an amount that was set off against those capital proceeds under the partnership agreement (*Hedges v FCT* [2023] FCAFC 105). **See item 5.**

Tax agent: judicial review proceedings

A registered tax agent has been unsuccessful in judicial review proceedings brought by him in the Federal Court in relation to two adverse decisions of the Tax Practitioners Board (*Incollingo and Tax Practitioners Board* [2023] FCA 878). **See item 6.**

Another tax agent registration case

There have been several other recent decisions in which the AAT has reviewed decisions of the Tax Practitioners Board relating to the cancellation of a tax agent's registration. **See item 7.**

Appeal: FBT otherwise deductible rule

An appeal has been lodged with the Full Federal Court from the decision of Logan J in *Bechtel Australia Pty Ltd v FCT* ([2023] FCA 676) in which his Honour held that travel expenses incurred by the taxpayer for fly in fly out employees did not, in the circumstances, satisfy the FBT otherwise deductible rule.

Small business litigation funding

The Inspector-General of Taxation has released a report that provides insights, observations and recommendations to improve the ATO's administration of the Small Business Litigation Funding Program. That program was initiated by a 2019 government measure and was aimed at levelling the playing field for unrepresented small businesses in the Small Business Tax Division of the AAT in cases where the ATO chose to engage a barrister to represent it.

President's Report

by Marg Marshall, CTA

The Tax Summit: bigger, brighter and better than ever

President Marg Marshall discusses The Tax Summit experience, the program, and which sessions she'll have on replay.

Last week in Melbourne, we all gathered for the biggest event of our year: The Tax Summit. It was wonderful to be able to bring this experience to our friends in Melbourne, and to once again share the electric atmosphere of a big, bustling in-person event of this calibre.

I'd like to extend my thanks to all involved in making The Tax Summit such a wonderful event. First, to everyone who attended. We could not hold an event of this calibre without your presence and support. Your positivity and bright attitudes lit up the room and created a buzz of excitement over the whole three days. I appreciate that it's not always easy to get three days out of the office, but I am so glad you found the time and headspace to do so.

Thanks also go to our internal teams of staff and volunteers who pulled off this event. The Organising Committee and Program Committee put much heart and soul into designing a program and an event that truly catered to all corners of the profession, while always keeping in mind the big picture of how tax impacts the world around us.

A huge congratulations also to the recipients of our Community Achievement Awards. These individuals are members who really go above and beyond for our community, providing excellent examples of the generous, dedicated spirit shared by all tax practitioners.

The Community Achievement Awards were a special program designed as part of the celebration of our 80th year serving the profession. We wanted to take the opportunity to recognise those members of our community who stand out as making The Tax Institute what it is today, and the recipients certainly are exemplary of what it means to be part of our community.

Sessions you should catch up on

As I said, it can be tricky to find three days to delve into new ideas and experiences, while also keeping on top of general work commitments. Plus, with a program as large and wide-ranging as The Tax Summit's, it's inevitable that you may have missed a session or two (or three, four, five!) that you might have liked to see.

This is a reminder that you have access to the entire program for six months post-event, to catch up with on-demand recordings of anything you may have missed. So whether you had to duck out for a client meeting, wanted to see two concurrent sessions, or simply had a lie in (who can blame you?), on-demand is a wonderful way to fill in the gaps. It also means you can re-live the sessions you loved the most.

If you're not sure where to start, here are some sessions that received some wonderful feedback:

Session 4.3: Leadership in the new world with speakers Andy Hung, Wolters Kluwer, Victoria Lanyon, King & Wood Mallesons, and Rachael McLean, Wolters Kluwer. From the Emerging Leaders stream, this session took a look at the role technology and digital innovation takes in leading teams – a very interesting topic for those of us developing younger team members for a fruitful future career.

Session 6.1: What's on our radar? with speakers Denise Honey, CTA, Pitcher Partners, John Ioannou, CTA, Macpherson Kelley, and Dr Mark Pizzacalla, CTA, BDO, facilitated by Loreena Gillon, CTA, Arithmos Chartered Accountants. Part of our SME stream, this was a wonderful recap of some of the emerging issues that SME practitioners will face in the near future.

Session 7: Q&A Panel – Tax, climate and the economy – what does the future hold? with Bruce Billson, Australian Small Business and Family Enterprise Ombudsman, Cristina Wolters, CTA, Transurban, Danielle Wood, Grattan Institute, and our own Scott Treatt, CTA, facilitated by award-winning current affairs journalist Ellen Fanning. As expected with a line-up of this calibre, this session was a rousing discussion of issues vital not only to our profession, but also our world.

Session 9: Commissioner's Address from Chris Jordan AO, CTA, Commissioner of Taxation, ATO. Perhaps Chris Jordan's last engagement with us as Commissioner and always a pleasure to hear from him on the ATO's latest news.

Session 16: VIP Presentation with David Thodey was an unmissable rumination on the current state of the tax profession, technology and much more.

Value of a wide-ranging program

The Tax Summit program is the largest and broadest of all of our events. Events like this, with a program that touches every corner of the profession, are so important in fostering our community of professionals. They become a melting pot of tax practitioners, where you just might meet someone who puts your career on a new and unexpected trajectory.

I very much hope you enjoyed your time connecting with new ideas and new people. And for those who did not make it this year, I look forward to welcoming you at next year's event.

CEO's Report

by Chair and Acting CEO, Clare Mazzetti

Reaching new heights at The Tax Summit

Acting CEO Clare Mazzetti reflects on The Tax Summit and bringing the profession together as we move forward.

Well, that's a wrap! Last week, we closed out The Tax Summit for 2023. I hope I speak for everyone in attendance when I say it was an event worthy of the moniker "the Summit".

It was a delight to see our members and the wider tax community come together in Melbourne. One of the best ways to gain new inspiration or a fresh perspective on your work is to be shaken out of the day-to-day – and three days of tax technical insight, meeting new people, and discussing the big picture of where the profession is headed is certainly outside of the "ordinary" for most of us.

I echo Marg's thanks to all those involved in putting on the event, and congratulate the recipients of our Community Achievement Awards. It was very fitting to acknowledge members of our community who have gone above and beyond for our organisation and their fellow members. The gala dinner, at which we announced the recipients, was a dazzling affair, as usual. I hope you enjoyed getting frocked up and turning out to eat good food, hit the dancefloor and support the recipients.

Thank you to our Melbourne-based attendees for coming along and a special thank you to those who flew in from around the country. I hope we made your trip to Melbourne special, and that you took the time to enjoy the city as well as the tax technical program.

We were very happy to be able to take The Tax Summit south after a few years of being based in Sydney and online. Our events committees put considerable time and effort into ensuring that, no matter where you are in Australia, there are opportunities for you to experience our development events. If you weren't able to make it to Melbourne, I encourage you to explore the rest of the events being held this year, including the Death & Taxes Conference in Brisbane, the Tasmanian Convention in Launceston, and the ever-popular Noosa Tax Convention.

The theme at The Tax Summit this year was "Spark Change", and our program explored the different ways our future is evolving and how we can take the reins of that movement.

On the global and national scale, we explored the part that tax plays in our collective future. How does tax interact with issues like climate change, social welfare and economic equality? What is our role as custodians of the tax system?

We also explored issues facing different sectors of the profession, from SME practitioners, to corporates, to those just finding their feet in a tax specialty. The organising committee put many hours into fashioning a program that not only catered to different sectors of the profession, but also took attendees on a journey through topics that tie together into a bigger picture looking at the tax profession as a whole.

On a more personal level, we looked at the ethics of our profession. How do we navigate sticky situations in the correct way, in line with both our professional obligations and our personal morals? Where do our obligations begin and end?

We also looked at what success means as a tax practitioner in a new world of work. What does it look like to lead a team of new generation tax practitioners? How do you plan, act and advocate in favour of your own success?

I hope you took value away from your experience, both in a professional and a personal capacity. And I hope that, if you weren't able to make it this year, you will consider attending the Summit in 2024 – it's sure to be just as inspiring, exciting and enlightening.

Associate's Report

by Sumitha Krishnan, FTI

Central management and control

We review the updated ATO guidance on central management and control and evaluate if the additional guidance provides the required clarity or opens Pandora's box.

On 28 June 2023, the ATO released for consultation an updated draft practical compliance guideline, PCG 2018/9DC1, on the central management and control (CMAC) test. PCG 2018/9DC1 updates PCG 2018/9 which contained a transitional approach that ended on 30 June 2023. That transitional approach applied to foreign companies that had formerly relied on TR 2004/15 to establish their foreign residence but would have been treated as an Australian resident under the CMAC test in accordance with the Commissioner's revised view in TR 2018/5.

Overview of the CMAC test

As a corporate tax residency test, CMAC has been relevant since the 1930s when the definition of "resident" was first introduced in s 6 of the *Income Tax Assessment Act 1936* (Cth).

Over the years, the CMAC test has been a subject of dispute in numerous cases before the courts owing to the lack of clarity of the phrase. In *Malayan Shipping Co Ltd v FCT*,[1] the High Court, in finding that a foreign incorporated company was an Australian resident, observed that "if the business of the company carried on in Australia consists of or includes its central management and control, then the company is carrying on business in Australia and its central management and control is in Australia".

To clarify what constitutes CMAC, the ATO published TR 2004/15 in which the Commissioner expressed the view that the exercise of CMAC in Australia cannot, by itself, constitute the carrying on of business in Australia for the purposes of the CMAC test. Subsequently, and notably, approval of *Malayan Shipping* in obiter dictum was expressed by the High Court in its 2016 decision in *Bywater Investments Ltd v FCT*.[2]

This led to the ATO publishing TR 2018/5 and PCG 2018/9 which outlined the Commissioner's revised view. As set out in TR 2018/5, the Commissioner is of the view that the exercise of CMAC in Australia can, by itself, constitute the carrying on of business in Australia for the purposes of the CMAC test.

Proposed changes

PCG 2018/9DC1 is predominantly the same as PCG 2018/9 except for the appendix, which contains the Commissioner's new risk assessment framework and the compliance approach for the CMAC test of residency for foreign-incorporated companies.

Companies can self-assess against the risk assessment framework to understand the likelihood of the ATO applying compliance resources to review their residency. This is done by reference to the low, moderate and high-risk zones, and criteria set out for each.

Importantly, PCG 2018/9DC1 clarifies that, if a company has self-assessed as being a resident or a non-resident consistent with the view in TR 2018/5 and PCG 2018/9, particularly where its CMAC is ordinarily only exercised in one jurisdiction, the Commissioner does not expect the company to further self-assess against the new risk assessment framework.

The ATO would accept the following pieces of evidence the following as evidence in support of the low-risk self-assessment: contemporaneous board minutes; governance documents that accurately reflect high-level decision-making; and public groups that exercise corporate governance can rely on those processes to demonstrate the CMAC within the group.

Where evidence of high-level decision-making is not available, a company's residency position is likely to be considered moderate or high-risk by reference to the risk assessment framework. In such circumstances, the Commissioner may request other supporting documentation to demonstrate high-level decision-making and governance controls and processes.

Is this the best way forward?

There are concerns that PCG 2018/9DC1 has been written in the shade of an anti-avoidance measure which can create additional compliance and future disclosure burdens on impacted taxpayers when finalised. This is exacerbated by the concern that the additional compliance requirements do not stem from underlying tax law but from the practical compliance guideline itself.

The proposed changes to PCG 2018/9 will not address some of the underlying concerns that have been raised by the profession and industry in the past. This highlights the growing need for legislative amendment, as proposed in the Board of Taxation's key recommendation in its 2020 report *Review of corporate tax residency* and announced in the 2020–21 Federal Budget. The announced but unenacted measure does not appear to be a priority for the current government, despite having been welcomed by industry and advisers at the time.

The Tax Institute continues to advocate for legislative change to provide greater certainty to businesses as to their tax residency.

References

1 [1946] HCA 7.
2 [2016] HCA 45.

Tax News – the details

by TaxCounsel Pty Ltd

August – what happened in tax?

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

Government initiatives

1. Tax adviser misconduct

In a joint media release on 6 August 2023, the Treasurer, the Minister of Finance, the Attorney-General and the Assistant Treasurer announced action that is proposed to be taken to crackdown on tax adviser misconduct in light of the PwC tax leaks scandal.

To this end, the media release sets out a package of reforms covering the following three priority areas:

1. strengthening the integrity of the tax system;
2. increasing the powers of the regulators; and
3. strengthening regulatory arrangements to ensure that they are fit for purpose.

The media release gives details of each of these priority areas (see below).

Legislation to strengthen the integrity of the tax system and increase the powers of regulators is to be introduced this year, with consultation on the reforms to begin shortly.

Strengthening the integrity of the tax system

The reforms propose in this policy area to:

- increase the maximum penalties for advisers and firms who or which promote tax exploitation schemes from $7.8m to over $780m;
- expand the tax promoter penalty laws so that they are easier for the ATO to apply to advisers and firms who or which promote tax avoidance; and
- increase the time limit for the ATO to bring Federal Court proceedings on promoter penalties from four years to six years after the conduct occurred.

Increasing the powers of the regulators

The reforms propose in this policy area to:

- remove limitations in the tax secrecy laws that were a barrier to regulators acting in response to PwC's breach of confidence;
- enable the ATO and the Tax Practitioners Board to refer ethical misconduct by advisers (including but not limited to confidentiality breaches) to professional associations for disciplinary action;
- protect whistleblowers when they provide the Tax Practitioners Board with evidence of tax agent misconduct;
- give the Tax Practitioners Board more time (up to 24 months) to complete complex investigations; and
- improve the Tax Practitioners Board's public register of practitioners so that people have more transparency over agent and firm misconduct.

Strengthening regulatory arrangements

The joint media release states that the PwC scandal has shown some regulatory frameworks are not fit for purpose. It has raised questions about the adequacy of regulations applying to large consulting, accounting and auditing firms, and how this misconduct was able to occur and go undetected without consequence for so long. This includes whether there are appropriate governance obligations on these firms in areas such as transparency, executive responsibility, management of conflicts of interest, and dealing with misconduct.

The media release states that Treasury will be coordinating a whole of government response to the PwC matter and the systemic issues raised. These are complex policy areas that also go to the broader integrity of the tax and superannuation systems, and the integrity of capital markets.

Consultation

Consultation to ensure that options are targeted and effective will begin in the coming months. It will include:

- implementing the remaining recommendations from the independent review of the Tax Practitioners Board, including strengthening the range of sanctions available to the Board;
- a Treasury review of the promoter penalty laws to ensure that they address the types of promoter activity prevalent today, including schemes that are bespoke, complex, and/or operate across jurisdictional boundaries;
- a Treasury review of emerging fraud and threats so as to clamp down on systemic abuse of the tax system perpetrated by tax agents and other bad actors;
- a Treasury and Attorney-General's Department joint review of the use of legal professional privilege in Commonwealth investigations, with options for government to respond to concerns that some claims of privilege are being used to obstruct or frustrate investigations;
- a Treasury examination of the regulation of consulting, accounting and auditing firms to consider whether reforms are needed. This work will require collaboration with the states and territories, given the cross-jurisdictional regulation of partnerships, as well

as engagement with ongoing parliamentary committee inquiries;

- a Treasury review of the compulsory information-gathering powers of the ATO to ensure that it has the right tools to perform its role effectively and enable it to assist law enforcement agencies to investigate serious criminal offences perpetrated against the tax and superannuation systems;
- a Treasury review of the secrecy provisions that apply to the ATO and the Tax Practitioners Board to consider whether there are further circumstances in which it is in the broad public interest for information obtained by these regulators to be shared with other regulatory agencies;
- a Department of Finance review into the use of confidentiality arrangements across all government agencies to ensure that they are fit for purpose, legally binding and enforceable. The review will also identify opportunities to strengthen the management of conflicts of interest in contracts; and
- a Department of Finance review to explore options to increase the transparency and visibility of where Commonwealth contracts have been terminated for material breach.

2. Individual residence rules

The Treasury has released a consultation paper, *Modernising individual tax residency*, with a view to developing a new, modernised individual tax residency framework based on recommendations made by the Board of Taxation in its 2019 report, *Individual tax residency rules – a model for modernisation*.[1]

Under the Board's proposed model, the primary test will be a simple "bright line" test – a person who is physically present in Australia for 183 days or more in any income year will be an Australian tax resident. Individuals who do not meet the primary test will be subject to secondary tests that depend on a combination of physical presence and measurable, objective criteria.

