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Taxation *in* Australia

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Mathew Brittingham, CTA

Maximising value from corporate structures
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Invitation to write

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Tax News – at a glance

by TaxCounsel Pty Ltd

April – what happened in tax?

The following points highlight important federal tax developments that occurred during April 2023. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 554 (at the item number indicated).

Multinational tax integrity: intangible assets

Exposure draft legislation and explanatory material have been released in relation to the proposed anti-avoidance measure to prevent large multinationals from claiming tax deductions for payments relating to intangibles connected with low corporate tax jurisdiction. **See item 1.**

FBT: cents per kilometre

The Commissioner has released a determination that sets out the rates to be applied on a cents per kilometre basis for calculating the taxable value of a fringe benefit arising from the private use of a motor vehicle other than a car for the FBT year commencing on 1 April 2023 (TD 2023/1). **See item 2.**

FBT: LAFHA reasonable amounts

The Commissioner has released a determination that sets out the amounts that he considers reasonable under s 31G of the *Fringe Benefits Tax Assessment Act 1986* (Cth) for food and drink expenses incurred by employees receiving a living-away-from-home allowance fringe benefit for the FBT year commencing on 1 April 2023 (TD 2023/2). **See item 3.**

SMSFs: rectification directions

The Commissioner has released a practice statement that sets out what ATO officers need to consider when deciding whether to give an individual trustee, or a director of a corporate trustee, of a self-managed superannuation fund a rectification direction under s 159 of the *Superannuation Industry (Supervision) Act 1993* (Cth) (PS LA 2023/1). **See item 4.**

Electric vehicle home charging rate

The Commissioner has released a draft practical compliance guideline which describes a methodology to calculate the cost of electricity when an electric vehicle is charged at an employee's or individual's home (PCG 2023/D1). **See item 5.**

Business not being carried on

The AAT has held that two individuals, who provided a property owned by them to their related company for the agistment of cattle owned by the company, were not carrying on a business, and that the deductions claimed by them in excess of the agistment fee were not allowable (*DQTB and FCT* [2023] AATA 515). **See item 6.**

GST: enterprise issues

The Federal Court (Hespe J) has recently considered several GST issues which arose out of claims by the applicant (the trustee of a family trust (the Lewski Family Trust)) in respect of input tax credits that related to invoices paid by the applicant for services provided by lawyers and other professionals in relation to issues concerning members of the Lewski family and affiliated entities (the Lewski Family Group) (*Konebada Pty Ltd ATF the William Lewski Family Trust v FCT* [2023] FCA 257). **See item 7.**

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President's Report

by Marg Marshall, CTA

Change for a positive future

We continue to have your best interests at heart as we chart a course for the future of our organisation and the tax profession.

Changes at The Tax Institute

You will have received an email from me recently regarding structural changes at The Tax Institute. These changes are the necessary response to changes in trading conditions.

It's clear that the COVID-19 pandemic has altered how you, our valued members, want to interact. In response, we are modifying our delivery models across many of our member services and broader product offerings. We have invested in technology for online delivery of CPD and new methods of delivering education, including Tax Academy, our micro-credential offering. These significant changes have been led by our former CEO Giles Hurst, and we are grateful that, prior to departing, Giles has set us on a path of change that will ensure The Tax Institute is fit for the future.

I would like to extend thanks to Giles, once again, on behalf of National Council, our members and staff who have benefitted from his contributions over the years.

National Council, along with Acting CEO Clare Mazzetti, have commenced the search for our new CEO. The Institute's structural changes will also see a greater level of engagement with our state councils and committees. National Council is keen to ensure that members are engaged and have input into activities such as CPD and networking.

Federal Budget 2023–24

The Treasurer brought down the Federal Budget 2023–24 on 9 May. The Federal Budget is an important opportunity in the continual push for meaningful tax reform, and we continue to work towards this goal.

As usual, our TPA team worked hard on Budget night to bring you our member-only, comprehensive report. Our Federal Budget Report is an expert look at various tax measures affecting you. The report is available on our website and was sent directly to your inbox early on Wednesday morning. Our team worked hard into the night to be able to deliver this resource to you as soon as possible, so you can get a jump on digesting changes that the Federal Budget has introduced.

We also ran webinars to highlight key areas impacting members, with a deeper dive into relevant areas of the Budget. Our panel webinar hosted by Scott Treatt, CTA, and our analysis webinar with experts Robyn Jacobson, CTA, and Julie Abdalla, FTI, shared analysis and expert interpretation of the announced measures.

These webinars are a valuable opportunity not just to delve deeper into Federal Budget measures, but also for us to collect your questions and feedback around them and how they impact your day-to-day work. In this way, we hope to give you the tools to success and to help you use them in the best possible way.

If you missed the live webinars, I highly recommend you log in and view the recordings. Your clients rely on you to have up-to-date knowledge of measures like this, and to translate them into real-world outcomes for their lives and businesses.

Tax Forum season

Tax Forum season is in full swing and it's great to see so many members taking advantage of the excellent content being delivered. I am incredibly grateful for the hard work of the committees who bring you these events, as well as the speakers who both write and deliver their papers.

Committee members and speakers volunteer their time and expertise for our events and we are privileged that such high-quality content is available to our members, not only at these events but also via *Tax Knowledge Exchange* into the future.

If you've not yet joined us at a professional event this year, I encourage you to do so. There is no better way to connect with your peers and to stay up to date on the latest tax thinking.

Looking forward after 80 years serving the tax profession

As we celebrate our 80th birthday this year, I'd like to thank you for being on this journey with us. The past few years have been tough for individuals and organisations alike, and the current macro-economic environment continues to pose an array of challenges for us all.

We continue to keep a vision of a bright future – not only for The Tax Institute, but also for the tax profession as a whole – as we think about our strategic direction.

We have served the profession for 80 proud years and look forward to doing so for the next 80 years and more. Membership renewals opened this month, and to celebrate our birthday, we are giving away wonderful prizes over eight weeks. You can keep up with the winners in your weekly *TaxVine* – good luck to all of you!

As we head into a future that is at times uncertain, but just as often exciting and always with promise on the horizon, rest assured that we keep our members' interests at the heart of all of our actions. We look forward to supporting and working with you.

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Associate's Report

by Abhishek Shekhawat, ATI

Taxing unrealised gains

Although perceived to be a benefit from a purely economic analysis, the taxation of unrealised gains imposes significant practical issues on taxpayers.

On 31 March 2023, Treasury released a consultation paper outlining the proposed details of the government's earlier announcement to introduce an additional 15% tax rate on superannuation balances above $3m. If implemented, the proposal would mark a significant turning point in the treatment of gains and losses in our taxation system by taxing unrealised gains and losses. Australia is not alone in these developments. In the United States, the Budget for the 2024 fiscal year proposes to introduce a minimum wealth tax of 25% for individuals with wealth of more than $100m. Both of these developments are currently proposed to be limited to a small section of the population. However, if they gain traction, other governments will undoubtedly consider expanding the scope to a broader population.

Although there are theoretical economic benefits to taxing unrealised capital gains, the practical impact on taxpayers can cause significant and unreasonable burdens. In this article, we briefly examine some of the pros and cons, and consider alternatives to the taxation of unrealised gains that could deliver similar outcomes without the underlying issues.

Benefits of taxing unrealised gains

An often-cited benefit of taxing unrealised gains is that it is fundamentally an economically efficient tax as it: does not distort behaviours as the tax burden is linked only to market movements of the underlying assets; imposes a tax burden that is proportionate to the changes in the value of the asset; and serves as a means to raise regular and reliable revenue.

The broad economic benefits are usually combined with other potential objectives that the tax could achieve. For example, some have suggested that an annual tax on the unrealised gains on second and subsequent properties could reduce inflationary pressures, decrease demand, and stabilise prices through the disincentives created. Other examples include these taxes altering the tax base to target inefficient or excessive economic rent over beneficial behaviours, such as undertaking actual work to produce a good or service. However, these theoretical benefits need to be weighed against the practical challenges.

Disadvantages of taxing unrealised gains

Taxing unrealised gains often results in a mismatch between the tax liability and the cash flow associated with the underlying asset. This can place taxpayers under significant pressure, potentially requiring them to dispose of other assets to meet the tax liability. The size of the liability could have significant broader implications, such as a wealth tax on a very wealthy shareholder requiring them to sell a market-altering proportion of their shares to meet the tax bill.

Compliance costs for affected taxpayers are also likely to dramatically increase. For example, valuation is a costly and time-consuming process for many taxpayers. The taxation of unrealised gains will multiply the existing valuation pressures on the system, especially for assets with difficult to ascertain values (such as art or even property in a rapidly evolving or uncertain market). The likelihood of disputes arising over asset values may also place pressures on the administrator in addition to bearing the cost of developing and maintaining systems that accurately track taxpayers' carried forward losses. The costs of these disadvantages likely outweigh any theoretical benefits.

Considering alternative approaches

The taxation of unrealised gains can be executed through various mechanisms. The manner in which the tax is implemented may be linked to an underlying economic or social purpose and can vary the pros and cons analysis.

In any case, it is important to consider alternatives which are simpler, more practical and more equitable, and to an extent equally unpopular. Some examples include:

- removing or reducing current discounts and exemptions, such as the 50% CGT exemption, if the intention is to raise the revenue collected from certain taxes;
- removing perceived tax benefits to certain types of investments, such as negative gearing for property;
- undertaking holistic reform and relying on a more practical and efficient tax base, such as a broad-based GST, if the intention is to move towards a more efficient and reliable source of revenue; or
- non-tax measures such as restrictions on the types of investments that can be made or actions that taxpayers are required to undertake (such as limiting the amount that can be accumulated in superannuation or the ability to invest in certain types of assets).