The objective of the consultation process is to inform the development of robust principles that will underpin an enduring framework and achieve the policy intent. The outcomes of consultation will help to inform the government's decision on whether to proceed with this measure.

The details of the framework outlined in the paper have not received government approval and are not yet law. Consequently, the paper is merely a guide as to how the framework might operate.

3. Proposed technical amendments

The government has released exposure draft legislation and supporting explanatory materials relating to proposed miscellaneous amendments that seek to ensure that the law operates as intended by correcting technical or drafting defects, removing anomalies, and addressing unintended outcomes in legislation that is under the regulatory stewardship of the Treasury.

Of interest are amendments that are proposed to be made to the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GSTA99). Under these amendments:

- the provisions of the GSTA99 relating to the attribution of input tax credits to tax periods would be amended to ensure that the provisions operate as intended and that input tax credits are attributable to appropriate tax periods. The amendments are not intended or expected to be detrimental to taxpayers in any way; and
- a taxpayer would be able to claim an income tax deduction for GST payable by way of reverse charge, to the extent that the GST is greater than any input tax credits that they are entitled to and the requirements of s 8-1 (general deductions) of the *Income Tax Assessment Act 1997* (Cth) are satisfied.

The Commissioner's perspective

4. Correcting GST errors

The Commissioner has released a draft legislative instrument which will allow a taxpayer to correct GST errors that were made when working out their net amount for an earlier tax period in a later tax period in specified circumstances (LI 2023/D13).

LI 2023/D13 will allow an error that has been made when working out a net amount for an earlier tax period to be corrected by including the amount of the error when working out the net amount for a later tax period. Where the circumstances in the draft instrument are met, a taxpayer may choose to correct an error by including it in a GST return for a later tax period, instead of requesting the Commissioner to amend the assessment for the earlier tax period.

LI 2023/D13 would only be able to be relied on to correct an error from an earlier tax period by including the error amount in the calculation for the net amount for the original assessment in a current tax period. An error will not be able to be corrected by requesting an amendment to a later tax period.

Also, LI 2023/D13 will:

- only apply to errors relating to an amount of GST, an input tax credit or a GST adjustment;
- not apply to any error that results in the net amount for an earlier tax period being incorrect due to the operation of the *A New Tax System (Wine Equalisation Tax) Act 1999* (Cth) or the *A New Tax System (Luxury Car Tax) Act 1999* (Cth); and
- not apply to errors that were made when working out a net amount for a tax period that started before 1 July 2012.

Recent case decisions

5. Retiring partner: CGT issues

The Full Federal Court, in dismissing an appeal by a taxpayer from a decision of Cheeseman J, has unanimously held that the capital proceeds from the disposal by the taxpayer of his interest in the goodwill of a partnership from which he retired was not reduced for CGT purposes by an amount that was set off against those capital proceeds under the partnership agreement (*Hedges v FCT*[2]).

The taxpayer was a partner in a partnership (the partnership) which carried on a legal practice. He retired as a partner at the end of 2008. Under cl 25 of the partnership deed, this meant that the taxpayer was entitled to be paid: (1) the amount standing to the credit of his capital account in the books of the partnership (cl 25.1); (2) the amount standing to the credit of his current account in the books of the partnership (cl 25.2); (3) his proportionate part (calculated in accordance with the partnership interests) of the work in progress (cl 25.3); and (4) his proportionate part (calculated in accordance with the partnership interests) of the goodwill of the partnership, the value of the goodwill for this purpose being calculated in a particular way (cl 25.4).

Clause 26 of the partnership deed provided that, on the retirement of any partner, any moneys owing by the partner as at retirement were to be offset against any amount found owing to the retiring partner as at the date of retirement.

The parties also entered into a retirement deed which, however, did not affect the overall operation of cls 25 and 26 but provided (in cls 3.7 and 3.8) the terms of payment of the amounts calculated in accordance with cls 25 and 26 of the partnership deed (the retirement moneys).

Under cl 25 of the partnership deed, the taxpayer was entitled to a payment of $182,629 in respect of goodwill and owed the partnership $197,126 in respect of his capital account.

The Commissioner assessed the taxpayer for the 2009 income year by including in his assessable income a discount capital gain from the disposal of goodwill in the amount of $91,314, calculated as: capital proceeds of $182,629 less a cost base of $0 and applying the 50% CGT discount. When determining the capital gain, the Commissioner applied cl 25 of the partnership deed.

The taxpayer objected to the Commissioner's assessment on the basis that, on applying the set-off mechanism in cl 26 of the partnership deed, he received no payment because the goodwill amount of $182,629 was offset against the amount of $197,126 which he owed to the partnership.

The Commissioner's disallowance of the taxpayer's objection was affirmed by the AAT[3] and an appeal by the taxpayer to the Federal Court was dismissed by Cheeseman J.[4] Now the taxpayer's further appeal has been dismissed by the Full Federal Court (Logan, Goodman and Hespe JJ).

On the appeal, the Full Court rejected the taxpayer's contention that the source of his entitlement to a payment on retirement was cl 3.7 of the retirement deed and that, although calculated by reference to integers derived from cls 25 and 26 of the partnership deed, the only amount which he was entitled to receive pursuant to cl 3.7 was the calculated net sum.

In rejecting the taxpayer's contention, the Full Federal Court said that cl 3.7 of the retirement deed did not confer an entitlement on the taxpayer to be paid but provided for the terms on which the moneys payable under the partnership deed were to be paid. It referred to "all moneys payable to the Retiring Partner" and ascribed to the total of these moneys the label "retirement moneys" but it did not create in the partnership or in the remaining partners the obligation to pay moneys. The retirement moneys were the total of those moneys payable to the taxpayer pursuant to cl 25 of the partnership deed and did not constitute an obligation to pay an undissected lump sum for the taxpayer's partnership interest.

Clause 3.7 of the retirement deed incorporated the terms of cls 25 and 26 of the partnership deed and provided for cl 3.8 to determine the instalments for payment of the moneys liable to be paid pursuant to cls 25 and 26 of the partnership deed. The effect of cl 3.8 was to amend the instalment regime otherwise provided for in cl 27 of the partnership deed.

Further, the Full Court said that the purpose of cl 3.7 of the retirement deed was not to confer a right on the taxpayer to be paid or to impose an obligation on the remaining partners to pay the monetary entitlements of the taxpayer on his retirement, but to vary the payment terms and manner of calculation of the quantum. Properly construed, cl 3.7 did not create a new obligation to pay "retirement moneys". The term "retirement moneys" was just a convenient label to ascribe to the total of the moneys which cl 25 of the partnership deed required the remaining partners to pay after the set-off provided for in cl 26 of the partnership deed. Clause 3.8 of the retirement deed varied the instalment schedule provided for in cl 27 of the partnership deed.

Clause 26 of the partnership deed provided for an offset of amounts owing to the retiring partner against amounts owed by the retiring partner. That offset was not constrained to the retiring partner's proportionate share of goodwill of the partnership. Contrary to the submissions of the taxpayer, that offset did not result in the cl 25.4 amount being "zeroed" in the calculation of the retirement moneys. The amount of cash to be paid to the taxpayer was a balance remaining after offset. It was that balance that was to be subject to the quantum adjustment and instalment regime provided for in the retirement deed.

6. Tax agent: judicial review proceedings

A registered tax agent has been unsuccessful in judicial review proceedings brought by him in the Federal Court in relation to two adverse decisions of the Tax Practitioners Board (*Incollingo v Tax Practitioners Board*[5]).

By an originating application brought under the *Administrative Decisions (Judicial Review) Act 1977* (Cth) and s 39B of the *Judiciary Act 1903* (Cth), the tax agent (Mr Gerardo Incollingo) sought judicial review of two decisions of the Tax Practitioners Board (the Board) and related decisions. The two decisions, as defined in the originating application, were:

- the investigation decision, being to commence an investigation into Mr Incollingo's conduct as to whether he had contravened the Code of Professional Conduct contained in Pt 3 of the *Tax Agent Services Act 2009* (Cth) (TASA09), arising from the creation of backdated false documents and the provision of those documents by him to the ATO in response to a notice under the former s 264 of the *Income Tax Assessment Act 1936* (Cth) (Commissioner may require information and evidence); and
- the sanction decision, being to impose a sanction on Mr Incollingo on finding that such a contravention had taken place, including suspension of his registration as a tax agent under the TASA09.

Mr Incollingo was sent a notice of decision to investigate on 11 May 2021. The investigation concluded on 11 November 2021. Mr Incollingo was notified of the sanction decision on 1 December 2021.

The investigation decision was made by a Board officer who was an investigation and enforcement manager to whom the power to make that decision had been delegated. The sanction decision was made by a Board Conduct Committee which had a delegation from the Board, and that committee comprised three members of the Board who had no prior knowledge of Mr Incollingo. The Conduct Committee did not have any information about him other than the final submission provided to it (including attachments) and what was said about that submission.

Mr Incollingo also challenged the investigation continuing (when he asked that it be terminated) and the finding that contraventions had taken place leading to the sanction decision. These were broadly what were described as the "related decisions".

The basis for Mr Incollingo's challenges were an assertion that the investigation decision, the sanction decision and the related decisions were all invalid because each decision had been made by unlawfully using certain information against him. The information in question was obtained as a consequence of parts of the evidence he had given in cross-examination in a proceeding in the Federal Court.[6] The giving of that evidence by Mr Incollingo in cross-examination was protected from certain types of use or derivative use by a statutory protection bestowed by a certificate given to him by Davies J, who was the presiding judge, under s 128 of the *Evidence Act 1995* (Cth) (the s 128 certificate).

Mr Incollingo relied on what he contended was use, or derivative use, of part of his evidence in cross-examination contrary to the protection given to him by the s 128 certificate.

In dismissing Mr Incollingo's challenges, Bromwich J said that a problem for Mr Incollingo was that the same, or substantially the same, information was available and brought into existence well before he gave oral evidence in cross-examination, including from the affidavit on which he was cross-examined, and was the primary express basis for both the investigation decision and the sanction decision. A further problem for Mr Incollingo was that careful steps were taken to quarantine information and derivative information covered by the s 128 certificate from the ultimate makers of the sanction decision, being the Conduct Committee.

In the course of his judgment, Bromwich J said that, importantly, Davies J made serious adverse findings about the truthfulness of other aspects of Mr Incollingo's evidence in cross-examination which formed no part of the information that the materials before the Conduct Committee referred to, but were not covered by the s 128 certificate.

7. Another tax agent registration case

There have been several other recent decisions in which the AAT has reviewed decisions of the Tax Practitioners Board relating to the cancellation of a tax agent's registration.

For example, in *Clifford and Tax Practitioners Board*,[7] the Board made a decision on 21 July 2022 to terminate the applicant's tax agent registration and to prohibit her from reapplying for registration for a period of two years. This followed findings by the Board that the applicant had breached her professional obligations and was not a fit and proper person to be registered as a tax agent.

The applicant breached several provisions of the Code of Conduct. She made false declarations to the Board in her renewal of registration form submitted on 6 June 2019. In answer to the question "do you have any overdue tax obligations?", she answered, "no". In truth, at the time of submitting the form, the applicant owed the ATO $145,455, with no payment plan in place.

Also, the applicant lodged 10 false declarations with the ATO for the years 2009 to 2018, claiming that a particular client (an SMSF) had been audited. In truth, the fund had not been audited in any of those years. She informed the Board that she knew there was no auditor's report when she lodged the returns. She said that she lodged the false declarations to stop "harassing phone calls" from the ATO asking why she had not lodged her client's tax returns.

She made the same declarations to the ATO in respect of another SMSF client for the 2015 to 2019 income years. That fund had only been audited in respect of the 2015 year (but no audit report had been provided by the date of lodgment) and there was no audit in respect of the other years.

The applicant misled the Board's officers about these defaults by claiming that these were the only SMSF clients in respect of which she had not received audit reports before lodging returns. In truth, the applicant had made similar false declarations in respect of several other clients for the 2014 and 2015 income years.

The AAT was satisfied that the applicant was not a fit and proper person to be registered as a tax agent. The AAT noted that the exercise of the discretion to disqualify a person from being a tax agent was not to be used in punishment of that person. The AAT said that the purpose of the power to disqualify is to protect the public. Protection of the public includes protection of the clients who may engage the tax agent's service and protection of the revenue. Protection of the public is also closely linked with public confidence in the system. The public is entitled to know and expect that persons who occupy the position of a tax agent are of high integrity.

The AAT considered the appropriate sanction was that the applicant's registration be terminated and that, taking all of the circumstances into account, including giving relevant weight to the applicant's health, her age, and other issues she had raised, she should be prohibited from applying for registration for a total of two years.

However, in the calculation of that two-year period, the time during which the applicant was deregistered and did not have the benefit of stay orders should be taken into account. The correct and preferable decision was that the applicant should be prohibited from applying for registration as a tax agent for 18 months from the date on which her termination pursuant to the AAT's decision took effect.

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1 Treasury, *Modernising individual tax residency*, consultation paper, July 2023. Available at https://treasury.gov.au/sites/default/files/2023-07/c2023-205344-cp.pdf.

2 [2023] FCAFC 105.

3 *Hedges and FCT* [2020] AATA 5307.

4 *Hedges v FCT* [2022] FCA 1389.

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7 [2023] AATA 2068.

Tax Tips

by TaxCounsel Pty Ltd

Arm's length issues

In a recent decision, the AAT considered some issues raised by the arm's length concept.

Background

There are a number of provisions of the taxation laws that operate by reference to an arm's length amount where the parties to a transaction do not deal with each other at arm's length or the consideration is greater or less than market value.

A well-known instance of such provisions are the market value substitution rules that apply for the purposes of determining the amount of a capital gain or capital loss that arises under the CGT provisions. Under those rules, the broad position is that, when determining the first element of the cost base or reduced cost base of a CGT asset that an entity acquires from another entity, the market value of the asset at the time of acquisition is what is relevant if the acquiring entity did not deal at arm's length with the other entity in connection with the acquisition.[1]

Conversely, in such a case, for the purposes of determining a capital gain or capital loss of the disposing entity, the capital proceeds that the disposing entity is taken to receive is the asset's market value at the time of the happening of the particular CGT event which gave rise to the capital gain or capital loss.[2]

The AAT, in a decision handed down on 28 July 2023, has considered the operation of the concept of parties to a scheme not dealing with each other at arm's length in relation to a scheme for the purposes of determining the non-arm's length income (NALI) of a complying superannuation fund under s 295-550 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97). The decision is *BPFN and FCT*.[3]

The facts

In the *BPFN* case, the taxpayer was the corporate trustee of a self-managed superannuation fund (SMSF).

During the 2015, 2016 and 2017 income years (the relevant years), the taxpayer derived income as the beneficiary of a fixed unit trust (JJUT) of which it was the sole unitholder.

Through a series of loan agreements, JJUT lent money through two related entities, ABC Pty Ltd (ABC) and X Finance Pty Ltd as trustee for the DEF Trust (DEF), which was ultimately lent to independent third parties who undertook development activities.

In summary, the structure was as follows:

- JJUT was the lender under the JJUT/ABC loan agreement;
- ABC was:
  - the borrower under the JJUT/ABC loan agreement; and
  - the lender under the ABC/DEF loan agreement; and
- DEF was:
  - the borrower under the ABC/DEF loan agreement; and
  - the lender under a number of third-party loan agreements.

The JJUT/ABC and ABC/DEF loan agreements were perhaps better described as "loan facility agreements". They contemplated that JJUT, ABC and DEF would first agree on each loan by DEF to a third party.

They so agreed by a resolution in writing, executed on behalf of each of JJUT, ABC and DEF, described as a funding resolution/memorandum (the funding resolution). The funding resolution typically set out the commercial interest rate payable by the third party, the fees payable to ABC and DEF with respect to the third-party loan, and the security which was required.

After the loan and security documentation was executed, and following the funding resolution, ABC drew down the required amount from JJUT, which DEF in turn drew down from ABC, and then DEF on-lent the money to the third party.

Interest on the loans to the third parties set the rate of interest charged by ABC to DEF, and by JJUT to ABC. It was common ground that the third-party loans were arm's length transactions and the interest was charged at commercial rates.

The interest income derived by JJUT through these loan arrangements was distributed to the taxpayer as JJUT's sole unitholder and included by the taxpayer as exempt current pension income.