This topic will undoubtedly continue to be an issue for the government and the community going forward. It is important that any proposals to broaden the scope of taxing unrealised gains in Australia is thoroughly considered from a practical perspective, with preference given to alternatives that can achieve the appropriate policy outcome. In the meantime, we should ensure that the current proposal is ring-fenced and not used as a precedent for the tax system more broadly.

Tax News – the details

by TaxCounsel Pty Ltd

April – what happened in tax?

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

Government initiatives

1. Multinational tax integrity: intangible assets

Exposure draft legislation and explanatory material have been released in relation to the proposed anti-avoidance measure to prevent large multinationals from claiming tax deductions for payments relating to intangibles connected with low corporate tax jurisdictions.

More particularly, the proposed amendments are intended to deter a significant global entity (SGE) from avoiding income tax by structuring its arrangements so that income from exploiting intangible assets is derived in a jurisdiction where no or low corporate tax rates apply, while tax deductions for payments attributable to intangible assets made by the SGE to an associate are claimed in Australia. The proposed rule is intended to prevent the SGE from claiming tax deductions for such payments.

The anti-avoidance rule aims to prevent large multinationals from securing an unfair tax advantage over other Australian businesses and seeks to ensure that large multinational enterprises are paying their fair share of tax in Australia.

The proposed amendments, which were announced in the 2022–23 Budget, are to operate in respect of payments or credits that an SGE makes to an associate, as well as liabilities incurred by an SGE from an associate, on or after 1 July 2023.

The Commissioner's perspective

2. FBT: cents per kilometre

The Commissioner has released a determination that sets out the rates to be applied on a cents per kilometre basis for calculating the taxable value of a fringe benefit arising from the private use of a motor vehicle other than a car for the FBT year commencing on 1 April 2023 (TD 2023/1).

The rates are:

Engine capacity	Rate per kilometre
0 – 2500cc	62 cents
Over 2500cc	73 cents
Motorcycles	18 cents

3. FBT: LAFHA reasonable amounts

The Commissioner has released a determination that sets out the amounts that he considers reasonable under s 31G of the *Fringe Benefits Tax Assessment Act 1986* (Cth) for food and drink expenses incurred by employees receiving a living-away-from-home allowance (LAFHA) fringe benefit for the FBT year commencing on 1 April 2023 (TD 2023/2).

Where the total of food and drink expenses for an employee (including eligible family members) does not exceed the amount that the Commissioner considers reasonable, those expenses do not have to be substantiated under s 31G. Where an employee receives a LAFHA fringe benefit with a component for food and drink expenses, for the employer to reduce the taxable value of the fringe benefit by the exempt food component, the expenses must be either:

- equal to or less than the amount that the Commissioner considers reasonable; or
- substantiated.

If the total of an employee's food or drink expenses exceeds the amount that the Commissioner considers reasonable, the substantiation provisions will apply.

TD 2023/2 sets out the amounts that the Commissioner considers reasonable for food and drink within Australia and overseas.

4. SMSFs: rectification directions

The Commissioner has released a practice statement that sets out what ATO officers need to consider when deciding whether to give an individual trustee, or a director of a corporate trustee, of a self-managed superannuation fund (SMSF) a rectification direction under s 159 of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA) (PS LA 2023/1).

PS LA 2023/1 points out that the Commissioner is responsible for ensuring that SMSF trustees comply with the relevant tax and superannuation laws, as well as dealing effectively with those who fail to do so, and that this role is fundamental in safeguarding the integrity of the superannuation system and the preservation of members' benefits. The ATO's role also ensures that tax concessions available within superannuation are appropriately targeted towards those who choose to operate within the regulatory framework.

When carrying out this role, the SISA provides a range of compliance options to deal with conduct which has resulted in a contravention of the SISA or the *Superannuation Industry (Supervision) Regulations 1994* (Cth) (SISR).

One compliance option is to give a rectification direction. Other compliance options (such as giving an education direction or applying administrative penalties) can be used alongside a rectification direction. The appropriateness of any additional compliance option that is chosen will depend on the circumstances of each case.

What is a rectification direction?

A rectification direction is a written notice that the Commissioner gives to a person which, within a stated period, requires them to take specified action to rectify the contravention (such as repay a loan or borrowing, dispose of an asset, or lodge a return) and provide the ATO with evidence showing that they have complied with the direction.

A rectification direction must not be given where the ATO has accepted an enforceable undertaking which is current and covers the particular contravention.

A rectification direction may be given to an individual where the ATO officer reasonably believes that a person has contravened a provision of the SISA (other than Pt 3B (data and payment regulations and standards)) or the SISR.

Relevant considerations

When deciding whether to give a rectification direction, ATO officers should consider the general principles and case-specific factors, which include all of the following:

- any financial detriment that might reasonably be expected to be suffered by the fund as a result of the person complying with the direction;
- the nature and seriousness of the person's contravention; and
- any other relevant circumstance.

5. Electric vehicle home charging rate

The Commissioner has released a draft practical compliance guideline which describes a methodology to calculate the cost of electricity when an electric vehicle is charged at an employee's or individual's home (PCG 2023/D1).

Some points from PCG 2023/D1 are as follows:

- it is the employer's or individual's choice if they want to use the methodology outlined in PCG 2023/D1 or if they would like to determine the cost of the electricity by determining its actual cost. The choice is per vehicle and applies for the whole income or FBT year. However, it can be changed by the employer or individual from year to year; and
- where the electric vehicle is a plug-in hybrid vehicle which has an internal combustion engine, the methodology in PCG 2023/D1 will not be able to be used as the methodology is a shortcut method which applies the home charging rate to all kilometres driven in the FBT or income tax year.

Employers who can rely on PCG 2023/D1

An employer may rely on PCG 2023/D1 to calculate the electricity costs of charging an electric vehicle at the employee's home if the employer:

- provides the electric vehicle to an employee or associate for private use resulting in the provision of a car fringe benefit, residual fringe benefit or pays for expenses associated with the car resulting in a car expense payment benefit;
- provides the electric vehicle to an employee or associate who charges the electric vehicle using electricity at a residential premises, where the electricity cost directly attributable to charging the electric vehicle cannot be practically segregated from the cost of running other electrical appliances in the home; and
- is required to calculate the taxable value for one or more of the following as part of the employer's FBT obligations:
  - car fringe benefit;
  - residual fringe benefit;
  - car expense payment benefit – where the electricity charging cost incurred by the employee is reimbursed by the employer; and/or
  - the grossed-up taxable value for the reporting of the reportable fringe benefit amount for the employee – which continues to be reportable even if the car benefit arising from the provision of the electric vehicle is exempt.

Individuals who can rely on PCG 2023/D1

An individual may rely on PCG 2023/D1 to calculate the electricity costs of charging an electric vehicle at their home if they:

- use a zero emissions electric vehicle while carrying out their income-earning activities;
- incur electricity expenses when charging their electric vehicle at home; and
- have kept the relevant records for the income year.

If a choice to rely on PCG 2023/D1 is made, it must be ensured that the electric vehicle home charging electricity cost has been incurred. The electric vehicle home charging electricity cost is incurred when an amount is actually paid or when a definitive obligation to pay the amount arises. This will generally occur where a contract has been entered into for the supply of electricity for the home which is in place at the time the individual charges the electric vehicle.

The practical compliance approach

If PCG 2023/D1 is applied, the cents per kilometre rate (the EV home charging rate) is multiplied by the total number of relevant kilometres travelled by the electric vehicle in the relevant income or FBT year. The EV home charging rate that is to apply for the income or FBT year commencing on and after 1 April 2022 is 4.20 cents per kilometre.

If electric vehicle charging costs are incurred at a commercial charging station, a choice has to be made. The EV home charging rate can be used, but only if the commercial charging station cost is disregarded. If the commercial charging station cost is used, the EV home charging methodology set out in PCG 2023/D1 cannot be applied.

Date of effect

PCG 2023/D1 is to apply:

- for FBT purposes, from 1 April 2022; or
- for income tax purposes, from 1 July 2022.

The choice to rely on PCG 2023/D1 for an electric vehicle is applicable for the whole FBT or income year.

Transitional approach: 2023 FBT year and 2023 income year

If odometer records have not been maintained as at 1 April or 1 July 2022, a reasonable estimate may be used based on service records, logbooks or other available information.

Recent case decisions

6. Business not being carried on

The AAT has held that two individuals, who provided a property owned by them to their related company for the agistment of cattle owned by the company, were not carrying on a business, and that the deductions claimed by them in excess of the agistment fee were not allowable (*DQTB and FCT*[1]).

The two taxpayers, DQTB and KHMQ (DQTB's partner), objected to amended assessments for the 2017 income year in which the Commissioner had disallowed certain deductions for expenses said to be associated with agistment activities on a property in Tasmania that they had acquired jointly during the 2017 income year.

The taxpayers decided to relocate to Tasmania and purchased the property which comprised 75.42 hectares and included a dwelling and sheds. After the purchase was completed in February 2017 and before the end of the 2017 income year, the taxpayers engaged contractors to construct approximately four kilometres of fencing at a cost of $42,720. This work was completed in the 2017 income year. Several large dams and large water tanks were also added in the 2017 income year.

In the 2018 income year, the taxpayers incurred the amount of $74,728 for internal fencing and repair work. This included approximately three kilometres of internal fencing, including the construction of a laneway to facilitate the movement of stock and subdividing paddocks at the northern end of the property into smaller paddocks.

The agistment fee ($20,000) payable by the company for the 2017 income year was lent to the company by the taxpayers. The company would only be able to afford to fund the annual agistment fee over the longer term if it succeeded in breeding and selling stock.

For the 2017 income year, the taxpayers returned the agistment fee ($10,000 each) as assessable income but claimed that they were entitled to various deductions on the basis that they were carrying on a business of providing agistment and full-care animal husbandry and veterinary services to the company that they owned. The Commissioner took the view that the taxpayers had not proved that they were carrying on a business and assessed each of them on the footing that the deductions allowable were limited to the amount of the agistment income of $10,000 derived by each taxpayer in the 2017 income year.

The AAT said that there were indicators pointing in favour of and against a conclusion that the agistment arrangements constituted a business.

There was a degree of systematic, business-like behaviour. The scale of the alleged enterprise was small but that was not fatal. In the context of the matter, the AAT gave little weight to this feature of the arrangements.

However, the absence of a satisfactory basis on which the AAT could conclude that the taxpayers had a profit-making purpose for the agistment arrangements told against the arrangements constituting a business. So, too, did the uncommercial nature of the transactions. The AAT said that, even giving full weight to the recognition that small business transactions between related persons are commonly attended by a high degree of informality, the arrangements with the company (involving no clearly recorded agreement on the services to be provided and terms for, or indeed any indication of an expectation of repayment of, the loan by the company without which the transactions could not have occurred) were uncommercial and not business-like in nature.

The AAT concluded that the weight of the evidence pointed against a conclusion that the taxpayers were carrying on a business.

7. GST: enterprise issues

The Federal Court (Hespe J) has recently considered several GST issues which arose out of claims by the applicant (the trustee of a family trust (the Lewski Family Trust)) in respect of input tax credits that related to invoices paid by the applicant for services provided by lawyers and other professionals in relation to issues concerning members of the Lewski family and affiliated entities (the Lewski Family Group) (*Konebada Pty Ltd ATF the William Lewski Family Trust v FCT*[2]).

Some services related to court or tribunal proceedings to which Lewski Family Group members were a party or were otherwise involved (litigation services). Members of the Lewski Family Group were parties to a number of proceedings which resulted in a need for legal representation and advice. Other services were not related to litigation (other services). In the relevant periods, the applicant paid invoices relating to litigation services and other services totalling over $3.6m.

The applicant, as trustee for the William Lewski Family Trust, was a party (the litigation funder) to several deeds dated 16 November 2016, each of which was styled "litigation funding agreement". The recital to each deed stated that the deed recorded the agreement between the litigation funder and the beneficiaries in relation to the payment of litigation costs and litigation proceeds arising in connection with the proceedings.

The term "proceedings" was defined to mean the court proceedings described in Sch 2 of the deed and any claim, demand, cause of action or other legal proceedings, whether intermediate, incidental or ancillary, which related to or were connected with such court proceedings.

Clause 2 of each deed provided that the parties acknowledged and agreed that the litigation funder had, up to the date of the deed, paid and would, after that date, continue to pay all litigation costs. "Litigation costs" was defined as all costs and expenses paid or payable by the beneficiaries, or incurred for the benefit of the beneficiaries, that related to or arose in connection with the proceedings.

The deed also provided (in cl 3) that, in consideration for the payment of the litigation costs by the litigation funder in accordance with cl 2, each of the beneficiaries agreed to pay to the litigation funder any litigation proceeds that were paid to it. The term "litigation proceeds" was defined to mean all money paid or payable to the beneficiaries in respect of the proceedings, including (without limitation) amounts paid or payable in connection with (inter alia) the settlement of the proceedings or awarded by the court by way of judgment in favour of the beneficiaries.

Central issue

The central issue in the proceedings before the Federal Court was whether the applicant was entitled to input tax credits in respect of its payment of invoices for the provision of legal and other professional services. The resolution of this issue involved the determination of two sub-issues:

1. whether the applicant acquired anything by way of taxable supplies; and
2. whether the applicant's acquisitions were made in carrying on an enterprise.

The decision

As to sub-issue (1), Hespe J held that there were acquisitions by the applicant and the supplies to the applicant were taxable supplies.

In relation to sub-issue (2), Hespe J said that it was necessary to consider the extent to which the applicant made its acquisitions in carrying on its enterprise. Contrary to the applicant's contention, it was not sufficient that an acquisition be made "while carrying on an enterprise". The phrase "in carrying on" required more than a temporal nexus. The goods or services acquired must be used, or be for use, for the purposes of, the enterprise.

Her Honour said that the nature and extent of the enterprise must be identified with some precision. Whether a taxpayer is engaged in an enterprise (more specifically, a business) was a matter of fact and degree, and required a "wide survey and exact scrutiny" of the taxpayer's activities. In the present case, there was an insufficient connection between the applicant's acquisitions and the achievement of some commercial purpose of the applicant to stamp the acquisitions by the applicant as being made in carrying on an enterprise.

Hespe J held that the applicant did not carry on a business of providing litigation consulting services, or a business of receiving and disseminating advice, or formulating and making recommendations based on advice it received, to members of the Lewski Family Group in respect of litigation proceedings. The evidence did not support a finding that the applicant carried on a business of providing or disseminating legal advice or of managing professional services for members of the Lewski Family Group. Her Honour said that she did not have before her contemporaneous records that would satisfy her that the applicant's activities extended to it providing such services. There was no acquisition of services by the applicant in carrying on an enterprise of providing services and information to the members of the Lewski Family Group.

Nor, her Honour said, was there evidence to support a conclusion that the engagement of service providers, or the funding of the provision of the litigation services or other services, was made in the course of an enterprise involving the applicant providing procurement services for the members of the Lewski Family Group. There was no evidence that the applicant was paid for any such procurement or funding service, or that it otherwise provided such a procurement service or funding service in a way from which it anticipated to earn a return.

Also, the litigation funding agreements did not support a finding that the applicant carried on an enterprise involving the provision or procurement of litigation-related consultancy or advisory services. The obligation of the applicant under those agreements was to pay invoices. The litigation funding agreements did not provide for the applicant to provide consulting or advisory services, or require it to arrange for the provision of such services.

Hespe J went on to say that the litigation funding agreements did not themselves evidence a concern in the nature of trade. The litigation funding agreements required the applicant to incur significant costs which it needed to fund without an entitlement to fees for a service. The applicant had to borrow in order to fund its obligations under the litigation funding agreements. The only return to the applicant under the terms of the litigation funding agreements depended on the beneficiary being paid litigation proceeds. Just how the applicant could be expected to earn a return from proceedings in which the family member or affiliated entity was either a defendant or respondent making no cross-claim as to damages, and/or a party to a taxation dispute in the Administrative Appeals Tribunal in respect of which no costs order could be made, was not apparent. Even if a costs order were to be made in favour of a beneficiary, such a costs order would be unlikely to cover the beneficiary's actual (as opposed to taxed) costs. The prospect of the applicant ultimately making a return on any of the litigation funding agreements was so remote that it had no meaningful nexus to the services that were supplied.

Hespe J did not accept that, prior to the execution of the litigation funding agreements, the payment of lawyers' invoices had been done in a systematic manner on a

commercial basis. Apart from the fact that the litigation funding agreements were entered into repeatedly, her Honour did not accept that the agreements were entered into in a systematic and organised manner which stamped them as bearing a commercial character. There was no contemporaneous evidence as to the manner in which the applicant (or any director) came to decide to enter into any of the litigation funding agreements or came to agree to pay the invoices. No trustee resolutions, no accounts, no financial statements or board papers relating to or explaining the basis on which those agreements were entered into or payments made were in evidence.

Accordingly, Hespe J dismissed the appeal.

Appeal

The applicant has lodged an appeal to the Full Federal Court from the decision of Hespe J in this case.

TaxCounsel Pty Ltd
ACN 117 651 420

References

1 [2023] AATA 515.

2 [2023] FCA 257.

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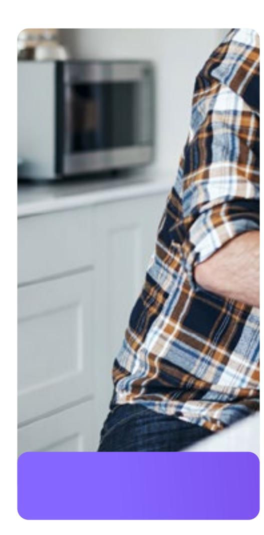

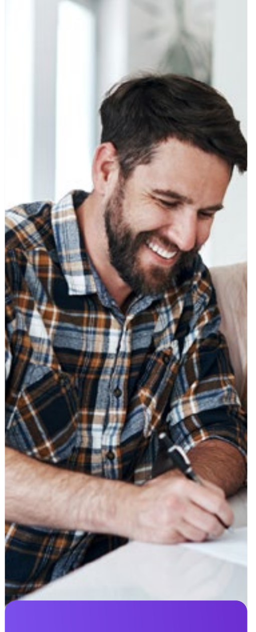

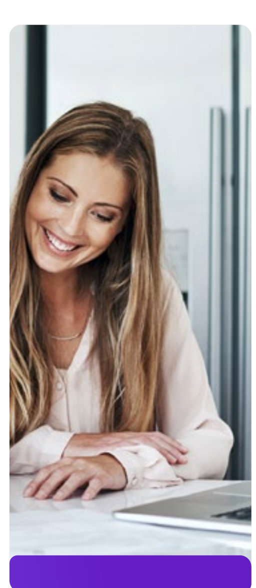

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Tax Tips

by TaxCounsel Pty Ltd

The "entity" concept

The statutory definition of "entity" in the income tax law was recently considered by the Full Federal Court.