Following an ATO audit, the Commissioner took the view that the interest income was NALI and issued notices of amended assessment to the taxpayer on that basis for the relevant years. The taxpayer objected to each assessment and, on the Commissioner's disallowance of the objections, applied to the AAT for a review of the objection decision.[4]

The issue

The issue was whether the NALI provisions (and, in particular, s 295-550(5) ITAA97) applied in respect of the distributions by JJUT to the taxpayer.

Further factual background

The taxpayer had been the sole unitholder of JJUT since at least 2006. At all relevant times, it had a fixed entitlement to distributions under the JJUT trust deed.

The SMSF had four members: Mr J, his wife and their two children. The members of the SMSF were also the directors of the taxpayer/corporate trustee.

For the relevant years, JJUT received the following interest on the loan to ABC:

- 2015: $1,204,186;
- 2016: $3,855,184; and
- 2017: $2,609,956.

ABC was incorporated on 10 January 1992. At the time of the loan agreements (June 2009), Mr J was the sole director of ABC and the taxpayer was the sole shareholder.

DEF was established as a discretionary trust by deed on 5 August 2002. The corporate trustee was X Finance Pty Ltd, and the primary beneficiaries were Mr J and his wife. Mr J and his son were directors of X Finance Pty Ltd from June 2009 to July 2012. During the relevant period, Mr J was the sole director of the corporate trustee.

A Pty Ltd (a company of which Mr J was a director and an 80% shareholder) was the sole shareholder of X Finance Pty Ltd.

In 2018, Mr J ceased to be a director of X Finance Pty Ltd and the shares were transferred from A Pty Ltd to third parties.

Prior to the loan agreements, and until 2008, DEF provided building and project development consultancy services.

Loan agreements

As indicated, JJUT loaned funds to ABC, which on-lent the funds to DEF, and DEF in turn on-lent the funds to third parties.

Loan agreement between JJUT and ABC. Features of or concerning the loan agreement between JJUT and ABC were as follows:

- the loan amount was all loan amounts advanced by the lender or at the borrower's direction or request and as agreed in writing between the lender and the borrower;
- the loan facility was for 15 years or otherwise as agreed or repayable on demand;
- the purpose of the loan was for ABC to on-lend the funds to DEF;
- ABC executed a deed of charge in favour of JJUT;
- Mr J executed a guarantee with JJUT;
- the loan was to be repaid at the times directed by the lender from time to time;
- in the event of any failed investment or loss on any forward advance or on-advance, the borrower and the lender were to each bear those respective risks and losses from time to time; and
- the interest rate was to be no less than the amount or rate at which the moneys were invested or on-lent by the borrower.

Loan agreement between ABC and DEF. In respect of the loan agreement between ABC and DEF:

- the loan amount was all amounts advanced by the lender to the borrower or at the borrower's direction or request and as agreed in writing between the lender and borrower from time to time;
- the loan facility was for 15 years;
- the purpose of the loan facility was for DEF to on-lend the funds;
- by way of an executed deed of charge in favour of ABC, DEF provided a fixed and floating charge over all of its assets until such time as the loan was repaid;
- Mr J executed a guarantee with ABC;
- the interest rate payable was to be no less than the amount or rate at which the moneys were invested or on-lent by DEF;
- the trustee for DEF and ABC would equally share any loss incurred by DEF through investing/utilising the borrowed funds; and
- there was no maximum loan amount.

The loan agreements between JJUT and ABC, and between ABC and DEF, were therefore substantially the same. They contemplated the investing or on-lending of funds sourced from JJUT. They also contemplated that the amounts advanced would be subject to agreement and that the payment of interest would be at no less than the rate at which moneys were invested or on-lent.

Deeds of charge between JJUT and ABC, and between ABC and DEF, and two deeds of guarantee were executed on 30 June 2009. The deeds of charge were not registered on the Personal Property Securities Register (PPSR). In 2017, a new general security interest agreement was executed by ABC and DEF and it was registered on the PPSR in May 2017.

DEF entered into a number of loan agreements with unrelated parties at arm's length.

The financing was secured by either first or second mortgages, with the larger loans secured by properties on which the third-party borrowers were conducting development projects.

Professional advice

The structure involving JJUT, ABC and DEF was determined by Mr J on advice from his accountant, Mr B. Mr B's firm had been the advisers and accountants for Mr J and his associated entities since 2000.

Mr B recommended the structure of the scheme but he did not draft the documents. The structure was presented to Mr J's solicitor, Mr C, whose firm drafted the documents. Mr B (and Mr J) were conscious that the transactions between the various entities should be on arm's length terms.

Mr J explained to the satisfaction of the AAT his and Mr B's reasons for interposing DEF and ABC between JJUT and the third-party borrowers. Among other things, in consultation with his accountant, Mr J determined that it would be preferable that JJUT was not lending directly to the third parties. DEF was to be the "front-line person" dealing with the third parties for which it would obtain "proper fees".

Mr J also explained the reason that ABC was interposed. He described it as a gatekeeper or someone to keep an eye on DEF. Mr B gave evidence to the same effect and explained that it was commonplace with private investors to have two intermediate entities.

In his evidence, Mr J impressed that he was looking to the long-term when he may no longer be personally involved. He said that his accountants recommended that the loan facilities from JJUT to ABC, and from ABC to DEF, be long-term arrangements both for longevity and associated benefits, such as not having to re-do a loan agreement on multiple occasions.

As indicated, Mr J gave evidence that he understood, including from advice provided by Mr B, that the dealings between the related entities must be arm's length transactions. So far as he was concerned, they took particular care to ensure that that was the case.

Having seen and heard Mr J and Mr B cross-examined, and on reviewing their statutory declarations in light of the contemporaneous documents, the AAT accepted their evidence, including the reasons for the structure of the loan arrangements.

Funding resolutions

As contemplated in the loan agreements, for each advance that DEF made to unrelated third parties, JJUT, ABC and DEF executed a funding resolution. The funding resolutions detailed:

- the loan amount, which was initially drawn down by ABC from JJUT, and subsequently by DEF from ABC;
- the interest rate to be applied on the loan to the third party, and thereby the minimum interest payable under the loans between DEF and ABC, and ABC and JJUT;
- the term of the loan; and
- the security provided by the third party.

The funding resolutions also set out the fees or other consideration payable to ABC and DEF. By way of example, under a funding resolution dated 17 May 2012, for a loan amount of $725,000, DEF would receive and retain an establishment fee ($11,962), a mortgage sale fee (if a mortgagee sale occurred) ($36,250), and a discharge fee ($500/lot, anticipated to be 26 lots = $13,000). ABC would be entitled to an amount of 0.5% of the loan amount on either discharge of the mortgage or repayment of the loan from DEF.

Mr J said that, on each occasion, the fees were negotiated between DEF and the third party based on the market and the circumstances of the loan. ABC only drew down on the loan from JJUT at the same time that DEF drew down on its loan from ABC.

The legislation

The primary issue for decision by the AAT was whether the NALI provisions applied and this turned on s 295-550(5) ITAA97. That provision, as in force for the relevant years, provided:[5]

> "**295-550(5)** Other income derived by the entity as a beneficiary of a trust through holding a fixed entitlement to the income of the trust is ***non-arm's length income*** of the entity if:
>
> (a) the entity acquired the entitlement under a scheme, or the income was derived under a scheme, the parties to which were not dealing with each other at arm's length; and
>
> (b) the amount of the income is more than the amount that the entity might have been expected to derive if those parties had been dealing with each other at arm's length."

Scheme

The AAT took the view (which was accepted by the parties) that the relevant scheme for the purposes of s 295-550(5)(a) ITAA97 was the totality of the arrangement between JJUT, ABC, DEF and the third-party borrowers.

It may be noted that "scheme" for the purposes of the ITAA97 is defined in the Dictionary to mean:

- any arrangement (as broadly defined); or
- any scheme, plan, proposal, action, course of action or course of conduct, whether unilateral or otherwise.

Arm's length dealing

As to s 295-550(5)(a) ITAA97, the AAT held that the parties were not dealing with each other at arm's length. There was no dispute that DEF was dealing with the third parties at arm's length, but that could not be said of the dealings between JJUT, ABC and DEF. The directing mind of each of JJUT, ABC and DEF, in relation to these dealings, was Mr J.

The AAT referred to the following observations of Edmonds and Gordon JJ in *FCT v AXA Asia Pacific Holdings Ltd*:[6]

> "105. Any assessment of whether parties were dealing at arm's length involves 'an assessment [of] whether in respect of that dealing they dealt with each other as arm's length parties would normally do, so that the outcome of their dealing is a matter of real bargaining': *Trustee for the Estate of the late AW Furse No. 5 Will Trust v Commissioner of Taxation* ...[7] The reference in *Furse* to 'real bargaining' is significant. It focuses on actual dealing between the parties: see also *Re Hains (deceased); Barnsdall v Federal Commissioner of Taxation* ...[8] That is not surprising. It is the same mental process as that described by Griffith CJ in *Spencer v The Commonwealth* ...[9]
>
> 106. The question of whether parties dealt with each other at arm's length in respect of a particular dealing is one of fact in each case: *Granby v Federal Commissioner of Taxation* ...[10] What is required is that 'parties to a

> transaction have acted severally and independently in forming their bargain': *Granby* … Put another way, it requires consideration of how 'unrelated parties, each acting in his or her own best interest, would carry out a particular transaction': *Australian Trade Commission v WA Meat Exports Pty Ltd* …[11]"

The AAT also referred to *Minister of National Revenue v Merritt*,[12] a Canadian decision, and to the following passage from the judgment of Cattanach J:

> "In my view, the basic premise on which this analysis is based is that, where the 'mind' by which the bargaining is directed on behalf of one party to a contract is the same 'mind' that directs the bargaining on behalf of the other party, it cannot be said that the parties are dealing at arm's length. In other words where the evidence reveals that the same person was 'dictating' the 'terms of the bargain' on behalf of both parties, it cannot be said that the parties were dealing at arm's length."

The AAT said that nothing that could be described as "real bargaining" occurred in respect of the respective dealings between JJUT, ABC and DEF. What was agreed was based on Mr J's views about the market, and what was considered by him to be fair and reasonable based on the work that was done by each entity and the market rate for that work.

The AAT went on to say that it has been pointed out that, in a particular fact situation, related parties may deal with each other at arm's length in relation to a transaction.[13] That, however, was not the present case. The evidence was that there was no bargaining between the parties to the scheme. They did not deal with each other, for example, through a medium such as the stock exchange. Mr J controlled and directed each of them.

The taxpayer submitted that the arrangement between the parties was what could be expected from dealings between parties acting at arm's length. The AAT said that that may be so but it did not assist in the present case where there was direct evidence of what occurred in terms of para (a) of s 295-550(5) ITAA97. The AAT went on:

> "55. The enquiry is whether in fact the parties I have been referring to, in their respective dealings with one another, were or were not dealing with each other at arm's length. Plainly they were not."

Income derived if parties dealing at arm's length

The conclusion of the AAT on the dealing at arm's length issue meant that it was necessary for the AAT to determine whether, under para (b) of s 295-550(5) ITAA97, the amount of income was more than the amount that the entity might have been expected to derive if the parties had been dealing with each other at arm's length.

The taxpayer submitted that s 295-550(5)(b) required a comparison between the actual transaction (and the income derived) and that which might have been expected to have been the position if the scheme had not been entered into.

The taxpayer further submitted that the ultimate transactions involved the lending of funds, sourced from JJUT, to the third-party borrowers. The taxpayer submitted that the proper comparison was a hypothetical transaction in which JJUT dealt directly with the third parties on the same terms as DEF lent to those borrowers.

Pursuant to that hypothetical situation, it was submitted that JJUT would have derived interest income paid by the third parties, admittedly at commercial rates pursuant to arm's length transactions, equating to (or perhaps greater than) the interest income that JJUT actually received.

Under these hypothetical transactions, the intermediate entities, ABC and DEF, did not feature at all. The taxpayer relied on the observation of Allsop CJ in *Chevron Australia Holdings Pty Ltd v FCT*[14] that the form of the transaction "may, to a degree, be altered if it is necessary to do so to permit the transaction to be analysed through the scope of mutually independent parties".

The AAT did not accept that the hypothetical transactions should be modified to the extent of ignoring ABC and DEF. That "would [not] be" a modification, "to a degree", as contemplated in *Chevron*, but would instead be a substantial restructuring of the scheme. Nor did the AAT consider that it was a necessary modification so as to permit the transactions to be analysed. The AAT said:

> "62. To accept the [taxpayer's] submission would fail to give effect to the wording and intent of s 295-550(5)(b). The reference in that provision is to the amount of income the entity might have been expected to derive if those parties had been dealing with each other at arm's length. In this case 'those parties' include ABC and DEF."

The taxpayer submitted, in the alternative, that the comparison was with what income might have been derived if there had not been a lack of independence between the parties in dealing with each other in the actual scheme. That was also the Commissioner's submission and the AAT thought that it was essentially correct.

The task, as the AAT saw it, involved considering what the parties to the scheme would have agreed, particularly JJUT, ABC and DEF, and what income would have ultimately been derived, if the parties to the scheme had been dealing with each other at arm's length.[15]

The Commissioner submitted that the evidence did not support a finding that the scheme would have been entered into on the same terms as agreed between JJUT, ABC and DEF if those parties were dealing at arm's length. The Commissioner pointed out that no margin was charged on interest rates between the various lenders. He also submitted that ABC's fees were "unsustainably low".

It was the Commissioner's submission that, by keeping all of the interest for itself and paying ABC what were described as "unsustainably low fees", the taxpayer thereby ensured that it earned more than it would have if the parties were dealing at arm's length.

After considering the evidence adduced by the taxpayer and the Commissioner, the AAT was satisfied that the scheme established under the private lending facility did not differ from that which might be expected to have operated between independent parties dealing independently with one another in the private lending market at the time. Accordingly, the relevant interest income received by the taxpayer in the relevant income years was not NALI.

Observations

Although not referred to by the AAT, it should be noted that the Dictionary in s 995-1(1) ITAA97 contains this entry:

> "***'arm's length'***: in determining whether parties deal at arm's length, consider any connection between them and any other relevant circumstance."

This means that the concept of dealing at arm's length in the ITAA97 is not confined to relationships or connections between entities but extends further to "other relevant circumstances". It would seem to be clear that there may, in appropriate circumstances, be an absence of arm's length dealing even if there is no connection between the parties to a transaction or other dealing.

That there may be such a transaction or other dealing was in fact clear from the case law. Thus, in *Marion Elizabeth Collis v FCT*,[16] the taxpayers were proposing to sell at auction several abutting parcels of land. One parcel was vacant and had been acquired by the taxpayers for $200,000 within the preceding 12 months, which meant that any profit arising from its sale would be assessable under the former s 26AAA of the *Income Tax Assessment Act 1936* (Cth). The other parcels had been owned by the taxpayers for some time and there was a factory on them. The successful bidder at the auction was a Mr Bonython, acting on behalf of a company, and the properties were sold to him for $1,430,000. Mr Bonython was asked to and did sign two contracts for the purchase. One contract was for the vacant parcel of land with a sale price of $200,000, and the other contract was for the other parcels with a sale price of $1,230,000. The Commissioner assessed the taxpayers on the basis that the taxpayers and Mr Bonython were not dealing with each other at arm's length and, so, by reason of the arm's length provisions of the former s 26AAA, each of the taxpayers was assessable under that section by reference to the market value of the parcel.

Jenkinson J, in disallowing the taxpayer's appeals from a decision of the AAT, said that the inference must surely be drawn that Mr Bonython, being indifferent, submitted the exercise of his will to the taxpayers' wishes in acceding to their request. Jenkinson J referred to the decision of Lee J in *Granby Pty Ltd v FCT*,[17] where Lee J said:

> "21. If the parties to the transaction are at arm's length it will follow, usually, that the parties will have dealt with each other at arm's length. That is, the separate minds and wills of the parties will be applied to the bargaining process whatever the outcome of the bargain may be.
>
> 22. That is not to say, however, that parties at arm's length will be dealing with each other at arm's length in a transaction in which they collude to achieve a particular result, or in which one of the parties submits the exercise of its will to the dictation of the other, perhaps to promote the interests of the other."

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References

1 S 112-20(1)(c) of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).

2 S 116-30(2)(b)(i) ITAA97.

3 [2023] AATA 2330.

4 The Commissioner also assessed the taxpayer for penalties but it was not necessary for the AAT to consider this issue in light of its decision on the primary issue.