Background

When it was enacted, the *Income Tax Assessment Act 1997* (Cth) (ITAA97) introduced the defined concept of "entity" into the income tax law. While most defined terms are asterisked where they first occur in a provision, there are some basic terms used throughout the ITAA97 that are not identified with an asterisk; "entity" is one such term.[1]

The way the statutory definition of "entity" in the ITAA97 operates was recently considered by the Full Federal Court in *Sunlite Australia Pty Ltd v FCT* (the *Sunlite* case).[2] The Full Court in its decision referred to some issues of statutory construction. This article discusses aspects of the decision of the Full Court.

The decision in the *Sunlite* case highlights the need to have careful regard to the terms of the relevant statutory provisions when considering their operation. That can, and frequently does, raise difficulties of construction. Problems of statutory construction are an inherent feature in much of the taxation laws in Australia and elsewhere.

In the recent decision of the UK Supreme Court in *Moulsdale t/a Moulsdale Properties v Commissioners for His Majesty's Revenue and Customs*,[3] Lady Rose, giving the decision of the court, said:

> "3. Drafting tax legislation is a difficult and complex task so it is not surprising that sometimes the legislation does not quite work. It is common ground that this appeal arises because of one such occasion. Problems can arise in particular where, as here, provisions that were drafted in an enactment for one purpose are incorporated by cross-reference into a different enactment dealing with something else. The drafter does not spot that there might be a circumstance in which the imported provisions which work perfectly well in their original setting, create a conundrum in their new setting. If that circumstance arises, it falls to the court to decide how the legislation applies, giving effect to Parliament's intention and the purpose for which the provisions relevant to the appeal were enacted."

It is suggested in the present article that the construction of the relevant provisions adopted by the Full Court in *Sunlite* is correct.

It should be noted that the "entity" concept is now a feature in other commonwealth taxation laws, including GST[4] and FBT.[5]

The Sunlite case: facts

Sunlite Australia Pty Ltd (Sunlite) was the trustee of a trading trust and, in its capacity as trustee, owned and operated a business that developed and manufactured products such as awnings, external venetians, glazing and weather shades. In the 2012 and 2013 income years, Sunlite, acting in its own interests and not as trustee, was registered as an R&D entity for the purposes of the R&D provisions in Div 355 ITAA97 (Research and Development). Sunlite claimed notional deductions in excess of $1.1m for those income years on the basis that it had incurred expenditure on R&D activities (as defined in Div 355).

In 2016, the Commissioner conducted an audit and issued amended assessments. Sunlite's objections to the amended assessments were disallowed by the Commissioner and Sunlite applied to the AAT for a review of the Commissioner's objection decision.[6] The AAT upheld the decision under review and, in doing so, found that the relevant expenditure was incurred by Sunlite acting in its capacity as trustee.[7] Sunlite then appealed to the Federal Court from the decision of the AAT. The appeal was heard by a Full Federal Court which has now dismissed Sunlite's appeal.

The statutory provisions

On the appeal, the critical issue was whether the AAT erred in its construction of a key provision in Div 355, namely, s 355-205(1) ITAA97 which provides:

> "(1) An R&D entity can deduct for an income year (the ***present year***) expenditure it incurs during that year to the extent that the expenditure:
>
> (a) is incurred on one or more R&D activities:
>
> (i) for which the R&D entity is registered under section 27A of the *Industry Research and Development Act 1986* for an income year; and
>
> (ii) that are activities to which section 355-210 (conditions for R&D activities) applies; and
>
> (b) if the expenditure is incurred to the R&D entity's associate – is paid to that associate during the present year."

Section 355-210: conditions for R&D activities

Section 355-210(1) states that an R&D activity "covered by one or more of the following paragraphs is an activity to which this section applies". It then has various provisions that deal with geographical connections with Australia. For example, para (a) states:

> "(a) the R&D activity is conducted for the *R&D entity solely within Australia;"

The concept of an R&D entity is defined in s 355-35 ITAA97 as follows:

"(1) Each of the following is an ***R&D entity***:

(a) a body corporate incorporated under an Australian law;

(b) a body corporate incorporated under a foreign law that is an Australian resident.

Note: Each of the above paragraphs extends to a body corporate acting in its capacity as trustee of a public trading trust (see subsection 102T(9) of the *Income Tax Assessment Act 1936*)."

The definition of "entity"

Section 995-1(1) ITAA97 provides that:

"(1) In this Act, except so far as the contrary intention appears:

...

'entity' has the meaning given by section 960-100."

Section 960-100 ITAA97 provides:

"(1) ***Entity*** means any of the following:

(a) an individual;

(b) a body corporate;

(c) a body politic;

(d) a partnership;

(e) any other unincorporated association or body of persons;

(f) a trust;

(g) a superannuation fund;

(h) an approved deposit fund.

Note: The term ***entity*** is used in a number of different but related senses. It covers all kinds of legal person. It also covers groups of legal persons, and other things, that in practice are treated as having a separate identity in the same way as a legal person does.

(1A) Paragraph (1)(e) does not include a non-entity joint venture.

(2) The trustee of a trust, of a superannuation fund or of an approved deposit fund is taken to be an ***entity*** consisting of the person who is the trustee, or the persons who are the trustees, at any given time.

Note 1: This is because a right or obligation cannot be conferred or imposed on an entity that is not a legal person.

Note 2: The entity that is the trustee of a trust or fund does not change merely because of a change in the person who is the trustee of the trust or fund, or persons who are the trustees of the trust or fund.

(3) A legal person can have a number of different capacities in which the person does things. In each of those capacities, the person is taken to be a different ***entity***.

Example: In addition to his or her personal capacity, an individual may be:

- sole trustee of one or more trusts; and
- one of a number of trustees of a further trust.

In his or her personal capacity, he or she is one entity. As trustee of each trust, he or she is a different entity. The trustees of the further trust are a different entity again, of which the individual is a member.

(4) If a provision refers to an ***entity*** of a particular kind, it refers to the entity in its capacity as that kind of entity, not to that entity in any other capacity.

Example: A provision that refers to a company does not cover a company in a capacity as trustee, unless it also refers to a trustee.

Note: Under section 87-35, certain parts of Australian governments and authorities are treated as separate entities for the purposes of ascertaining whether another entity is conducting a personal services business."

The Full Court decision

In a joint decision, the Full Federal Court (Colvin, O'Sullivan and Feutrill JJ) rejected the contentions of Sunlite and dismissed the appeal by Sunlite.

Some statutory construction points

Before considering the proper construction of s 355-205 ITAA97 and the arguments advanced by Sunlite, the Full Court referred to some aspects of statutory construction, particularly in relation to the construction of statutory definitions that were of relevance. These are noted below.

General principles

The Full Court said that the general principles of statutory construction were not in issue and were well established.[8] In this regard, the court referred to the following passage from the judgment of Kiefel CJ, Nettle and Gordon JJ in *SZTAL v Minister for Immigration and Border Protection*:[9]

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

The Full Court went on to say:[10]

"6. Further, 'tax statutes do not form a class of their own to which special rules apply; they are to be construed by application of the settled principles' that apply

> generally … However, 'the fact that a statute is a taxing Act, or contains penal provisions, is part of the context and is therefore relevant to the task of construing the Act in accordance with those settled principles' …"

Their Honours said that, in the present case, provisions dealing with the way in which to interpret references to entities (as described in the ITAA97) were at the heart of the competing contentions. Given the nature of the contentions, it was important to bear in mind the distinction between those legislative provisions that are truly definitional on the one hand and those which inform the approach to interpretation of other provisions or have substantive operative effect on the other hand.

Statutory definitions

The Full Court went on:[11]

> "8. Where a definition simply articulates the terminology to be given effect when the defined term is used in the operative text then, unless there is clear contrary intent, the proper course is to read the words of the definition into the substantive enactment and then construe the operative provision … This reflects the character of a definition which simply provides an aid to the construction of the substantive provisions and the words used in the definition take their meaning informed by the context and purpose to be discerned from the operative provisions …
>
> 9. Further, the ordinary meaning of a defined term is displaced by a statutory definition. This means that in the case of the statutory definition of a composite expression, the ordinary meaning of a word used as part of the defined term is not to be used to construe the definition …, but see … as to circumstances in which it may be appropriate to have regard to the ordinary meaning of the defined term."

Their Honours then said:[12]

> "10. Care must be taken to confine such an approach to provisions that are truly definitional and have no operative elements … For example, some provisions do not seek to define a term but rather provide instances by way of explanation to aid in the application of the term …
>
> 11. Further, these principles are subject always to the possibility that the application of the statutory definition to a particular provision may be excluded expressly or by implication from the context."

The Full Court noted that the ITAA97 is drafted with many notes and examples. They all form part of the Act (s 950-100 ITAA97). Even though they are not operative, they can be taken into account when construing its provisions and have been prepared on the basis that the examples are accurate expressions of the way the law applies. As explained by Steward J in *Burton v FCT*,[13] the notes may be used to help understand the operative effect of a provision. Likewise, the examples may be used when construing the operative provisions.[14]

Definition of entity

The Full Court noted that the ITAA97 uses the term "entity" in a manner that departs in significant respects from the ordinary meaning of the term. After setting out the definition of "entity" in s 960-100(1) ITAA97, the court went on to say[15] that entity is used in the ITAA97 as a collective term which means any of the terms listed. Those terms are not all legal persons. Some, such as a partnership and a trust, describe a particular type of legal relationship that may be recognised by the law. Neither a partnership nor a trust is a separate person and neither has separate legal personality.

With reference to subs (2) of s 960-100, the Full Court said that the subsection expanded the definition of "entity" to include "trustee" and described what was meant by that term. It also made clear that the term "trustee" refers to all of the trustees of a trust and treats them as a single entity.[16]

The Full Court said that the remaining provisions in s 960-100 ITAA97 were perhaps more exegetical than definitional. The provisions explained the way to interpret provisions that used the term "entity" or any of the terms listed in the definition of "entity" when those terms were deployed in substantive provisions of the ITAA97. The Full Court said that the provisions addressed the way to apply the provisions to a case where one legal person constitutes more than one entity, a possibility that arose from the way "entity" is defined.[17]

After referring to subs (3) (which provides that a legal person can have a number of different capacities in which the person does things, and that, in each of those capacities, the person is taken to be a different entity), the Full Court said that it could be seen that references to an "entity" are not to be equated with the notion of legal entity such that there is unity between the nature and extent of a legal person and an entity. Rather, a legal person acting in different capacities is taken to be a distinct entity when acting in each of those capacities. This was explained in the example which is given after subs (3).[18]

The Full Court, after referring to the terms of subs (4) and the example and note to the subsection, said:[19]

> "23. Therefore, there is a unitary nature to an entity for the purposes of ITAA97. Its operative provisions apply both to what are typically considered by the general law to be legal persons (such as a corporation) and to non-legal persons (such as a trust) by defining 'entities'. Having defined those entities, it provides that each entity may be the subject of separate application of its provisions even though the same entity fulfils a number of different roles. The effect is that where the Act refers to an entity (or any of the terms within the definition) then it applies to that entity in its capacity as that kind of entity and not in another capacity."

The Full Court then went on:[20]

> "24. These matters are fundamental to the structure of ITAA97 because the legislation imposes many taxpayer obligations and confers taxpayer benefits upon entities. So, a person who also acts as a trustee has separate

taxpayer responsibilities as 'an individual' entity and as the person responsible for 'a trust' entity when it comes to matters such as lodging returns and the raising of assessments. The same legal person manifests as two entities for the purposes of the legislation. When acting in a personal capacity the individual is one entity and when acting as trustee the individual is a different and distinct entity. A company acting on its own behalf and also as trustee must lodge a tax return in its capacity as a trustee, and a separate tax return in its own capacity. The tax rates that are applicable are different and the way in which taxation applies to trust income is very different to the way it applies to corporate income. The whole of ITAA97 speaks in the context of a division between entities.

25. It is the distinction between the activities of a body corporate (as one entity) and a body corporate acting as trustee (another entity) that looms large in the present case.

26. Significantly for present purposes, s 960-100(4) deals with those instances where a provision of ITAA97 refers to an entity 'of a particular kind', for example, a body corporate. It provides that in such a case the reference is to the body corporate and not to the body corporate in another capacity (such as the trustee of a trust). So, any reference to a body corporate is to that body corporate acting in its own and not in any other capacity. That is, a substantive provision which refers to a body corporate applies only to the 'entity' being the body corporate acting in its own right."

Definition of "R&D entity"

In relation to the definition of "R&D entity", the Full Court said that it may be observed that the definition of "R&D entity" does not refer to other entities, such as a trust or partnership, as one of the entities that is an R&D entity (noting the exceptional case of a public trading trust). Sunlite approached the construction of the term "R&D entity" on the basis that it described a sub-set of the defined term "entity" for the purposes of Div 355 ITAA97 and that the references to "body corporate" in the definition were references to that term that were to be understood in the context of s 960-100 ITAA97. Further, it was accepted by Sunlite that a trust is not an R&D entity and that the reference to "a body corporate" was a reference to that body corporate acting in its own right. The Full Court said that, plainly, Sunlite was correct to make those concessions.

Sunlite's contentions

Sunlite began its contentions by emphasising certain general law principles in relation to trusts. First, at general law, a trust is not a separate legal entity. Second, liabilities incurred by a trustee acting as trustee are personal liabilities of the trustee. Third, the trustee will usually have a right of indemnity as against the trust assets in respect of trust liabilities. The Full Court said that, for present purposes, these propositions may be accepted at the level of generality with which they were expressed.

Next, Sunlite submitted that when it, as a body corporate acting as trustee, incurred expenditure on R&D activities, the trust could not have incurred that liability because it was not a separate legal entity. Rather, as a matter of general law, it could only be a body corporate acting on its own behalf that incurred liability for the relevant expenditure. This was said to flow from the general propositions concerning the incurring of liabilities by the trustee of a trust.

Therefore, so it was submitted, when s 355-205 ITAA97 refers to expenditure that an R&D entity incurs, it is referring to expenditure that has to be incurred by a body corporate in its own right. This was said to be because, as a matter of general law, only Sunlite could have incurred that liability.

Reliance was then placed by Sunlite on the terms of s 960-100(2) ITAA97 which were said to recognise that it is the trustee of a trust that is the entity. Based on its terms, the submission advanced was that, in a case like the present, the entity is the trustee of the trust.

The Full Court's analysis

As to the reliance by Sunlite on the terms of s 960-100(2) ITAA97, the Full Court said that that submission misread s 960-100(2). The subsection was not saying that, in the case of a trust, the trustee was the entity. Rather, it was saying that, in the case of a trust (which itself is an entity by definition), the trustee is also taken to be an entity. Contrary to the submission advanced by Sunlite, the terms of s 960-100(2) are not creating a single entity comprising the body corporate that is a trustee and the trust, but recognising and maintaining the distinction for the purposes of the legislation between a legal person, such as a body corporate, (as one entity) and that legal person as trustee of a trust (as another entity). Therefore, the proposition that s 960-100(2) operates so as to make a body corporate that is a trustee *the* entity where there was a trust should not be accepted.

The next step in the analysis advanced by Sunlite relied on s 960-100(4) ITAA97. This contention was that the words of the subsection meant that the reference in s 355-205 ITAA97 to an R&D entity (as defined in s 355-35 ITAA97) – which could only be a body corporate – did not apply to the body corporate acting as trustee. The Full Court went on:[21]

"40. As to that contention, it may be accepted that s 355-205 does not apply to a trust or a trustee. And it may also be accepted that s 355-205 is confined to a body corporate acting in its own right. However, despite Sunlite's submission to the contrary, that does not mean that the reference in s 355-205 to an R&D entity (that is, a body corporate) includes the activities of that body corporate as trustee of the trust, particularly the incurring of expenditure in its capacity as trustee. Rather, what the provisions in s 960-100 require is that the reference to 'body corporate' be read as an entity that is acting in its own capacity *and in no other capacity.*

41. Therefore, expenditure incurred by Sunlite as the entity that is a trustee of the trust is not expenditure that it incurs in its own right. Put another way, the differentiation between a body corporate acting in

its own right (being one particular entity) and a body corporate acting as a trustee (being a distinct entity even though it is the same legal person) means that expenditure incurred as trustee is not expenditure of the body corporate acting in its own capacity.

42. For those reasons, the contentions advanced by Sunlite should not be accepted. The provision in s 355-205 to the effect that an R&D entity (a body corporate acting in its own right) can deduct 'expenditure it incurs' means expenditure it incurs in its own right and not as trustee."

Sunlite sought to support its construction by arguing that s 355-210 provided the operative qualification for a deduction by requiring that the R&D activity be conducted "for" the R&D entity. By reference to its terms, Sunlite contended that the expenditure that it incurred acting as trustee (for which it was liable in its own right under general law) could be deducted provided the expenditure was incurred "for the R&D entity". It sought to demonstrate that, even though the expenditure in the present case had been found by the tribunal to be incurred by Sunlite acting in its capacity as trustee, the arrangement that was in existence was that Sunlite in its own right would reimburse the trust for the expenditure and be the proprietor of the knowledge gained from the R&D activity.

The Full Court then went on:[22]

"44. However, the problem with focussing upon s 355-210 as conferring the qualifying basis for the notional deduction is that it would allow for a deduction by a body corporate even though it incurred no liability in its own right. In the particular circumstances of this case, Sunlite says that it took on a liability to reimburse the trust for the expenditure incurred by it in its capacity as trustee. However, the construction advanced would apply equally in a case where there was no such arrangement. Accordingly, if there was an arrangement whereby the benefit of the R&D expenditure was to be enjoyed by the R&D entity in its own right without assuming any responsibility for the expenditure incurred on the R&D activity then it might still be said that the R&D activity was conducted for the body corporate in its own right such that it could claim the notional deduction as that entity without having incurred any of the expenditure.

45. Also, in order to be entitled to claim a notional deduction an entity must be registered under s 27A of the Industry Research and Development Act 1986 (Cth) (IRD Act) in respect of the R&D activities the subject of the deduction because the notional deduction is only available to the extent that the expenditure is incurred on R&D activities 'for which the R&D entity is registered': s 355-205(a). Therefore, it must be the R&D entity that is registered. As Sunlite accepts, Sunlite acting in its capacity as a trustee is not an R&D entity. The IRD Act uses the same definition for R&D entity as is in ITAA97. Therefore, Sunlite in its trustee capacity cannot be a registered R&D entity."