5 This version of s 295-550(5) was replaced by the present subsection by Act No. 78 of 2019. The same issues as were considered by the AAT would also arise under the present version of the subsection. References in this article are references to the former provision.

6 [2010] FCAFC 134.

7 (1991) 21 ATR 1123 at 1132 per Hill J.

8 [1988] FCA 192.

9 (1907) 5 CLR 418 at 432.

10 (1995) 129 ALR 503 at 507.

11 (1987) 75 ALR 287 at 291.

12 [1969] CTC 207 at 217.

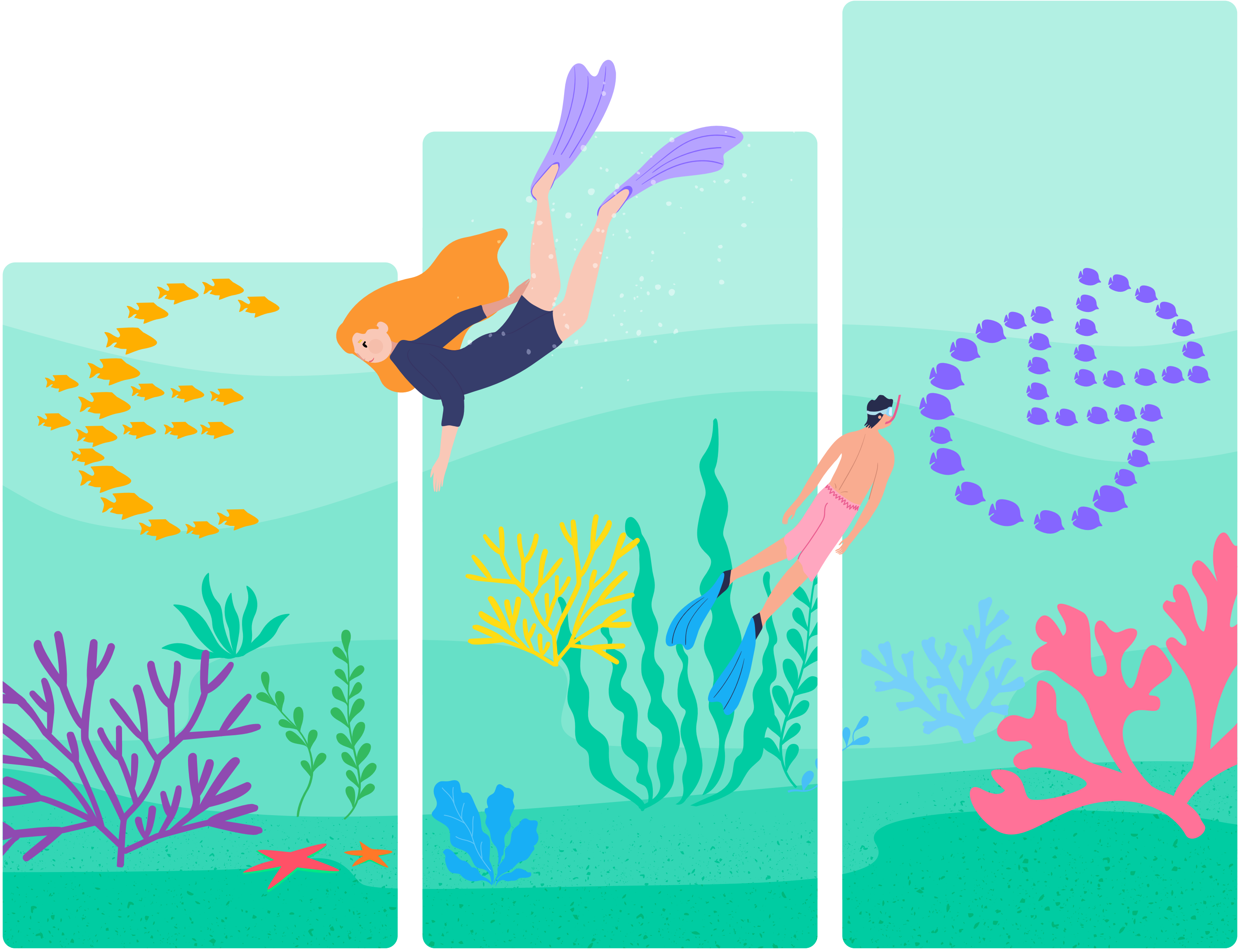
13 In this regard, the AAT cited *Copperart Pty Ltd v FCT* [1993] FCA 462 at [109] per Hill J, *Re Barnsdall v FCT* [1988] FCA 192 at [17] per Davies J, and *FCT v AXA Asia Pacific Holdings Ltd* (2010) 189 FCR 204 at 213 per Dowsett J.

14 [2017] FCAFC 62.

15 The AAT referred in this regard to *Glencore Investment Pty Ltd v FCT* [2019] FCA 1432 at [314]; *FCT v Glencore Investment Pty Ltd* [2020] FCAFC 187 (Middleton and Steward JJ).

16 [1996] FCA 1717.

17 [1995] FCA 1217.



Mid Market Focus

by Gaurav Chitnis, CTA, HLB Mann Judd

CGT roll-overs and tax consolidation for SMEs

This month's column discusses certain complexities with the interaction between the tax consolidation regime and CGT roll-overs that could result in adverse tax outcomes.

Introduction

There are several reasons why small-to-medium enterprises (SMEs) choose to restructure to a corporate entity. Most importantly, a corporate structure provides access to a lower tax rate, enables the retention of funds for working capital and debt repayments in a tax-effective manner, and could provide a structure that is eligible for tax consolidation. The use of CGT roll-overs is an effective way to restructure to a corporate group by deferring CGT on the disposal of assets and interests in entities. While a roll-over could provide immediate relief from CGT, it is important to consider the impact that a roll-over can have on an entity joining a tax consolidated group. Without adequate consideration, the consolidation tax cost setting process could result in adverse tax outcomes.

Using CGT roll-overs

An individual or a trustee of a discretionary trust could choose the roll-over contained in Subdiv 122-A of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) whereby assets can be transferred to a wholly owned company in a CGT-free manner. Most commonly, this roll-over is used to transfer business assets to a company to provide a more tax-effective structure. Subdivision 122-B ITAA97 provides an equivalent roll-over for partnerships.

Corporatising a unit trust, or "top hatting", is achievable in a CGT-free manner using the roll-over contained in Div 615 ITAA97.[1] This roll-over allows the transfer of ownership in the unit trust to a company that is wholly owned by two or more unitholders.[2]

Subdivision 124-N ITAA97 provides a roll-over for unit trusts whereby all of the assets in the trust could be transferred to a company that is wholly owned by the unitholders in a CGT-free manner.[3]

Subdivision 124-M ITAA97 provides a roll-over, commonly referred to as the "scrip-for-scrip" roll-over used to provide a "double-holding" structure, whereby a new company is interposed between the shareholders of an existing company. The interposed entity acquires 80% or more of the shares in the original company,[4] and the original shareholders obtain shares in the interposed company in proportion to the market value of their original shareholdings.[5] This roll-over is commonly used to create a holding company structure to form a tax consolidatable group.[6] A double-holding company structure can also be achieved using the Div 615 roll-over.[7] However, unlike the Subdiv 124-M roll-over, Div 615 requires at least two shareholders in the original company.

In some instances, a corporatised structure can be achieved in a tax-free manner using the small business CGT concessions (the concessions) contained in Div 152 ITAA97. There are a number of conditions that need to be satisfied in order to access the concessions, including the $2m turnover or the $6m net asset value tests, the connected entity test, the active asset test and the significant individual test.[8]

A notable difference between CGT roll-overs and the concessions is the manner in which the cost base of the shares in the corporate entity is determined. For entities using the Subdiv 122-A roll-over, the original cost base of the assets transferred will become the cost base of the shares in the transferee company.[9] Similarly, under Subdiv 124-M, the interposed company's cost base of the shares in the original company will be the original cost base of those shares.[10] The Div 615 roll-over recalculates the cost base of the shares in the original entity in a different manner, worked out as the difference between the cost base of the assets of that entity less any liabilities in respect of those assets. Under the concessions, the cost base of the assets or interests in the transferee entity is generally set at their respective market values.[11]

The use of CGT roll-overs also requires consideration of the market value of the assets or interests transferred. Under the Subdiv 122-A roll-over, the market value of the shares received by the individual or trustee must be substantially the same as the assets transferred to the company.[12] This requirement can be overcome by simply incorporating a new company with a nominal amount of share capital for the purposes of the roll-over.

The Subdiv 124-M roll-over also requires that the shares in the interposed company received need to be of substantially the same value as the original shares held.[13] Obtaining market valuation becomes critical when the interposed company owns other subsidiaries at the time of the exchange as the number of shares issued to the original interest holder must be of substantially the same value as their original interest.

The Div 615 roll-over requires the ratio of the market value of each exchanging member's shares in the interposed company to be equal to the market value of the shares or units exchanged.[14]

Tax consolidating a corporate structure

As discussed above, corporatising a structure could allow for the formation of a tax consolidated group. The benefits of forming a tax consolidated group include the ability to transfer assets between group members without immediate CGT consequences and the use of tax losses in member entities against group income. A tax consolidated group operates under the "single entity" rule whereby the assessable income and deductions of each member entity are attributable to the head company, intra-group transactions are ignored, a single franking account is maintained, and the head company lodges a group income tax return.[15] When a consolidated group is formed, the cost of acquiring each subsidiary is allocated to the assets of the particular subsidiary. This requires the head company to calculate the allocable cost amount (ACA) for a subsidiary member. The ACA is then allocated to the assets of that joining entity. The steps in calculating the ACA can broadly be summarised as follows:[16]

- step 1: determine the cost base of membership interests in the joining entity;
- step 2: add the liabilities of the joining entities (subject to adjustments);
- step 3: add the undistributed, taxed profits that accrued to the joining group before joining time;
- step 3A: adjust for certain pre-joining time roll-overs from a foreign resident company to an Australian resident company;
- step 4: subtract the pre-joining time distributions;
- step 5: subtract the losses accrued to the joining group before joining time;
- step 6: subtract the losses transferred by the joining entity; and
- step 7: subtract certain deductions to which the group becomes entitled.

Once the ACA is calculated, it needs to be allocated to the retained cost base assets, which ordinarily include cash, debtors and loans.[17] The balance of the ACA is then allocated proportionately to the reset cost base assets according to their respective market values. Reset cost base assets include goodwill, depreciable assets and trading stock.[18] The preferred outcome in most cases would be a higher allocation of ACA to depreciable assets and trading stock. However, in many instances, a "goodwill skew" occurs where a joining entity has a significant goodwill value in comparison to its depreciable assets and trading stock at joining time. In such a scenario, the pre-joining time tax cost of depreciable assets and trading stock reduces post-consolidation due to a higher proportion of the ACA being allocated to goodwill.

Further, the recent stimulus measures, such as temporary full expensing and the instant asset write-off applied to depreciable assets prior to joining time, are likely to have adverse consequences in the tax cost setting process. This is due to the ACA being notionally allocated to depreciable assets in proportion to their market value, while the tax cost base of such assets remains nil. This has been recognised in LCR 2021/3:

> "102. Where a joining entity becomes a subsidiary member of a consolidated group and, prior to the joining time, the decline in value of a depreciating asset of the joining entity was worked out for Division 40 of the ITAA 1997 purposes under TFE, BBI or IAWO, then subsection 705-45(2) of the ITAA 1997 will apply to the asset. Subsection 705-45(2) of the ITAA 1997 provides that, if the tax cost setting amount for the asset exceeds the terminating value for the asset just before the joining time (that is, in the joining entity's hands), the tax cost setting amount is reduced to that terminating value. Note 2 to subsection 705-45(2) of the ITAA 1997 confirms that the reduction amount is not reallocated to other assets."

In some cases, the amount of the ACA is less than the retained cost base assets. Therefore, a shortfall arises between the ACA and the amount of retained cost base assets. This shortfall is an assessable capital gain under CGT event L3.[19]

Choosing a roll-over wisely

The use of CGT roll-overs can have an adverse effect on the tax cost setting process at joining time. Step 1 of the ACA requires determining the cost base of the membership interests in the joining entity. This can be illustrated in the example below where the shareholders of a company (Company A) choose the Subdiv 124-M scrip-for-scrip roll-over in order to create a tax consolidatable group. The total cost base of the shares in Company A is $100. The balance sheet of Company A is as follows:

	Cost	Market value
Cash on hand	$100	$100
Cash at bank	$250,000	$250,000
Trade debtors	$150,000	$150,000
Goodwill[20]	Nil	$1m
Plant and equipment	Nil[21]	$500,000
Trading stock	$100,000	$100,000
Trade creditors	($75,000)	($75,000)
Net assets	$425,100	$1,925,100
Retained profits	$425,000	
Share capital	$100	

A company (HeadCo) is interposed between Company A and its shareholders using the Subdiv 124-M roll-over. The cost base of HeadCo's shares in Company A will be $100, being the original cost base of the shares in Company A. HeadCo forms a tax consolidated group with Company A. The ACA of Company A is worked out as follows:

Step 1	$100
Step 2	$75,000
Steps 3 to 7	Nil[22]
ACA	$75,100

The retained cost base assets of Company A consist of cash on hand, cash at bank, and trade debtors totalling $400,100. Once the ACA of $75,100 is allocated to the retained cost base assets, there is a shortfall giving rise to a CGT event L3 capital gain of $325,000.

A different outcome will arise if the shareholders of Company A satisfy the requirements to apply the Div 615 roll-over instead. In this case, HeadCo's cost base of the shares in Company A will be worked out as the cost base of its assets less liabilities relating to those assets. This amount will be equivalent to the net assets of $425,100 as stated above. The ACA of Company A is worked out as follows:

Step 1	$425,100
Step 2	$75,000
Steps 3 to 7	Nil
ACA	$500,100

The ACA is first allocated to the retained cost base assets totalling $400,100. The balance of the ACA is then allocated to goodwill and trading stock.[23] While the Div 615 roll-over provides a better tax outcome compared to the Subdiv 124-M roll-over, the tax cost setting process results in a reduction in the tax cost of trading stock for the ACA balance of $100,000 allocated to reset tax cost base assets as follows:

ACA balance	$100,000
Plant and equipment	Nil
Goodwill	$62,500
Trading stock	$6,250

The $100,000 ACA balance is reduced by $31,250 as this amount is notionally allocated to plant and equipment. However, as discussed above, this amount cannot be reallocated to goodwill and trading stock.

Board of Taxation recommendations

The Board of Taxation issued a discussion paper in 2012 identifying anomalous outcomes that can occur when entities join a tax consolidated group following a roll-over.[24] Most of the issues identified are more prevalent where SME groups are restructured. The Board recommended a number of changes to address this anomaly and a possible solution for the tax cost setting issue that can arise due to the use of roll-overs:

> "7.41 When a rollover involves a restructure and the entity joins the tax consolidated group, the Board is of the view that there is little change with respect to the ultimate ownership of the assets of the joining entity.
>
> 7.42 Accordingly, the Board suggests that it would be appropriate to require entities that are rolled into a tax consolidated group to retain the existing tax costs, rather than require a resetting of amounts."

The discussion paper received numerous responses from stakeholders who generally agreed with the Board's identification and analysis of the issues and strongly supported the solutions suggested by the Board in this regard. However, to date, the roll-over provisions have not been amended to address this issue despite the support from the Board and stakeholders.

Key takeaways

It is evident from the above that tax advisers need to consider any adverse tax outcomes that may arise as a result of the tax cost setting process due to the use of roll-overs. Such considerations include the preparation of indicative ACA calculations to caution the use of a particular CGT roll-over. While such precautionary measures could be perceived by clients to be a costly exercise, the adverse tax outcomes that could arise without adequate planning are likely to outweigh such initial costs.

An alternative to using CGT roll-overs is utilising the concessions for the transfer of interests in entities. Unlike roll-overs, the concessions could provide a "step up" in the cost base of interests that would otherwise have a nominal cost base amount resulting in a greater step 1 amount. It is also critical to factor in the cost of obtaining market valuations for the use of roll-overs and the consolidation tax cost setting process. In many cases, the advice to clients could be to simply not restructure using roll-overs or to plan for tax consolidation in a future year with a better outcome.