The construction contended for by Sunlite was that the expenditure incurred by Sunlite in its capacity as trustee (for which Sunlite in its own capacity was liable as a matter of general law but which it did not otherwise incur) can be the subject of a notional deduction even though the entity that is Sunlite acting as trustee is not registered. The consequence of Sunlite's construction was that there could be a deduction when expenditure was being incurred by an entity (Sunlite as trustee of a trust) that could not be registered.

The Full Court said that the fundamental flaw of Sunlite's submission was that it ignored the terms of the legislation that require references to an entity that is a body corporate to be read as applying singularly to the body corporate acting in its own right and not to another entity (relevantly, the body corporate acting as trustee). The premise for the case advanced by Sunlite was that expenditure by Sunlite as trustee could be the subject of a notional deduction (on the basis that it was sufficient if it could be shown that Sunlite had a general law liability for the expenditure and that R&D activity was conducted for Sunlite in its own capacity) even though such an entity could not be registered for the R&D activities. That premise had not been established.

Observations

It is submitted that the decision of the Full Court in the *Sunlite* case is correct.

The question of the proper construction of a statutory definition arises with some frequency and can depend on a number of factors, including whether the definition of an expression provides what the expression means or includes.

A recent example of an issue that can arise in relation to a definition is to be found in the decision of the Full Federal Court in *Eichmann v FCT*.[23] In that case, there was a question of the meaning of the defined expression "active asset" that is relevant for the purposes of the operation of the active asset test that applies for the purposes of the small business CGT reliefs. McKerracher, Steward and Stewart JJ, in a joint judgment, said:

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

It is suggested that this observation may be expressed too widely. In that regard, the recent decision of the UK Supreme Court in *Moulsdale t/a Moulsdale Properties v Commissioners for His Majesty's Revenue and Customs*[24] is relevant. Lady Rose, giving the decision of the court, said:

"A point was raised at the hearing as to whether there was any significance to be attached to the term 'developer of land'. Here there was no intention or expectation that either Mr Moulsdale or Cumbernauld SPV would 'develop' the land in any ordinary sense of that word. As Lord Hoffmann said in *MacDonald v Dextra Accessories Ltd* [2005] UKHL 47 … at [18]:

'a definition may give the words a meaning different from their ordinary meaning. But that does not mean that the choice of words adopted by Parliament must

be wholly ignored. If the terms of the definition are ambiguous, the choice of the term to be defined may throw some light on what they mean.'"

Contrary context?

It is submitted above that the conclusion of the Full Federal Court in the *Sunlite* case is correct.

Most fundamentally, the definition of "R&D entity" in s 355-35(1) ITAA97 does not use the word "entity" on its own and thus there is no basis for introducing the defined concept of entity for the purposes of construing the definition. On this view, the definition of "R&D entity" is in fact an exhaustive one, particularly having regard to the note to s 355-35(1) which indicates that, apart from the circumstance described in the note, an entity acting as the trustee of a trust cannot be an R&D entity.

It will be noted that the definition of "entity" in s 995-1(1) ITAA97 applies, by reason of the opening words of the subsection, except so far as the contrary intention appears. That means that the statutory definition of "entity" in s 960-100(1) ITAA97 (and, it is suggested, the operation of the other provisions of that section) may be displaced by a contrary intention.

There is, it is submitted, such a contrary intention in the R&D provisions and there is no need to look outside the definition of "R&D entity" to determine the meaning of the concept of an "R&D entity".

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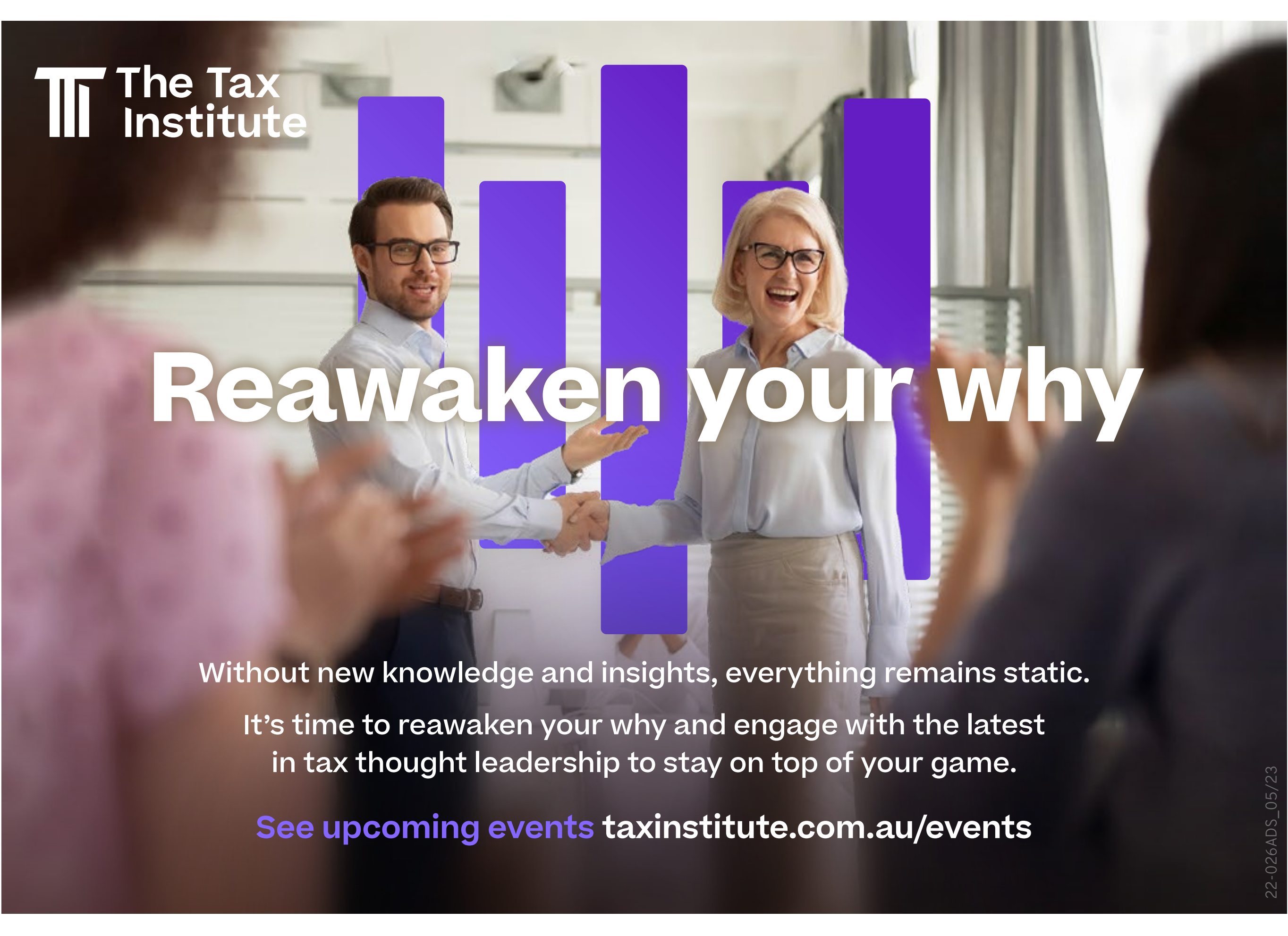
References

1 See ss 2-10 and 2-15 ITAA97.
2 [2023] FCAFC 43.
3 [2023] UKSC 12.
4 See s 195-1 of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth).
5 See s 136 of the *Fringe Benefits Tax Assessment Act 1986* (Cth).
6 *XQDX and FCT* [2021] AATA 4070.
7 The administrative penalty issue was not of any relevance in the appeal.
8 [2023] FCAFC 43 at [5].
9 [2017] HCA 34 at [14].
10 [2023] FCAFC 43 at [6].
11 [2023] FCAFC 43 at [8] and [9].
12 [2023] FCAFC 43 at [10] and [11].
13 [2019] FCAFC 141 at [104] and [147].
14 *Brooks v FCT* [2000] FCA 721 at [64] per Hill, Nicholson and Sundberg JJ.
15 [2023] FCAFC 43 at [16].
16 [2023] FCAFC 43 at [17].
17 [2023] FCAFC 43 at [18].
18 [2023] FCAFC 43 at [19].
19 [2023] FCAFC 43 at [23].
20 [2023] FCAFC 43 at [24] to [26].
21 [2023] FCAFC 43 at [40] to [42].
22 [2023] FCAFC 43 at [44] and [45].
23 [2020] FCAFC 155 at [45].
24 [2023] UKSC 12 at [64].



Mid Market Focus

by Peter Wirtz, HLB Mann Judd

R&D tax incentive developments

This month's column provides updates regarding important R&D tax incentive developments that occurred during the 2022–23 year.

Recent cases

In September and October 2022, decisions were handed down in two cases relating to the R&D tax incentive. Both of these cases highlight important considerations when determining whether an activity is eligible for the R&D tax incentive.

Eligible R&D activities are discussed in more detail below, but first we briefly look at the recent cases.

Moreton Resources

The first case is *Moreton Resources Ltd and Industry Innovation and Science Australia* (*Moreton Resources*),[1] which centred on whether activities in one tax year qualified as support activities when the core R&D activities were carried out in an earlier year.

Moreton Resources Ltd undertook a pilot project involving underground coal gasification, commencing in the 2010 financial year.

During 2010, Moreton Resources Ltd carried out a number of activities, including the construction and commissioning of a pilot gas processing plant. These activities were accepted as being core R&D activities, and therefore eligible for the R&D tax incentive.

In the 2012, 2013 and 2014 financial years, Moreton Resources Ltd carried out a range of activities, mostly related to environmental protection, including the process for rehabilitating the site and decommissioning the pilot plant.

The pilot project was abandoned in the 2014 financial year.

Innovation and Science Australia determined that the activities carried out in the 2012, 2013 and 2014 years were not core activities as they were not subject to experimental risk. Nor were they support activities as they did not have a "direct close and relatively immediate relationship" with the experimental activities, and the time lapse between these activities and the core activities carried out in 2010 was too great.

The AAT held that the activities were supporting R&D activities based on a holistic analysis of the circumstances. It concluded that these activities were directly related to the core R&D activities on the following three bases:

1. any remediation of the site of the pilot project was an incidental part of the project. The steps taken in 2012, 2013 and 2014 were directly related to the pilot project commencing in 2010;
2. the activities carried out in 2012, 2013 and 2014 were directly related to the pilot project as they could not occur in isolation or in relation to any other activity; and
3. if the pilot project had not been conducted, the remediation activities would not have been required.

Based on this, it was determined that the activities in 2012, 2013 and 2014 were undertaken for the dominant purpose of supporting the core R&D activities.

TDS Biz

The second case is *TDS Biz Pty Ltd and FCT* (*TDS Biz*),[2] which considered the eligibility of support R&D activities carried out overseas.

TDS Biz Pty Ltd was designing and developing an electric tricycle.

During the 2018 financial year, TDS Biz Pty Ltd received invoices totalling $1,280,742 to produce vehicle components, and $332,720 for the production of electrical components. Each of these components was developed overseas on TDS Biz Pty Ltd's behalf.

When registering for the R&D tax incentive, TDS Biz Pty Ltd did not mention that the R&D activities to produce the components for the prototype were conducted overseas. Rather, the company claimed that these activities were merely a supply of parts and components from China.

The AAT held that the development of the components was a support R&D activity, not the mere supply of existing items. As these activities were conducted overseas, they required an overseas finding in order to be eligible for the R&D tax incentive.

As TDS Biz Pty Ltd did not have an overseas finding covering these activities, the related costs were disallowed.

This decision has been appealed to the Federal Court.

R&D activities

R&D activities can be broken down into two categories: core R&D activities and support R&D activities.

In order to be eligible for the R&D tax incentive, a company must conduct, or intend to conduct, at least one core R&D activity. There can be any number of support activities.

Core R&D activities

Core R&D activities are defined in s 355-25(1) of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) as being experimental activities:

> "(a) whose outcome cannot be known or determined in advance on the basis of current knowledge, information or experience, but can only be

determined by applying a systematic progression of work that:

(i) is based on principles of established science; and

(ii) proceeds from hypothesis to experiment, observation and evaluation, and leads to logical conclusions; and

(b) that are conducted for the purpose of generating new knowledge (including new knowledge in the form of new or improved materials, products, devices, processes or services)."

The decision of whether the outcome of the activities can be determined in advance should be based on the opinion of a competent professional, with knowledge, skills and expertise in a relevant field. This should include a worldwide search for existing ways to achieve the outcome.

As knowledge is seldom gained in isolation, it is important to consider whether a solution which works in one particular industry, or a specific location, will necessarily work in another industry or location.

This is illustrated in the original AAT decision in *Moreton Resources*. Underground coal gasification technology had previously been successfully demonstrated in other parts of the world. However, the tribunal accepted that there was no certainty that it would work in Moreton Resource Pty Ltd's location.

A core R&D activity should be clearly documented and include a clear hypothesis, the steps that would be undertaken to test the hypothesis, and the process for measuring success or failure of these tests. This should include a clear, measurable criteria for success.

Excluded activities

Section 355-25(2) contains a list of activities which are specifically excluded from being core R&D activities. These activities are:

"(a) market research, market testing or market development, or sales promotion (including consumer surveys);

(b) prospecting, exploring or drilling for minerals or petroleum for the purposes of one or more of the following:

(i) discover deposits;

(ii) determining more precisely the location of deposits;

(iii) determining the size or quality of deposits;

(c) management studies or efficiency surveys;

(d) research in social sciences, arts or humanities;

(e) commercial, legal and administrative aspects of patenting, licensing or other activities;

(f) activities associated with complying with statutory requirements or standards, including one or more of the following:

(i) maintaining national standards;

(ii) calibrating secondary standards;

(iii) routine testing and analysis of materials, components, products, processes, soils, atmospheres and other things;

(g) any activity related to the reproduction of a commercial product or process:

(i) by physical examination of an existing system; or

(ii) from plans, blueprints, detailed specifications or publicly available information;

(h) developing, modifying or customising computer software for the dominant purpose of use by any of the following entities for their internal administration (including the internal administration of their business functions):

(i) the entity (the ***developer***) for which the software is developed, modified or customised;

(ii) an entity connected with the developer;

(iii) an affiliate of the developer, or an entity of which the developer is an affiliate."

While these activities cannot be core R&D activities, they can be supporting activities.

Supporting R&D activities

As the name suggests, supporting R&D activities are activities which support the company's core R&D activities.

A more formal definition is contained in s 355-30(1) ITAA97, which states that "supporting R&D activities are activities directly related to core R&D activities".

However, s 355-30(2) adds the additional requirement that an activity will only be a supporting R&D activity if it is undertaken for the dominant purpose of supporting core R&D activities where it is one of the following:

- an activity which s 355-25(2) would exclude from being a core R&D activity;
- an activity which produces goods or services; or
- an activity which is directly related to producing goods or services.

This additional requirement is highlighted in *Moreton Resources* and the AAT's conclusion that the environmental protection activities were only undertaken because of their connection with the core R&D activities related to the pilot gas plant.

Moreton Resources also highlights that the support R&D activities and the core R&D activities do not need to occur in the same year in order to be eligible for the R&D tax incentive. A support R&D activity can take place before, during or after the core R&D activity to which they relate.

Foreign R&D activities

As with most tax concessions, the R&D tax incentive is intended to benefit the Australian economy. To this end,

s 355-210 ITAA97 sets out a number of additional eligibility requirements where there are international dealings related to the R&D activities, whether that involves foreign entities or R&D activities carried out overseas.

These requirements include that R&D activities which are undertaken solely or partially outside of Australia be covered by a finding under s 28C(1)(a) of the *Industry Research and Development Act 1986* (Cth).

Section 28D of the *Industry Research and Development Act 1986* sets out the following four eligibility requirements for granting an overseas finding:

1. the overseas activity must be an R&D activity;
2. the overseas activity must have a significant scientific link with one or more core R&D activities carried out solely within Australia, and must be registered, or intended to be registered, for an income year;
3. the overseas activity cannot be conducted in Australia because:
    a. it requires access to facilities, expertise or equipment not available in Australia;
    b. conducting it in Australia would contravene the *Biosecurity Act 2015* (Cth) or a law relating to quarantine;
    c. it requires access to a population (of living things) not available in Australia;
    d. it requires access to a geographical or geological feature not available in Australia; or
    e. it meets a condition specified in regulations made for the purposes of s 28D; and
4. the actual, or reasonably estimated, expenditure on overseas activities must be less than the actual, or reasonably anticipated, expenditure on Australian activities in all income years.

An overseas activity will have a significant scientific link to Australian core activities where the Australian core activities cannot be completed without the overseas activities being completed.

The *TDS Biz* case does not specifically consider the application of these eligibility requirements due to the fact that the company accepted that they were not met. However, it illustrates the need to meet all of the requirements.

The AAT determined that the overseas activities were R&D activities related to the development of the components. Therefore, the first requirement will have been met.

The core R&D activities of developing an electric trike could not occur without the development of the underlying components. Therefore, the second requirement will have been met.

However, from the information which is available, it is unlikely that the development of these components could not have occurred within Australia. Therefore, the third requirement will have been failed.

As the third requirement will have been failed, it is not necessary to consider the fourth requirement. However, it would be reasonable to assume that the costs of developing the components would be less than the Australian costs of developing the electric trike overall.

Registering R&D activities

Once it has been determined that activities meet the requirements of being R&D activities, they must be registered with AusIndustry prior to an R&D tax incentive claim being lodged, with the registration number included in the relevant income tax return.

Applications for registration must be lodged with AusIndustry within 10 months of the company's year-end. For companies with a standard 30 June year-end, the final date for applications to be lodged is 30 April, the following year.

Where a claim includes foreign R&D activities, the company must apply for an overseas finding prior to the end of the financial year in which the expenditure occurs.

Both the registration of R&D activities and overseas findings can cover multiple years, removing the need to lodge a new application each year. However, it is necessary to consider whether the actual activities undertaken are consistent with these covered by the registration.

Conclusion

The decision in *Moreton Resources* and *TDS Biz* should provide clarity to companies claiming the R&D tax incentive, with the Federal Court finding in favour of the legislative interpretation of "R&D activities" and "supporting activities". This highlights that following the legislative definitions relating to the R&D tax incentive program is crucial when preparing a successful application.

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Discretionary trusts: are they still effective?

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Discretionary trusts have been a constant staple for professional advisers when arranging their tax planning and asset protection strategies. However, their utility in this respect has come into sharp focus in recent times, whether it be the wider scope given to s 100A ITAA36 to limit the use of discretionary trusts to split income, the end of sub-trust arrangements to prevent Div 7A ITAA36 from applying to unpaid present entitlements, or distributions ostensibly made within the terms of a trust deed being ruled invalid. This article explores such recent developments, including the *Guardian* and *BBlood* litigation, and PCG 2021/4 on splitting professional services income. Moreover, it aims to outline what things advisers now need to be aware of when considering whether to use discretionary trusts as part of their tax planning and asset protection strategies. From an international perspective, the article also details recent developments for Australian discretionary trusts with overseas beneficiaries.