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References

1 Advisers should consider the application of transfer and landholder duty in the relevant jurisdiction.

2 S 615-5(1)(b) ITAA97.

3 S 124-875(1) ITAA97.

4 S 124-780(2)(a)(i) ITAA97.

5 S 124-780(5)(a) ITAA97.

6 S 703-10(1) ITAA97.

7 S 615-5(1)(a) ITAA97.

8 S 152-10 ITAA97.

9 S 122-50(1) ITAA97.

10 S 124-785(2) ITAA97.

11 The market value substitution rule in s 122-20 ITAA97 will restate the value of such assets or interests where parties are not dealing with each other at arm's length.

12 S 122-20(3) ITAA97.

13 This requirement is specific to transactions where the original interest holders and acquiring entity are not dealing with each other at arm's length and have less than 300 members.

14 S 615-20(2) ITAA97.

15 S 701-1 ITAA97.

16 S 701-60 ITAA97.

17 S 701-25 ITAA97.

18 S 701-35 ITAA97.

19 S 104-510 ITAA97.

20 Internally generated.

21 Due to the assets being written down to nil using temporary full expensing.

22 Note that there is no step 3 amount as the retained profits did not accrue to the group before joining time.

23 A notional allocation to plant and equipment will be required which will reduce the balance of $100,000 allocated to goodwill and trading stock.

24 Board of Taxation, *Post-implementation review of certain aspects of the consolidation tax cost setting process*, discussion paper, September 2012. Available at https://taxboard.gov.au/consultation/post-implementation-review-of-certain-aspects-of-the-consolidation-tax-cost-setting-process.

Higher Education

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The dux of CommLaw2 in Study Period 3 2022 shares what he learnt from this elective in his Graduate Diploma and his plans for future study.

Chris Green
Divisional Director, Corporate Services and Assurance
PKF Gold Coast

Could you give us a brief background of your tax career?

My career has spanned over 13 years, 10 of which have been spent in public practice (mainly audit) and approximately two and a half years as a financial controller in an ASX-listed software company. My commercial role requires in-depth knowledge of international tax (transfer pricing, controlled foreign companies etc) and my audit role requires an understanding of the tax law as it applies to corporations in Australia and internationally.

Why did you take CommLaw2?

I chose CommLaw2 as an elective in my Graduate Diploma of Applied Tax Law. It's an interest area of mine and is a particularly relevant area for external auditors, who require a sound knowledge of company law. I chose to study at The Tax Institute as it's a fantastic, reputable organisation and is recognised as the number one provider of tax education in Australia.

What have you gained by completing CommLaw2?

I have gained increased knowledge in all aspects of company law, including bankruptcy law, employment law, the role of ASIC and APRA in the regulation of superannuation entities and corporations, and a host of other useful areas. Having this detailed knowledge allows me to gain a more in-depth understanding of our clients' regulatory regimes and risks around employment law and other critical areas.

Any tips for managing study and work and performing so well?

I generally try to study before work as this is when I'm most fresh, and on weekends. It's always difficult and there are times where you may fall behind due to work commitments, but you just have to go with the flow and fit the study in when you can.

What advice do you have for other tax professionals considering studying?

I'm technically not a tax professional. However, anyone in practice would absolutely benefit from having a sound knowledge of tax and The Tax Institute's study materials are a fantastic way to gain this knowledge.

Where to next when it comes to continuing your tax education?

Next, I'll take the CTA3 Advisory subject to become a Chartered Tax Adviser.

SMSFs and death benefit payments

by Shirley Schaefer, Superannuation Partner, BDO

This article discusses the practical considerations of what to do with superannuation on the death of a member. The death of a loved one can be a stressful time and can also lead to family arguments over the most trivial of matters. Dealing with a deceased family member's superannuation requires careful consideration and management. This article starts with some common misconceptions and dispels a number of pre-conceived ideas. It is important that certain administrative tasks are undertaken prior to any payments of benefits; this not only ensures that any following transactions are valid, but also reduces or eliminates the ability for those transactions to be overturned or challenged. The article then goes through the practical steps that must be taken or at least considered to ensure that the process is as stress-free and easy as possible.

Common misconceptions

While many people do not want to plan for death, there are a few misconceptions around death benefits and superannuation that should be dismissed.

"Superannuation is dealt with in my will"

Superannuation is not an estate asset and is not automatically included in an individual's estate or will. This is confirmed in *Stock v NM Superannuation Pty Ltd*.[1] In this case, the trustee of a large Australian Prudential Regulation Authority (APRA) regulated superannuation fund paid a member's death benefit to their three adult children in equal shares. The decision was appealed to the Superannuation Complaints Tribunal on the basis that there was documentation that indicated that some of the beneficiaries should not benefit from the deceased's estate.

The Superannuation Complaints Tribunal upheld the APRA superannuation fund decision on the basis that trustees generally should only pay benefits to the member's legal personal representative (LPR) if there are no superannuation dependants or there is a valid and effective binding nomination in place directing the payment of the superannuation benefits to the deceased's estate. The Federal Court upheld the decision of the Superannuation Complaints Authority.

It is possible to direct superannuation benefits to be paid to an individual's estate, but this has to be a conscious decision by the SMSF member if they want to ensure that they can then dispose of their superannuation benefits in accordance with their will. This is usually done by a binding death benefit nomination (BDBN), but it can be achieved in other ways.

Once superannuation moneys are in an individual's estate, the instructions in the will must be followed.

"My executor will take care of the fund"

An individual's executor is not automatically appointed to take care of the SMSF. The executor can be appointed, but the trustee appointment instructions, found within the trust deed, must be followed.

The practical considerations around SMSF fund structure and the requirements if the deceased's LPR is to be appointed as a trustee or director of the corporate trustee of an SMSF are discussed below under the heading "Fund structure".

"My family won't argue about my superannuation"

In a large proportion of cases, families may not argue about death benefits or superannuation benefits, but if the SMSF member does not want to leave this up to chance, they should take steps to "lock down" their instructions.

"We have to wait for probate"

As superannuation is not an estate asset, there is no requirement to wait for probate to be granted on the deceased's estate. The SMSF trustees can take whatever decisions are required to deal with the deceased's superannuation balances before probate is finalised.

"I'm too young to worry about death"

While most of us would like to think we are too young to consider our own death, an SMSF member is never too young to put in place plans for their superannuation benefits.

It is not expected that these plans will remain unchanged. As SMSF members get older, their family circumstances may change and estate plans (including superannuation estate plans) should be reviewed on a regular basis.

Fund structure

Following the death of a member, the structure of the SMSF may need to be reviewed or updated.

On the death of a member, the SMSF may fail the definition of an SMSF outlined in s 17A of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA). Section 17A allows that, if an SMSF fails the trustee and membership rules outlined in that section due to the death of a member, the fund can continue to meet the requirements of the section for a period of six months.[2]

The definition of an SMSF also allows an SMSF to meet the definition if an LPR has been appointed to act in their capacity of LPR of the deceased member. However, it should be noted that the LPR's appointment will automatically cease when death benefits commence to be paid.[3] At this time, the structure of the SMSF may need to be reconsidered.

Where an LPR is appointed to act for the deceased member as a trustee of the SMSF, their appointment will need to comply with the requirements of the fund's trust deed and the superannuation legislation. Specifically, the LPR will need to:

- consent to be a trustee of the SMSF;
- be appointed in accordance with the fund's trust deed (via deed of appointment or minutes as outlined in the trust deed); and
- sign the ATO's trustee declaration within 21 days of being appointed.

It should be noted that the individual who is the deceased member's LPR may be appointed in their personal capacity, simply as a second or an individual trustee. If they are appointed in a personal capacity, rather than that of LPR, they will also need to be a member of the fund, unless the fund is continuing with only one member.[4]

Before making decisions regarding the appointment of any additional or replacement trustees, the remaining trustee(s) should carefully read the SMSF's trust deed to ensure that there are no specific provisions for the appointment of a trustee in the event of death. This could be written into the SMSF's trust deed or could be in the form of an appointment deed that is not effective until the death of the member.

Where the SMSF has a corporate trustee, the remaining trustee(s) will need to consider not only the SMSF's trust deed and the superannuation legislation, but also the constitution of the corporate trustee. Depending on the age of the company's constitution, there may be specific provisions that need to be considered. For example, the constitution may provide that decisions of the company can only be made with two directors and not with a single director.

It should also be noted that, if the deceased member held shares in the corporate trustee, those shares are not part of the SMSF but in fact form part of the deceased's estate and will be disposed of in accordance with their testamentary instructions. The power of appointment of directors of a company usually rests with the shareholders and therefore the individuals who inherit the shares in the corporate trustee have the power to appoint directors of the corporate trustee.

Where the SMSF has a corporate trustee, it may be that no new director(s) are required to be appointed if the remaining SMSF members continue to act as directors of the corporate trustee and no new members are to be included in the SMSF.

In any event, where a new trustee or director is appointed to act (even in the capacity of LPR), their appointment will need to be in accordance with the SMSF's trust deed and the superannuation legislation. If the new trustee or director is to become a member of the fund, appropriate membership application documentation must be completed. The ATO must also be notified of any changes in the trustees or directors of the corporate trustee.

Who can get benefits?

On the death of the member, benefits can only be paid out in accordance with the SMSF's trust deed, any death benefit nominations, and the superannuation legislation. The remaining trustees of the SMSF will usually have the sole discretion regarding the payment of death benefits. Under the SISA, death benefits can only be paid to dependants as defined by the SISA (see Table 1).[5]

Before making payment of death benefits, the remaining trustees will need to establish whether there are any prescriptions in the SMSF trust deed which limit to whom death benefits can be paid. Alternatively, whether there are any instructions or death benefit nominations that need to be considered. Specifically, whether there are BDBNs that need to be considered.

Table 1. Definition of "superannuation dependant" (SISA)

Dependant	Definition (SISA)
Spouse	Includes: • another person (whether of the same sex or a different sex) with whom the person is in a relationship that is registered under a law of a state or territory; and • another person who, although not legally married to the person, lives with the person on a genuine domestic basis in a relationship as a couple.
Child	Includes: • a natural child of a person; • an adopted child, a stepchild or an ex-nuptial child of the person; • a child of the person's spouse; and • someone who is a child of the person within the meaning of the *Family Law Act 1975* (Cth).
Legal personal representative	Includes a person appointed as the member's LPR (usually the executor of the deceased member's estate).
Interdependency relationship	An interdependency relationship considers the following factors: • they have a close personal relationship; • they live together; • one or each of them provides the other with financial support; and • one or each of them provides the other with domestic support and personal care. Further considerations as per reg 1.04AAAA of the *Superannuation Industry (Supervision) Regulations 1994* (Cth) (SISR).

If allowed by the SMSF trust deed, members can complete a death benefit nomination. If the nomination is non-binding, it is only an indication of the member's wishes but is not binding on the remaining trustees. If the death benefit nomination is a binding nomination, benefits must be paid in accordance with the nomination. In accordance with the superannuation legislation, a death benefit nomination will only be binding if:[6]

- it nominates a valid SISA dependant (per above);
- it is less than three years since it was signed;
- it was witnessed by two people over 18 years of age (who are not the listed dependants); and
- it contains a declaration that the document was signed in the presence of the witnesses (and is dated).

There has been significant case law over a number of years regarding the payment of death benefits in SMSFs. Of note are the following cases:

1. *Katz v Grossman*;[7]
2. *Donovan v Donovan*;[8]
3. *Ioppolo & Hesford v Conti*;[9]
4. *Wooster v Morris*;[10]
5. *Munro v Munro*;[11] and
6. *McIntosh v McIntosh*.[12]

"An SMSF member is never too young to put in place plans for their superannuation death benefits."

The first five cases cover the situations where funds had valid BDBNs or did not have valid or effective BDBNs. The judgments consider: the requirements to appoint additional or replacement trustees; what constitutes a binding nomination; whether an SMSF can have a non-lapsing BDBN (providing the trust deed allows for this); and when trustees have sole discretion in relation to the payment of death benefits.

The final case, *McIntosh v McIntosh*, involves a member of a large APRA regulated fund who died intestate. The judgment considers the obligations of a beneficiary and the potential conflicts of interest arising where they are also the administrator of the estate.

It may be possible for the SMSF trust deed to be drafted so that BDBNs are "non-lapsing", that is, they do not expire after three years. Regulation 6.17A SISR does not apply to SMSFs and therefore a BDBN that purports to be non-lapsing is not constrained by the requirements of the SISA and the SISR. This means that all non-lapsing BDBNs do not expire after three years.

The issue of whether an SMSF could have a non-lapsing BDBN was recently contested in *Hill v Zuda Pty Ltd*,[13] where the plaintiff challenged the validity of a BDBN that had been made more than three years prior to the death of the member. The Western Australian Supreme Court determined that an SMSF could make a non-lapsing BDBN. The plaintiff then appealed the decision to the High Court of Australia. The High Court recently handed down its decision confirming that BDBNs in SMSFs can be non-lapsing.[14] This decision is a timely reminder for trustees to review existing BDBNs and the SMSF's deeds to ensure that they provide for non-lapsing BDBNs, as well as to ensure that they are valid and reflect the member's wishes and circumstances

How can benefits be paid?

Death benefits must be paid out as soon as is practicable after the death of the member.[15] The ATO generally interprets this as within:

- six months of the date of death;
- three months of the grant of probate for the deceased's estate; or
- some other reasonable time frame.

However, the time frame is not prescribed and will depend on the circumstances of the SMSF, the members and the SMSF assets. Where the SMSF trustees take a longer period of time to pay death benefits to beneficiaries, it will be important for SMSF trustees to be able to document or justify why a delay was encountered. This could include:

- the assets taking longer to realise to pay benefits;
- disputes with beneficiaries or in identifying appropriate beneficiaries; and
- the personal circumstances of the trustees and/or beneficiaries.

Death benefits can be paid as lump sums or as pensions. Where death benefits are paid as lump sums, they can be paid as either a single final lump sum, or as an interim benefit and a final benefit.

If death benefits are paid as pensions, they can either be the continuation of a reversionary pension (established during the member's lifetime) or a death benefit pension.

With the introduction of the transfer balance cap regime in 2017, additional considerations may need to be taken into account in relation to reversionary pensions or the commencement of a death benefit pension if the recipient is already in receipt of their own retirement phase income stream.

Death benefits as income streams can only be paid to superannuation death benefits dependants. This will generally be:

- a spouse;
- a child under the age of 18 years;
- a child under the age of 25 years who is financially dependent on the member; or

- a child with a disability (as defined by s 8(1) of the *Disability Services Act 1986* (Cth)).

The minimum pension that is payable in the year of death will depend on whether the original pension is reversionary or non-reversionary. Where a pension is reversionary and the deceased dies during the year, the minimum pension obligations are required to be met for the year of death (as the pension continues to be paid for the whole year). The minimum pension amount will have been determined based on the aged of the deceased at the beginning of the financial year. In subsequent years, the minimum pension obligation will be dependent on the age of the reversionary beneficiary at the beginning of the financial year.

Where the pension of the deceased member is non-reversionary, there is no obligation to make the minimum pension payment in the year of death. Where a death benefit pension is commenced for a tax dependant, the minimum pension obligation will be determined based on the age of the death benefit pension recipient at the commencement of the pension and then subsequently at 1 July each financial year.

It should be noted that, once a benefit is a death benefit, it is always a death benefit. This will mean that, where a death benefit (or a reversionary death benefit) income stream is commuted, it must be paid out as lump sum death benefit to the beneficiary. Commuted death benefit pensions cannot remain in the superannuation fund. This is important where a child is in receipt of a pension. The pension will need to be commuted at age 18, or at age 25 if the child was financially dependent on the member, and paid to the child as a lump sum benefit. The same commutation rules do not apply for children in receipt of pensions where they have been paid due to the child having a disability.

How are death benefits taxed?

How death benefits are taxed in the hands of the recipients depends on whether the benefits are paid to a superannuation death benefits dependant as defined by the *Income Tax Assessment Act 1997* (Cth) (ITAA97).[16] Table 2 sets out how the ITAA97 defines a superannuation death benefits dependant.

The taxation of death benefits paid are outlined in the ITAA97 and are summarised below and in Table 3 and Table 4.[17]

An untaxed element will typically only arise where the death benefit includes proceeds from a life insurance policy held by the fund, or where the death benefit is being paid from an untaxed superannuation fund, for example, certain government sector superannuation funds.

Income tax withholding obligations

Where death benefits are paid to non-tax dependants, it is the obligation of the SMSF trustee(s) to withhold the appropriate amount of income tax and remit this to the ATO.

Where death benefits are paid to the deceased's estate (paid to the LPR), the lump sum benefits are not taxed in the superannuation fund but may be required to have tax withheld by the LPR prior to payment, depending on whether they are paid to a non-tax dependant. Superannuation moneys that are a part of a deceased's estate must be separately identified so that they can be taxed appropriately. However, it is not the obligation of the superannuation fund to withhold income tax on any lump sum benefits.

Where death benefit pensions are subject to income tax, when both the deceased and the death benefits recipient are below the age of 60 years, the SMSF trustee(s) are required to withhold the appropriate amount of income tax and remit this to the ATO.

Table 2. Definition of "superannuation dependant" (ITAA)

Dependant	Definition (ITAA97)
Spouse or former spouse	Includes: • another person (whether of the same sex or a different sex) with whom the person is in a relationship that is registered under a law of a state or territory; and • another person who, although not legally married to the person, lives with the person on a genuine domestic basis in a relationship as a couple.
Child aged less than 18 years of age	Includes: • a natural child of a person; • an adopted child, a stepchild or an ex-nuptial child of the person; • a child of the person's spouse; and • someone who is a child of the person within the meaning of the *Family Law Act 1975*.
Interdependency relationship	An interdependency relationship considers the following factors: • they have a close personal relationship; • they live together; • one or each of them provides the other with financial support; and • one or each of them provides the other with domestic support and personal care. Further considerations as per reg 1.04AAAA SISR.

Table 3. Taxation of lump sum benefits (tax rates)

	Tax-free component	Taxable component	Untaxed element
Paid to a tax dependant	0%	0%	0%
Paid to a non-tax dependant	0%	15% plus levies	30% plus levies
Paid to LPR (deceased's estate)	0%	0%	0%

Table 4. Taxation of pension benefits (tax rates)

	Tax-free component	Taxable component	Untaxed element
Paid to a tax dependant: • where either the beneficiary or the deceased are over 60 years of age; and • where paid to a child who is less than 25 years of age or to a child with a disability.	0%	0%	Personal marginal tax rates (with a 10% tax offset)
Paid to a tax dependant where both the beneficiary and the deceased are less than 60 years of age.	0%	Personal marginal tax rates (with a 15% tax rebate)	Personal marginal tax rates (no tax offset)

Conclusion

Superannuation rules can be complex and are constantly subject to change. While the payment of death benefits have not changed for some time, there are a number of elements that need to be considered by SMSF trustees before paying out those benefits. The information in this article is general in nature and trustees should always seek specialised SMSF advice in these circumstances. Every situation will be different, and it will depend on the wishes of the deceased and the other estate matters.

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This article is an edited and updated version of "Practical steps of death benefits – what's next?" presented at The Tax Institute's Superannuation Intensive held on 30 to 31 March 2023.

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3 S 17A(3) SISA.
4 S 17A(2) SISA.
5 For the definitions of "spouse", "child" and "legal personal representative", see s 10(1) SISA; for the definition of "a person in an interdependency relationship with the deceased", see s 10A SISA.
6 Reg 6.17A SISR.
7 [2005] NSWSC 934.
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Testamentary discretionary trusts: practical implications

by Mark Streeter, Principal, Streeterlaw

Family discretionary trusts are commonly used in private family wealth management. Family discretionary trusts are an example of an inter vivos trust, that is, a trust made during the lifetime of the person. There has been an increasing appreciation of the value and utility of the benefits of incorporating discretionary trusts within the succession an estate plan of an individual. A trust created in a will or on the death of a willmaker is a *testamentary* trust. This article describes some of the benefits and the practical realities of implementing a testamentary discretionary trust, that is, a trust created in a will. A testamentary discretionary trust has many similarities to family discretionary trusts commonly used in private wealth management.

Introduction

Australians love discretionary trusts. In 2020–21, the ATO recorded that there were 947,264 trusts in operation across Australia.[1]

This zeal for establishing trust instruments is increasingly being applied in the context of estate planning; there are many ways in which trusts may be utilised in the estate plan.

Due to the prolific use of trusts, a substantial percentage of an individual's wealth may not be held in their own name but held beneficially for them in a trust. If the asset is not held legally or directly by the individual, it will not form part of their estate on their death to be devised in their will.

Benefits of a testamentary discretionary trust

Trusts are an effective and secure way of passing on your estate to your nominated beneficiaries and may provide a useful vehicle or mechanisms to be utilised in the following contexts:

- asset protection;
- wealth management;
- estate succession and planning;
- flexible taxation;
- family law disputes; and
- fix clear priorities.

There are also a multitude of distinct types of trust which can provide flexibility and customisation for the circumstances of a particular individual or family.

Administration of a will

Probate of a will

Traditionally, the core functions of the executor with regard to a deceased's estate are:[2]

1. to reduce the estate of the deceased into possession;
2. to pay the debts of the deceased; and
3. to distribute the residue of the estate after payment of debts and expenses of administration to those beneficially entitled under the will or intestacy rules.

Reducing the estate into possession is the process by which an executor identifies the assets and then transmits them so that the executor becomes the "legal" owner of the estate and gain control over the assets. This process involves identification of the property of the deceased and an application to the Supreme Court for an order of "probate". This court order confirms the executor's legal authority and power to deal with the property and to give effect to the wishes of the deceased as set out in their will.

The payment of liabilities and debts of the deceased may involve the challenges of verification and quantification of these exposures.

Distribution of the property of the estate on an interim or final basis will provide the capital for a trust created in the will.

Each jurisdiction will have specific processes and procedures for the administration of the estate of deceased estates. While this article mainly discusses New South Wales, the principles identified are broadly applicable across each state and territory in Australia.[3]

How does a trust obtain its "corpus"?

Once the executor of the will has a grant of probate that empowers them to legally administer the estate, they can begin to make interim distributions to the beneficiaries or to a trust established in the will for a nominated beneficiary.

"Executor" and "trustee"

It is a widespread practice for will drafters to use the words "executor" and "trustee" interchangeably. The two words are "terms of art" and have particular and specific legal meanings. However, there is the potential for substantial overlap in their functions. The role of the executor is described above in the fundamental trilogy of functions of the executor. In reducing the "estate into their possession", the executor is also acting (properly construed) as a trustee of the estate. That is, they have legal ownership of the property but are not entitled to the beneficial ownership of the property. The specific obligations that are particular to the role of executor will be imputed on the office holder and apply certain requirements as to the nature and function of their duties while also acting as trustee.

A trust established in a will

Development of trusts at law

The *Succession Act 2006* (NSW) commenced on 1 March 2008, and s 44 specifically provides for the power of a willmaker to establish a trust in their will:

> "A power or a trust to dispose of property, created by will, is not void on the ground that it is a delegation of the testator's power to make a will, if the same power or trust would be valid if made by the testator by instrument during his or her lifetime."

Prior to the commencement of the *Succession Act 2006*, the ability in NSW of a willmaker to gift their property to a trust created by the will was appreciably more constrained. This is because this was considered to be a delegation of the willmaker's personal role to nominate the beneficiaries of their estate. The law gave a willmaker the specific right to dispose of their property in their estate in favour of ascertained or ascertainable persons – a vaguely defined class of beneficiaries was therefore considered to be an unlawful delegation.[4]

This restriction on the delegation of the power to select beneficiaries was only applicable for testamentary trusts and did not apply to charitable trusts.[5]

Reasons for including a testamentary discretionary trust in a will

A testamentary discretionary trust is a trust established in a will for the primary benefit of a nominated individual.

The main benefits of a testamentary discretionary trust are that:

- it quarantines the fund in a separate legal vehicle that may provide asset protection from the creditors of a beneficiary;
- it may provide for professional management and provision of accommodation and income for spendthrift or vulnerable beneficiaries;
- it may ensure that the assets in the trust are not considered property of the relationship of a beneficiary within the definition of the *Family Law Act 1975* (Cth); and
- it allows the beneficiary to "split" the income of the trust and distribute income to minors at adult tax rates.

That is, the testamentary discretionary trust seeks to provide all of the advantages of the bequest to the nominated individual but without the disadvantages of receiving the gift directly in their own name.

Limits on a BDBN being a "will" for superannuation

A payment from a superannuation fund on the death of a member is referred to as a "death benefit". The purpose of a superannuation death benefit is to provide for those dependants of a superannuation fund member who would have continued to rely on the member for financial support, if for the member's premature death.

A common misconception is that the payment of a death benefit is controlled by the will of the deceased. The reality is that the governing rules of the fund and provisions in the *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA) and the *Superannuation Industry (Supervision) Regulations 1994* (Cth) (SISR) direct the superannuation trustee's payment of who may receive the death benefit of the deceased member.

A member of a superannuation fund can provide direction as to how the payment of their superannuation fund is directed by using a binding death benefit nomination (BDBN). One of the contexts in which BDBNs are crucial is that of self-managed superannuation funds. However, there are significant limits on both BDBNs and self-managed superannuation funds.

A BDBN is a written document that dictates how a superannuation fund is to be paid out. The restrictions on this are that a BDBN can only be directed to a certain class of persons, that is, dependants or a legal personal representative.

The SISA is responsible for prescribing how and to whom any death benefits are payable.

In s 10 SISA, "dependant" is defined as:

> "in relation to a person, includes the spouse of the person, any child of the person and any person with whom the person has an interdependency relationship."

Section 10A SISA contains the definition of an "interdependency relationship":

> "(1) Subject to subsection (3), for the purposes of this Act, 2 persons (whether or not related by family) have an ***interdependency relationship*** if:
>
> (a) they have a close personal relationship; and
>
> (b) they live together; and
>
> (c) one or each of them provides the other with financial support; and
>
> (d) one or each of them provides the other with domestic support and personal care."

The SISR operate together with the SISA.

Regulation 1.04AAAA SISR specifies that the following is to be taken into account when determining whether two persons had an interdependency relationship immediately before the death of one of the persons:

> "(a) all of the circumstances of the relationship between the persons, including (where relevant):
>
> (i) the duration of the relationship; and
>
> (ii) whether or not a sexual relationship exists; and
>
> (iii) the ownership, use and acquisition of property; and
>
> (iv) the degree of mutual commitment to a shared life; and

(v) the care and support of children; and

(vi) the reputation and public aspects of the relationship; and

(vii) the degree of emotional support; and

(viii) the extent to which the relationship is one of mere convenience; and

(ix) any evidence suggesting that the parties intend the relationship to be permanent."

In this way, BDBNs are limited in the class of persons that they can be directed to. However, in many cases, it is not desirable that the money be paid to individuals. For instance, in the case of a child, the money might be more appropriately held in a trust. This can be achieved by creating a BDBN that directs the funds to a legal personal representative (being the executor or administrator of the estate). In this case, the benefits will form part of the estate of the person and distributed in accordance with the will which includes a testamentary discretionary trust for the benefit of that child. This will fulfil the wishes of the willmaker in providing a structure of asset protection for the child.

There are several rules which apply to prescribe the class of beneficiaries who may be nominated in a BDBN as set out in the SISA and the SISR (which work in conjunction with each other). In particular, s 59(1A) SISA provides that:

> "(1A) Despite subsection (1), the governing rules of a superannuation entity may, subject to a trustee of the entity complying with any conditions contained in the regulations, permit a member of the entity, by notice given to a trustee of the entity in accordance with the regulations, to require a trustee of the entity to provide any benefits in respect of the member on or after the member's death to a person or persons mentioned in the notice, being the legal personal representative or a dependant or dependants of the member."

Regulation 6.17A SISR sets out the requirements that BDBNs must adhere to in the context of superannuation funds, including:

- the BDBN must include the class of persons (whether a dependant or the legal personal representative);
- the proportions of payment must be certain, must equal exactly 100%, or they will be invalid;
- the BDBN must be in writing, signed and dated in the presence of witnesses who are older than 18 and not beneficiaries; and
- the BDBN must include a declaration by the witnesses that the BDBN was signed in their presence.

Section 59(1A) SISA does not apply to BDBNs in the context of SMSFs. Accordingly, it was held by the High Court in *Hill v Zuda Pty Ltd*[6] that reg 6.17A does not apply to BDBNs in the context of SMSFs.

Subject to the terms of the trust deed, the absence of a BDBN in an SMSF may grant substantial discretion on the part of the trustees, and any wishes of the deceased will be directives that are not binding. This is what occurred in the case of *Katz v Grossman*.[7]

Katz v Grossman

Katz v Grossman[7] illustrates the risk of not having a BDBN in an SMSF. In this case, Ervin and Evelin Katz desired for their estate to be split evenly between their two children, Daniel Katz and Linda Grossman. Evelin Katz died on 28 July 1998, and probate of her will was granted to Ervin Katz. On 18 May 1999, Ervin appointed his daughter Linda by deed as the additional trustee of the fund. After Ervin's death on 19 September 2003, Linda appointed her husband Peter as the additional trustee on 5 December 2003. Linda and Peter did not follow the wishes of Linda's parents in dividing the fund evenly, and as such, Daniel Katz challenged the appointments of Linda and Peter as trustees of the fund.

Ervin had a non-binding nomination as to the proceeds of his death benefits, which served only as a directive for the trustees, and Linda and Peter, as trustees of the SMSF, chose to exercise their discretion contrary to the non-binding nomination.

Reasons to not place assets in a testamentary trust

While testamentary trusts are a valuable tool in estate planning, there are situations in which the use of a testamentary trust might not be appropriate. These include:

- where there is a desire to hold a particular property for the benefit of children. The transfer of real property from an individual into a testamentary trust may create a liability for transfer duty under the *Duties Act 1997* (NSW) and the relevant duties Acts in other states and territories. Furthermore, it may then introduce a land tax liability on an ongoing basis; and
- under s 104JA(1) of the *Duties Act 1997* (NSW), a foreign person will be deemed to be included as a foreign trustee unless they are specifically excluded by the terms of the trust. This can result in additional surcharge taxes, including stamp duty and land tax, when the foreign person acquires real property in NSW.

Reason not to incorporate a testamentary discretionary trust in a will

The size of the estate might not be large enough to justify the ongoing costs of maintaining the structure of and the tax return for (at the very least) the testamentary discretionary trust each year when weighed against the advantages.

Commencement of the trust

Elements of a testamentary discretionary trust

A trust is said to exist when:[8]

> "... the holder of a legal or equitable interest in certain property is bound by an obligation cognisable and enforceable in equity, to hold that interest not for his

[or her] own exclusive benefit but for the benefit, as to the whole or part of such interest, of another person or persons, or of himself and such other person or persons, or for some object or purpose permitted by law."

It follows that the essence of a trust is the holding of property by its legal owner (the "trustee") for the benefit of others (the "beneficiaries").[9]

From this, it can be inferred that there are three elements that are common to all trusts:[9]

1. there must be a trustee who holds the legal title to the trust property;
2. the property must be held by the trustee for the benefit of a beneficiary or for a "charitable purpose" recognised by law; and
3. the trust property must vest in the trustee.

Commencement of a testamentary discretionary trust

The date for commencement of a testamentary discretionary trust "may be different" depending on whether it is in the context of trust law, accounting or taxation.[10] The ATO has a clear position; the trust commences once assets or income is transferred/devised into it.[11]

Definitionally, no trust can exist until property has been transferred into the trust.[11] This is the principle in *Livingston*, that a testamentary trust commences on the transfer of property from the estate into the trust.[12] However, this case also recognises the fact that a trust can exist at law if "it is possessed of a chose in action".[10]

One of the challenges of will drafting that has been identified is that defects can arise if the trust is not created until funds or income are moved into it. This can result in depriving the primary beneficiary of the testamentary discretionary trust of the right to hold the executor/administrator accountable for the manner in which they are exercising the administration of the estate.

If a trust is held only to exist when the executor transfers assets or income into the trust, this will mean that the right to complete administration of the estate will not exist until that point. The danger here is that the executor will not complete the administration, and so the trust is held to exist at law at the time of death of the willmaker, which gives the beneficiary the right to sue to enforce administration of the estate.

If the will is drafted so that the trust only comes into existence when capital or income is transferred into it, the beneficiary may be vulnerable to maladministration of the estate as they will not have the legal basis (as a named beneficiary) to compel the due administration of the estate in their capacity as a beneficiary of a trust named in the will.

Why is the commencement date important?

The commencement date of a trust will be relevant for different purposes. From a compliance and financial hygiene perspective, it is important to document the source and date of the transfers of the funds from the estate into the trust. The cost base and assets being sourced from the estate are critical for consideration (discussed below).

Minors

Definition of "property" in the ITAA36

The *Income Tax Assessment Act 1936* (Cth) (ITAA36) defines "property" under s 102AA(1) as "property whether real or personal, and includes money".

Additionally, s 102AA(4) provides that:

> "A reference in this Division to income that is derived from particular property shall be read as including a reference to income that is derived from property that, in the opinion of the Commissioner, represents that property."

Tax rates

To prevent adults from "splitting income" with their children, rules were established that introduced harsh penalty tax rates for minor beneficiaries who receive income from a trust. These rules are contained within Div 6AA ITAA36.

The tax rates for residents who are under 18 years of age as at 30 June 2023 can be found on the ATO website[13] and are set out in Table 1.

Excepted trust income

The *penalty* tax rates in Table 1 can be avoided in situations where the minor beneficiary is considered an "excepted person", or if they receive "excepted income".

Section 102AG(2)(a) ITAA36 provides that any income that is distributed from a testamentary discretionary trust to a minor beneficiary can be classified as "excepted trust income". It is therefore not subject to the tax rates in Table 1. The relevant subsection provides:

> "(2) Subject to this section, an amount included in the assessable income of a trust estate is excepted trust income in relation to a beneficiary of the trust estate to the extent to which the amount:
>
> (a) is assessable income, of a kind covered by subsection (2AA), of a trust estate that resulted from:
>
> (i) will, codicil or an order of a court that varied or modified the provisions of a will or codicil; or
>
> (ii) an intestacy or an order of a court that varied or modified the application, in relation to the estate of a deceased person, of the provisions of the law relating to the distribution of the estates of persons who die intestate."

Where a minor is treated as an "excepted person" or if they receive "excepted income", which is not limited to but includes "excepted trust income", the income is taxed at adult marginal rates.

Tax rates for residents for the year ending 30 June 2024 can be found on the ATO website[14] and are set out in Table 2.

Table 1. Rates for eligible income of a minor

Taxable income	Tax on this income* (2023–24 income year)
$0–$416	Nil
$417–$1,307	Nil + 66c for every $1 over $416
Over $1,308	45c for every $1 of entire amount

* Applies to minors who are Australian tax residents, are not excepted persons, and have no excepted income. No low income tax offset or low and middle income tax offset applies, as it only reduces tax payable on excepted net income. The above rates do not include the Medicare levy of 2%.

Reforms to the law

The *Treasury Laws Amendment (2019 Measures No. 3) Act 2020* was passed, after receiving royal assent on 22 June 2020. This amendment contained developments and reforms pertaining to the concessions accessible for minor beneficiaries. The result was the insertion of new subs (2AA) in s 102AG ITAA36, which provides:

> "(2AA) For the purposes of paragraph (2)(a), assessable income of a trust is of a kind covered by this subsection if:
>
> (a) the assessable income is derived by the trustee of the trust estate from property; and
>
> (b) the property satisfies any of the following requirements:
>
> (i) the property was transferred to the trustee of the trust estate to benefit the beneficiary from the estate of the deceased person concerned, as a result of the will, codicil, intestacy or order of a court mentioned in paragraph (2)(a);
>
> (ii) the property represents accumulations of income or capital from property that satisfies the requirement in subparagraph (i);
>
> (iii) the property represents accumulations of income or capital from property that satisfies the requirement in subparagraph (ii), or (because of a previous operation of this subparagraph) the requirement in this subparagraph)."

Income that is acquired from assets and accumulations that are held in a testamentary trust on or after 1 July 2019 are subject to the additional conditions that are imposed by the reforms contained in s 102AG(2AA). These conditions do not apply to any income that is acquired from assets and accumulations that existed before 1 July 2019.

Protective trusts

Beneficiaries who are unable to manage their affairs

Significant issues can arise for a willmaker who plans to leave part of their estate to a beneficiary who is vulnerable or has a physical or mental disability. If the beneficiary is not able to manage their own affair and receives their inheritance in a lump sum, there is the potential for exploitation. The creation of a protective trust may assist in ensuring that the inheritance that is left to the vulnerable beneficiary is administered for the benefit of the vulnerable beneficiary.

Protective trust

A protective trust is a type of trust that is established to protect a vulnerable beneficiary who is unable to manage their own affairs. The share of the estate that is granted to the beneficiary is held within the trust and is controlled by the trustee who is required to act in the best interests of the beneficiary.

The benefits of a protective trust include:

- a protective trust protects against the misuse or abuse of an estate/inheritance that would otherwise be received as a lump sum;
- the only purpose that the assets in the trust can be used for is for the benefit of the vulnerable beneficiary; and
- a vulnerable beneficiary will have the necessary funds to pay for personal, medical and education costs.

Beneficiaries with a substance addiction

In the case of a beneficiary who has a substance addiction or is otherwise vulnerable, a protective trust is an effective measure for protecting the inheritance. While special disability trusts have constraints on who can be a beneficiary and how the funds are granted, there are no such limitations on protective trusts. A protective trust can be set up with a trustee who can regulate income from the trust to the vulnerable beneficiary who has a substance addiction.

Table 2. Resident tax rates 2023–24

Taxable income	Rate	Tax on this income* (2023–24 income year)
$0–$18,200	0%	Nil
$18,201–$45,000	19%	19c for each $1 over $18,200
$45,001–$120,000	32.5%	$5,092 plus 32.5c for each $1 over $45,000
$120,001–$180,000	37%	$29,467 plus 37c for each $1 over $120,000
$180,001 and over	45%	$51,667 plus 45c for each $1 over $180,000

* The above rates do not include the Medicare levy of 2%.

Minors

A protective trust can also be beneficial for minors because it allows the trust to be controlled by family members or another trustee who continue to ensure that the trust benefits the child. This means that a trusted family member or other trustee will have discretion to determine how the funds in the trust can be used for the benefit of the minor.

Children with a disability

A protective trust allows for a flexible approach to providing for children with a disability. It is not limited to the specific constraints and requirements under a special disability trust and allows for the trustee to have complete discretion as to how the funds can be best used to advantage the beneficiary.

Special disability trusts

Special disability trusts are a type of protective trust. However, they have specific requirements as to who can be a beneficiary and how the funds are administered.

The requirements for a special disability trust are numerous and can be found under the *Social Security Act 1991* (Cth).[15] Whether these requirements are met is determined by Centrelink.

The limitations of a special disability trust include:

- there can only be one beneficiary and Centrelink requires the beneficiary to fit under the definition of "severely disabled". Such limitations do not exist with an "all needs" protective trust;
- the funds in a special disability trust can only be used for the specific purposes of care and accommodation for the beneficiary, unlike a protective trust where the trustee has full discretion; and
- there is a limit on how much can be in the trust before it impacts a disability pension.

Disability pension

In the case of a vulnerable beneficiary who receives a disability pension, a special disability trust is more effective than a protective trust in preserving the pension. As at 1 July 2023, special disability trusts have an asset limit of $781,250; once this limit is reached, the beneficiary will begin to lose part of their disability pension.[16]

For a protective trust, there is no such concessional limit; the trust funds will be attributed solely to the beneficiary for whose benefit they are used. This means that protective trusts should not be used where it is a requirement to protect some form of pension or social security benefit that the beneficiary otherwise receives.

Insolvency

Beneficiaries who are at risk of insolvency

There are a legion of causes that can lead to personal insolvency, that is, it is not merely risky or spendthrift behaviour that can result in personal insolvency. Willmakers may seek to provide their legacy in a structure that will permit the beneficiary to engage in entrepreneurial risk-taking while quarantining the inheritance from a failure which may result in personal bankruptcy. An asset protection structure may also protect beneficiaries against unknown "black swan" events that could result in insolvency or otherwise result in the loss of the legacy if the inheritance was given directly to the beneficiary.

In recent memory, the failure of HIH Insurance, which had 35% of the market for professional indemnity in the financial year 30 June 2000, left many professionals without (or without complete) professional indemnity insurance.[17] This event is a reminder that a layered asset protection strategy may ease unnecessary anxiety.

It is not just particularly high-risk professionals who could be subject to an unanticipated liability. In this modern age, many travel to foreign countries, which increases the risk of exposure to substantial unfunded damages claims. This risk can come in the form of a negligent driving suit or the risk of an uninsured and underinsured exposure because of the "inadvertence" of a beneficiary. Quarantining the inheritance within a testamentary discretionary trust can provide additional comfort against any prospective personal exposure. To understand the nature of the risks, it is helpful to appreciate the nature and power of the personal insolvency regime in Australia and what assets would be exposed under this regime.

Definition of "property" of the bankrupt

Section 5 of the *Bankruptcy Act 1966* (Cth) (Bankruptcy Act) defines "property" as:

> "... real or personal property of every description, whether situate in Australia or elsewhere, and includes any estate, interest or profit, whether present or future, vested or contingent, arising out of or incident to any such real of personal property."

Section 58 of the Bankruptcy Act provides that, on bankruptcy, the property of the bankrupt, not being after-acquired property, vests forthwith in the trustee.

Further, after-acquired property of the bankrupt vests, as soon as it is acquired by, or devolves on, the bankrupt on or after the date of bankruptcy, being property that is divisible among the creditors of the bankrupt.

Power of appointment

Section 116(2)(a) of the Bankruptcy Act provides that bankruptcy does not capture or vest in a bankruptcy trustee property that is held on trust. As such, any trust property that is held by a bankrupt executor or trustee is not divisible between the executor's creditors.

The role of appointor of a trust has been determined to be a "personal" appointment and, as such, is not property within s 116 of the Bankruptcy Act.[18] This power to appoint a new trustee has been held to be a fiduciary power, and if it is held by a bankrupt, it cannot be exercised by their trustee in bankruptcy.[19]

In *Re Burton; Wily v Burton*, it was submitted that the power of appointment would vest in Mr Burton's trustee in bankruptcy. Davies J determined that:[20]

> "... the power which Mr Burton holds as Appointor is not 'property' which vests in his trustee in bankruptcy nor a power 'as might have been exercised by the bankrupt for his own benefit'."

Family law

Family separation of child beneficiaries

One of the most unsettling possibilities for a willmaker is a future relationship breakdown of the child beneficiary. If there are already indications of this possibility, appropriate planning can be implemented that seeks to protect the estate of the deceased from being available to be divided as property of the relationship in a family law dispute.

According to the Australian Bureau of Statistics, the divorce rate was 2.2 divorces per 1,000 residents in 2021.[21] There were 56,244 divorces granted in Australia in that same year.[22] It is estimated that one in three marriages will end in divorce.[23] Relationship breakdown is a very real possibility and should be a consideration when engaging in the succession and estate planning process.

To understand how a trust could be used to shield the bounty from being "divided" in any subsequent property division, it is necessary to consider the nature of the powers under the *Family Law Act 1975* (Cth) (Family Law Act) to divide the property of the relationship or to categorise the nature of the property or asset as a financial resource.

Definition of "property" in family law

Section 4(1) of the Family Law Act broadly defines "property" in relation to the parties of a marriage or de facto relationship as "property to which those parties are, or that party is, as the case may be, entitled whether in possession or reversion". As such, "property" under this wide definition has been held to include a beneficiary's right to due consideration and due administration under a testamentary discretionary trust.

Nature of the trust – who has control?

The Federal Circuit and Family Court of Australia (the court) looks carefully at trusts, particularly testamentary discretionary trusts, when determining whether a spouse party's interest in such a trust should be included as property within the asset pool pursuant to s 79 of the Family Law Act or, failing that, as a potential financial resource of the spouse party to be taken into account with respect to their income and future needs pursuant to s 75(2) of the Family Law Act.

An important consideration for the court when determining the nature of the trust for family law purposes is who controls the trust. For instance, a spouse party's position as appointor of the trust and having the power to change the trustee of the family trust is a recognised feature of control. Being one of a number of trustees and not having the ability to direct distributions to be paid in a certain way has been found to be evidence of a lack of control.

Illustrative cases

In *Woodcock & Woodcock (No. 2)*,[24] the question before the court on an interlocutory basis was whether the husband's interest in four discretionary trusts were "property" pursuant to s 79 of the Family Law Act and therefore capable of valuation. Relying on the decision in *Harris & Dewell*,[25] counsel for the husband in that case argued that property of a trust can only be treated as property pursuant to s 79 of the Family Law Act where a person has complete or de facto control over the trust and can direct income or capital for their own benefit or the benefit of a spouse party. On the facts of *Woodcock v Woodcock (No. 2)*, it was determined that the husband held a "bundle of rights" and exercised "considerable influence", had received $15m in distributions, and had the power to block his distributions or decisions of the trustee. His interests under the trust were therefore deemed to be property for s 79 purposes and could be valued.

> "It is imperative to carefully consider whether a testamentary trust may be useful and to appreciate the protection and benefits that a testamentary discretionary trust may provide."

The Full Court in *Atkins & Hunt*[26] determined that "something more than mere control is required" to establish that a company is a "mere puppet" or "alter ego" of a spouse, such that the court can treat the spouse and the company as one and the same".

In *Ogden & Ogden*,[27] the court considered *Kennon v Spry*[28] when considering the nature of the wife's interest in a family trust established by the wife's mother from an inheritance from the wife's late grandmother. The court deemed the interest in the trust to be "property" rather than a financial resource, but found that neither the husband nor the wife made any contribution to the trust asset as it had never been treated as a matrimonial asset or a resource that they could access. So, while it was considered as property for s 79 purposes, it was placed into a separate pool of assets for determining the distribution between the parties.[29]

In *Harris & Harris*,[30] the Full Court held that the trial judges' finding that one party to the proceedings (who held no position in the trustee company) had indirect control over the trust assets, was an error and therefore the trust interest was not property for the purposes of s 79 of the Family Law Act.

In *Morton & Morton*,[31] the court found that the husband's interest in a discretionary trust (the husband was a co-director of the corporate trustee, along with his brother) was not directly under his control. Therefore, it was not property pursuant to s 79 of the Family Law Act but was deemed to be a financial resource of the husband.

Harris & Harris

Facts and procedural history

In *Harris & Harris*,[30] the Full Court delivered a judgment on 22 December 2011 that illustrates the treatment of discretionary trusts in family law.

The judgment that was being appealed was from a single judge who had assessed the net value of the parties' assets to be $4,269,180. This figure included the agreed amount of $1,500,000 that represented the net value of a discretionary trust known as the Harris Family Trust. The trial judge split the property 45:55 in favour of the wife.

The Harris Family Trust had been established by the father of the husband in 1978. The husband's father was the first appointor until his death on 21 August 1995. On his death, his widow (the husband's mother) became and continued to be the appointor.

The principal beneficiaries of the trust were the husband's parents, their children (the husband and his sister), and the "lineal issue" of the husband's father. The following persons were the directors and the shareholders in the trustee company: the husband's mother (two shares); the husband's son (A) from a previous marriage (one share); and a person known as MB, a longstanding friend of the husband (one share).

Issue on appeal

A significant issue that was considered by the trial judge was whether the Harris Family Trust was constituted as the "property" of the husband and whether it was therefore available for division by the Family Court. The husband appealed to the Full Court on the ground that he did not have control of the trust and as such it was not his property. The wife submitted the argument that the husband had indirect control over the trust through his mother who acted as a "puppet" for his interests. The wife received distributions from the trust during the marriage.

Held by Full Court

The Full Court considered the principle established in the High Court decision of *Kennon v Spry*,[28] in which the court held that, for the assets of a discretionary trust to be considered the property of a beneficiary for family law property settlement purposes, there must be "direct" or "indirect" control of the trust by that beneficiary.[32] In the first instance, the court held that the trust's assets should be treated as the husband's property because they were indirectly controlled by him. The assets of the trust were therefore held to form part of the pool available for division between the parties.

In *Harris & Harris*, the Full Court affirmed the principle of law that the beneficiary of a non-exhaustive discretionary trust who does not control the trustee directly or indirectly has a right to due consideration and to due administration of the trust, but it is difficult to value those rights when the beneficiary has no present entitlement and may never have any entitlement to any part of the income or capital of the trust.

The Full Court in *Harris & Harris* overturned the trial judge's ruling on the family trust and held:[33]

> "In the present case and on the basis of the material before us the husband appears to be no more than such a beneficiary of such a trust. He is not the appointor of the Trust nor does he hold any position in the current trustee company. On the assumption that by the use of the word 'directly', the Chief Justice was referring to the strict legal position, it therefore cannot be said that the husband 'directly' controls the current trustee. Nor could it be said that he 'directly' controlled the previous trustee."

Accordingly, the trust was not to be considered an asset of the husband and thus should not be included in the property pool available for division by the Family Court.

Conclusion

Testamentary discretionary trusts are an incredibly flexible and still underutilised resource for succession and estate planning. They allow for a structured transfer of assets and are a flexible tool for the successful implementation of a succession plan.

Close and accurate record-keeping will save many hours of angst, concern and potential costs.

Testamentary discretionary trusts can provide certainty and ensure that the estate will be effectively used to address a variety of needs, concerns and wants with regard to minors, family law issues, vulnerable beneficiaries and charities.

It is imperative to carefully consider whether a testamentary trust may be useful and to appreciate the protection and benefits that a testamentary discretionary trust may provide.

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This article is an edited and updated version of "Testamentary trusts — practical implications" presented at The Tax Institute's Trusts Intensive held on 1 to 2 June 2023.

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A Matter of Trusts

by Neil Brydges, CTA, Sladen Legal

Section 99B: is it safe to go back in the water?

Section 99B, the "sequel" to 2022's s 100A focus, may make taxpayers and advisers wish they had a bigger boat.

The sequel to *Jaws*[1] used the tagline "just when you thought it was safe to go back in the water …".

After the focus in 2022 on s 100A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36), taxpayers and their advisers may feel it is safe to go back in the water, but s 99B ITAA36 could change that.

Section 99B was introduced into the ITAA36 in the same Bill[2] as s 100A. You can see where we are going here …

Both sections are broadly drafted and there was little judicial or ATO guidance until 2022 (for s 100A).

Why was s 99B introduced?

Section 99B was introduced in response to *Union Fidelity Trustee Co of Australia Ltd v FCT*[3] which held that Div 6 ITAA36 did not capture foreign source income.

As the explanatory memorandum to the Bill[3] which introduced s 99B said, s 99B "will usually apply where accumulated foreign income of a non-resident trust estate is distributed to a resident beneficiary".

This leads to the main myth about s 99B, that is, it applies only to foreign trusts. Wrong, there is nothing in the words of s 99B to limit its operation to foreign trusts, as recognised in the consultation paper *Modernising the taxation of trust income – options for reform* in 2011:[4]

> "One of the most significant concerns is about the extent to which [s 99B] can apply to distributions from resident trusts."

What does s 99B catch?

In short, any amount, being property of a trust estate, that is paid to (or applied for the benefit of) an Australian resident beneficiary is included in assessable income pursuant to s 99B(1) unless that amount is reduced by one of the items in s 99B(2).

Section 99B will not apply where one of the following carve-outs under s 99B(2) applies:

- corpus of the trust estate, but not an amount that is attributable to income derived by the trust that would have been included in the assessable income of a resident taxpayer had it been derived by that taxpayer;
- an amount that would not have been included in the assessable income of a resident taxpayer had that taxpayer derived it;
- an amount included in the assessable income of the beneficiary under s 97 ITAA36;
- an amount assessed to the trustee of the trust or the trustee of another trust under s 98, 99 or 99A ITAA36; or
- an amount included in the assessable income of a taxpayer under s 102AAZD ITAA36.

The difficulty that this creates for taxpayers and their advisers is, once the elements of s 99B(1) are established, the taxpayer has the onus of establishing that one of the carve-outs in s 99B(2) applies in order to reduce (or eliminate) the amount included in assessable income under s 99B(1).[5]

A sting in the tail is that the Australian beneficiary may also be liable to pay an interest charge on the amount assessable under s 99B back to the time when the income representing the amount was derived by the trust.[6] That interest is unlikely to be deductible.

But wait … there's more

Section 99C ITAA36 expands the operation of s 99B by taking into account all benefits which have accrued to the beneficiary, whether or not the beneficiary had rights to those benefits, and irrespective of the nature or form of the benefits.

Section 99C(2) outlines the various non-exhaustive ways in which benefits might be provided to beneficiaries, including capitalisation of an amount, increases in the value of the beneficiary's property or rights, whether the beneficiary can, by exercising its power, obtain beneficial enjoyment, and with a beneficiary obtaining a benefit by assigning any interest it might have.

Section 99C(2)(c) provides that an amount is taken to have been applied for the benefit of the beneficiary if the beneficiary has received, or is entitled to receive, a benefit, including a loan or a repayment of a loan (for example, if the trust repays a loan of the beneficiary to a third party, or repays a loan made by the beneficiary to the trust) or any other payment of any kind which is provided directly or indirectly.[7]

In short, extremely broad, and yes, you read it correctly, a trust repaying a loan from a beneficiary is within the scope of s 99B (via s 99C). Broader than intended?

Hill J in *Re Traknew Holdings Pty Ltd v FCT*[8] said that s 99B (with s 99C) had "extreme width", and can only be understood in its historical context, but that it was not necessary at that time to decide whether it should be read down. Has the time for that decision arrived?

What about those carve-outs?

Probably the most common way in which to reduce any s 99B assessable amount is via the "corpus exclusion" in s 99B(2)(a).

"Corpus" is not defined. Whether an amount is corpus of the trust estate is a matter to be determined applying the applicable principles of trust law and the deed. Problems may emerge in establishing this, especially in a non-common law jurisdiction.

In many deeds, an amount of income which is accumulated in the trust can be "converted" to corpus. However, s 99B(2)(a) excludes such amounts from being treated as corpus as it provides:

> "… to the extent to which it is attributable to amounts derived by the trust estate that, if they had been derived by a taxpayer being a resident, would have been included in the assessable income of that taxpayer of a year of income …"

The "exclusion to the corpus exclusion", and the otherwise assessable carve-out, depend on a hypothetical resident taxpayer. *Howard v FCT*[9] suggests that the hypothetical taxpayer is neither the beneficiary nor the trustee, but a separate fictional entity. The ATO accepts this and says you cannot assume that this hypothetical taxpayer has other characteristics, for example, it is an entity eligible for the CGT discount.[10]

The ATO view means that a capital gain by a foreign trust from non-taxable Australian property distributed to an Australian beneficiary will not be eligible for the CGT discount (or reduction by capital losses).[9]

Howard also busted the myth that untaxed accumulated income of one trust can be settled as corpus of another trust and fall within the corpus exclusion.

What does s 99B mean?

Unless an amount paid or applied from a trust is included in assessable income, the practical difficulty in proving that s 99B does not apply is the need to trace amounts, representing corpus, to identify whether their origin relates to prior year income, the sum originally settled, or subsequent capital contributed.

When doing this, the decision in *Campbell and FCT*[11] is a reminder that establishing, on the balance of probabilities, that the corpus reduction in s 99B(2)(a) applies in favour of a taxpayer will usually require sufficient and probative evidence. Taxpayers should not underestimate this burden.

Section 99B is starting to appear in ATO compliance activity. The "Advice under development" section of the ATO website does not include s 99B, although the ATO may develop guidance material. Given the scope of s 99B, ATO guidance could be useful, or it could be a case of "be careful of what you wish for". That said, many would welcome clarity around how the ATO will apply compliance resources to Australian trusts, including redomiciled foreign trusts, on s 99B issues.

Other areas could include tax-preferred amounts and the interaction with CGT event E4.[12]

Section 99B, like s 100A, was drafted long ago to fix a problem. Unfortunately, in fixing the problem, parliament legislated a cure of "extreme width".[13]

Perhaps another quote from *Jaws* is a suitable way to finish … "the great fish moved silently through the night water".

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7 Note that the concept of a "payment" includes an indirect flow of money from the trust to the beneficiary. See *FCT v Rozman* [2010] FCA 324.

8 [1991] FCA 129.

9 [2012] FCAFC 149.

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11 [2019] AATA 2043.

12 The consultation paper in 2011 acknowledged that s 99B can apply to tax-preferred amounts.

13 See *Re Traknew Holdings Pty Ltd v FCT* [1991] FCA 129.

Superannuation

by Bryce Figot, CTA, and Daniel Butler, CTA, DBA Lawyers

How the NALI and the CGT provisions interact

In TD 2023/D1, the ATO essentially states that NALI is the lesser of the "non-arm's length capital gain" (no reduction for discount percentage, capital losses etc) and the net capital gain.

There has been uncertainty as to how the following provisions interact:

1. the non-arm's length income (NALI) provisions in s 295-550 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97); and
2. the CGT provisions in s 102-5 ITAA97.

The ATO has recently released TD 2023/D1 which provides greater clarity and a practical approach to the ATO's view on this important issue.

In this article, we summarise our interpretation of TD 2023/D1 and provide detailed calculations of how we understand the draft determination would apply in practice.

Background

At the risk of oversimplifying the NALI provisions, they can, at a very high level, be summarised as follows:

> An amount of ordinary income or statutory income is NALI if it is greater than what it would have been if parties had been dealing on an arm's length basis.

Although the above is an oversimplification, one part of it is actually verbatim from the legislation, namely, "[a]n amount of ordinary income or statutory income is [NALI] if …".

This is interesting when it comes to the CGT regime. Naturally, a "capital gain", by itself, is neither ordinary income nor statutory income. However, a "net capital gain" is statutory income pursuant to the method statement in ss 102-5(1) and 6-10 ITAA97.

Of course, under the method statement in s 102-5, "net capital gain" is broadly calculated by (again, at a very high level and in a simplified way):

- adding up all capital gains for that financial year; then
- subtracting capital losses (for the present year and then any prior year losses carried forward); then
- reducing by the discount percentage each amount of a discount capital gain remaining.

The remaining amount is then the net capital gain. Accordingly, consider the following simple example.

An SMSF has:

- a $1 capital gain due to dealings not conducted on an arm's length basis; and
- a $1m capital gain due to dealings conducted on an arm's length basis.

Assume, for simplicity, that there are no losses and neither of the gains are eligible for the discount percentage (eg the relevant acquisitions and disposals occurred within 12 months of each other). Accordingly, applying the method statement in s 102-5, the net capital gain would be $1,000,001 (ie $1 "non-arm's length capital gain" + $1m "arm's length capital gain").

On a very strict view, the amount of statutory income could be seen as being the entire net capital gain (ie $1,000,001). Thus, because of a $1 "non-arm's length capital gain", the other $1m constitutes NALI. Naturally, NALI less relevant deductions is broadly taxed at 45%. Assume that there are no relevant deductions. Therefore, the $1 "non-arm's length capital gain" could cause a CGT-related income tax liability of $450,000.45 (ie $1,000,001 x 45%). Again, though, this is on a very strict view.

This is not a practical, nor fair, outcome. To its credit, the ATO in TD 2023/D1 considers but ends up rejecting this strict view.[1]

The ATO's view

In TD 2023/D1, the ATO instead chooses the following more practical and sensible approach:[2]

> "The phrase 'an amount' can, as a matter of ordinary usage, apply to an amount which is part of a larger amount."

Accordingly, we understand that, in TD 2023/D1, the ATO essentially states that NALI is the lesser of:

- the "non-arm's length capital gain" (no reduction for discount percentage, capital losses etc); and
- the net capital gain.

Therefore, according to TD 2023/D1, in the above example, instead of a $450,000.45 CGT-related income tax liability, there would be a CGT-related income tax liability of $150,000.45 (ie $1 x 45% + $1m x 15%).

The ATO provides three examples in TD 2023/D1. We have adapted these three examples into the first three scenarios in Table 1. We have also added certain facts (that is, in example 1 in TD 2023/D1, the ATO states that there is a "$500,000 arm's length capital gain", but we have added that the capital proceeds were $800,000 and the cost base was $300,000.)

Table 1. TD 2023/D1: adapted examples

Scenario-specific assumptions	**Scenario 1** Adapted from example 1 in TD 2023/D1	**Scenario 2** Adapted from example 2 in TD 2023/D1	**Scenario 3** Adapted from example 3 in TD 2023/D1	**Scenario 4** Based on scenario 3 but without the arm's length capital gain
Non-arm's length capital gain (NAL CG)				
Actual amount received on sale	2,300,000.00	2,300,000.00	6,000,000.00	6,000,000.00
Market value on sale	2,300,000.00	2,300,000.00	1,500,000.00	1,500,000.00
Actual amount paid to acquire asset	300,000.00	300,000.00	1,000,000.00	1,000,000.00
Market value on acquisition	1,000,000.00	1,000,000.00	1,000,000.00	1,000,000.00
Capital gain	1,300,000.00	1,300,000.00	5,000,000.00	5,000,000.00
Arm's length capital gain (AL CG)				
Capital proceeds	800,000.00	800,000.00	1,900,000.00	–
Less cost base	300,000.00	300,000.00	900,000.00	–
Capital gain	500,000.00	500,000.00	1,000,000.00	–
Current year capital losses	200,000.00	6,000,000.00	100,000.00	100,000.00
Carried forward capital loss	–	4,200,000.00	–	–
Discount percentage relating to remaining NAL CG	366,666.67	–	1,633,333.33	1,633,333.33
Discount percentage relating to remaining AL CG	166,666.67	166,666.67	333,333.33	–
Net capital gain	1,066,666.67	–	3,933,333.33	3,266,666.67
Non-arm's length income	1,066,666.67	–	3,933,333.33	3,266,666.67
Other income	883,333.33	883,333.33		
Taxable income	1,950,000.00	883,333.33	3,933,333.33	3,266,666.67
Non-arm's length component	1,066,666.67	–	3,933,333.33	3,266,666.67
Low tax component	883,333.33	883,333.33	–	–
Income tax payable	612,500.00	132,500.00	1,770,000.00	1,470,000.00

We feel that tax practitioners who wish to gain a very strong understanding of the ATO's approach in TD 2023/D1 simply need to:

- remember our summary of TD 2023/D1 above; and
- work through the calculations in Table 1.

A word of warning

Even under TD 2023/D1, a "non-arm's length capital gain" can still taint an "arm's length capital gain"!

To illustrate this, we have added a scenario 4 in Table 1. Scenario 4 is based on scenario 3 but without the arm's length capital gain. That is, scenario 4 just has a "non-arm's length capital gain". As shown in Table 1, the resulting income tax liability is $1.47m.

The difference between scenario 4 and scenario 3 is simply that scenario 3 has an "arm's length capital gain" of $1m, which is a discount capital gain. Everyone knows that such a $1m discount capital gain in an SMSF should typically cause a tax liability of $100,000 (ie $1m x 15% x (2/3)).

However, applying our summary of TD 2023/D1, the difference between the income tax payable in scenario 4 ($1.47m) and in scenario 3 ($1.7m) is not $100,000. Rather, the difference is $300,000 (ie $1.77m – $1.47m). Accordingly, in a practical sense, because of the presence of a "non-arm's length capital gain", the "arm's length capital gain" is still tainted. It is just not *fully* tainted.

A final warning

We stress that the draft determination is just that: a draft! Accordingly, heed must be paid to the ATO's reminder at the start of TD 2023/D1:

> "This publication is a draft for public comment. It represents the Commissioner's preliminary view on how a relevant provision could apply.

> If this draft Determination applies to you and you rely on it reasonably and in good faith, you will not have to pay any interest or penalties in respect of the matters covered, if the draft Determination turns out to be incorrect and you underpay your tax as a result. However, you may still have to pay the correct amount of tax."

The Tax Institute has lodged a submission in relation to TD 2023/D1 and it is hoped that the draft is varied before being finalised. Indeed, The Tax Institute has recommended that the legislation be revised. Until this position is clarified, taxpayers who rely on TD 2023/D1 reasonably and in good faith should be protected from interest and penalties, but not on primary tax. Once the draft is finalised as a tax determination, it should become a public ruling that is binding on the Commissioner. Given the uncertainty surrounding this topic and the fact that draft NALI legislation relating to non-arm's length expenses is expected to issue soon, expert advice is recommended.

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References

1 Paras 57–60 of TD 2023/D1.

2 Para 6 of TD 2023/D1.

Events Calendar

Upcoming months

OCTOBER
11–12
Wed–Thu

QLD

Death & Taxes Conference

12 CPD hours

OCTOBER
18–19
Wed–Thu

NSW

National Transfer Pricing Conference

12 CPD hours

OCTOBER
19–20
Thu–Fri

TAS

Tasmanian Convention

12 CPD hours

OCTOBER
25–26
Wed–Thu

NSW

National GST Conference

13 CPD hours

NOVEMBER
1
Wed

Online

Property Intensive

8 CPD hours

NOVEMBER
1–2
Wed–Thu

VIC

National Superannuation Conference

12 CPD hours

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