Introduction

In the past year or so, there has been an appreciable amount of significant developments in the way that tax laws are to be applied trusts, especially the most commonly used trust of all, the "family discretionary trust". These developments have emerged through several landmark rulings issued by the ATO aimed at limiting the ability to achieve lower tax rates on trust distributions by splitting income earned by professionals. The rulings achieve this by, among other things, restricting the use of unpaid present entitlements (UPEs) to adult beneficiaries with lower marginal tax rates and "bucket companies". There have also been seminal Federal Court and High Court cases that, respectively, have considered the tax implications of non-resident beneficiaries receiving trust distributions of gains from property that is not taxable Australian property (non-TAP) and the ability of beneficiaries to avoid the tax consequences of distributions made to them through disclaiming their interest in a trust distribution.

This article explores each of these developments and the implications that they will have in practice, with a view to outlining what things advisers now need to be aware of when providing advice on tax issues associated with family trusts. In particular, the article will consider:

- the ATO's recent PCG 2021/4 on professional services income;
- TR 2022/4 on the ATO's revised views on the application of s 100A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36), and the recent Federal Court litigation on s 100A;
- TD 2022/11 on the ATO's revised views as to when a UPE and sub-trust arrangement will constitute financial accommodation and therefore a loan for Div 7A ITAA36 purposes;
- the High Court's decision in *FCT v Carter*[1] (*Carter*) on the tax consequences of beneficiaries disclaiming their interests to trust distributions post-30 June; and
- the Full Federal Court's decision in *Peter Greensill Family Co Pty Ltd (Trustee) v FCT*[2] (*Greensill*) on the distribution of capital gains from non-TAP assets to foreign beneficiaries.

The article also draws the reader's attention to some other issues to be aware of in relation to non-resident beneficiaries and the utility of family trusts as an asset protection vehicle following the decision in *Owies v JJE Nominees Pty Ltd*[3] (*Owies*).

Overview

The majority of the recent concern and focus among tax advisers and their clients who utilise trust structures to split income has been directed towards the ATO's revised interpretation of s 100A in TR 2022/4. However, in a number of circumstances, other provisions and ATO pronouncements will come into play to prevent lower rates of tax being utilised on trust income, through the splitting of that income via trust distributions to entities with lower marginal rates. This is particularly evident in relation to trust income associated with professional services, where the personal services income rules (PSI rules) and PCG 2021/4 should be considered first.

PSI rules

As part of updating its position on the ability of trusts to split income, it is no surprise that the ATO also issued an updated public ruling on the PSI rules with the release of TR 2022/3. In fact, PCG 2021/4 only applies to income earned by an individual professional practitioner (IPP) who is not subject to the PSI rules.[4] Accordingly, in cases involving IPPs, the application of the PSI rules must be considered first.

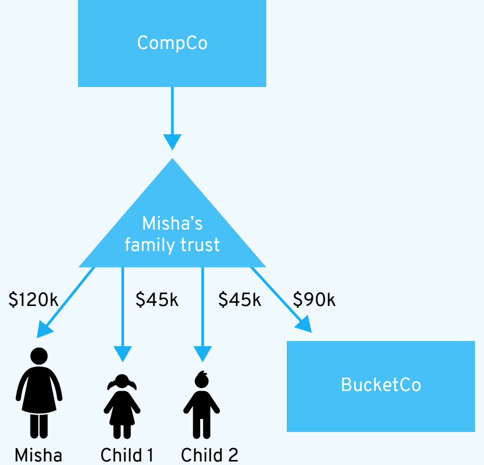
In the context of trusts, the PSI rules are designed to prevent individuals from reducing their tax by alienating their PSI to a trust (PS trust), which can in turn distribute that income to associates of the individual who pay tax at lower marginal rates. The PSI rules do this by including the

individual's PSI alienated to a PS trust in that individual's own assessable income.[5] In such cases, s 100A will not get a look in as the income in issue will be taxed in the hands of the individual and be non-assessable non-exempt income of the PS trust.[6]

A fairly standard scenario where this can apply is set out in example 1.

Example 1

Misha is a computer software engineer earning $300k. For many years, she was employed by CompCo. However, after successfully working from home for two years during the COVID-19 pandemic, CompCo asked Misha if she would consider setting up her own trust and for CompCo to contract with her trust to provide engineering services. Misha is told that she could keep the tax rate on her income below 34.5% by distributing $90k of that income between her two adult children at university, with the balance being paid to a bucket company. Is this wise?



Since more than 80% of Misha's PSI is from one client, Misha's family trust will not be a personal services business, unless the "results test" is satisfied,[7] and the $300k paid to it will be treated as Misha's personal income. However, even if the results test is passed, the ATO has indicated that it will look to apply Pt IVA ITAA36 to such arrangements where income derived from personal services is split among other family members who have a lower marginal rate of tax than the person providing the personal services, through the use of interposed trusts.[8] This is particularly the case where "there is very little, if any, outward sign of change in the method by which the income is derived from the former employer. The taxpayer continues to work for the former employer and performs the same functions for the same overall remuneration".[9]

Another related scenario where the PSI rules and Pt IVA could have application is in relation to service trust type arrangements involving professional staff. These types of service trust arrangements are far removed from the type in *FCT v Phillips*[10] (involving a service trust providing essential non-professional administrative and human resources services to a professional services business), which the ATO is willing to accept,[11] and are thus likely to come under close scrutiny.

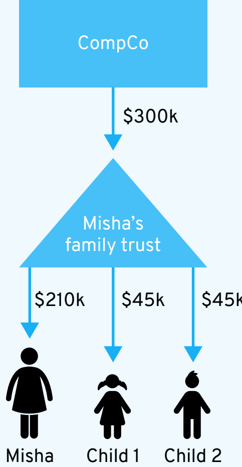
Redirecting IPPs' income through trusts

The ATO released PCG 2021/4 in March 2021 to provide guidance on its compliance approach to the allocation of income from professional services firms in the assessable income of IPPs. It replaced earlier guidelines which provided straightforward bright-line tests for when the ATO would not take any compliance action in relation to IPPs splitting income among associated entities. These tests included the IPP being assessed on 50% of the income which they and their associated entities were entitled to receive, or that income being assessed at an effective tax rate of 30%. Those guidelines were suspended and PCG 2021/4 was released as the ATO was, as a matter of administrative practice, precluded from applying Pt IVA to arrangements that passed such bright-line tests under those guidelines, but which the ATO considered to be tax, and not commercially, driven.[12]

Example 2 considers how PCG 2021/4 could apply to a slightly revised version of the facts as set out in example 1, assuming that the PSI rules do not apply due to the results test being satisfied, and assuming that the ATO has not provided any indication that it will look to apply Pt IVA on the basis explained in TR 2022/3.

Example 2

Misha is advised that paying 60% of Misha's trust income to associated entities may raise some issues with the ATO and that, if she pays 70% of the income to herself, her arrangements will be considered as "low risk". She is also advised that distributing trust income to BucketCo may cause some Div 7A issues, so she decides to only distribute to her two children. Will this revised arrangement be low risk?



Under the suspended guidelines, this arrangement would be considered low risk as over 50% of the income earned by the Family Trust is included in Misha's assessable income. Under PCG 2021/4, it would also

Example 2 (cont)

appear to be considered low risk. Misha is receiving 70% of the profit entitlement, giving a score of 3 for factor 1. The total effective tax rate on the amounts distributed will be just over 25%, giving a score of 4 for factor 2. Accordingly, this will give a total risk rating of 7, and thus be in the "green zone". However, and herein lies the point, this risk assessment guidance in PCG 2021/4 will have no application unless the two gateways are passed.[13]

The ATO has indicated that the issues considered under the gateways would form part of any Pt IVA analysis and that, accordingly, PCG 2021/4 should be used to understand the risk of Pt IVA applying.[14] As such, PCG 2021/4 achieves the objective of, in essence, causing Pt IVA to be considered upfront, without actually stipulating that it must.

Gateway 1 looks at whether the way in which the profits are distributed can be explained on a commercial footing. The ATO considers that the following factors suggest an arrangement lacks a sound commercial rationale:

- the arrangement is unnecessarily complex;
- the arrangement includes steps which serve no purpose other than to gain a tax advantage, like interposing an entity to access a tax benefit;
- tax results do not match economic results;
- the arrangement involves minimal risk where risks are expected;
- the arrangement involves non-commercial terms, especially the IPP's remuneration being less than a true comparable figure; and
- there is a gap between the substance of what is achieved under the arrangement and its legal form.

These are typical Pt IVA considerations. Apart from providing that a measure to gauge if an arrangement satisfies gateway 1 is if the IPP's remuneration represents a true comparable, these guidelines are rather nebulous and of little comfort to taxpayers seeking some certainty with their tax affairs.

If a taxpayer considers they can pass gateway 1, the considerations around whether they satisfy gateway 2 are more prescriptive in that the ATO has identified four high-risk features. The first of these is financing arrangements where related parties of an IPP use finance to acquire an existing portion of the IPP's equity interest in a professional firm. The ATO will take umbrage to arrangements such as those in *FCT v Hart*,[15] where money borrowed to acquire the IPP's equity interest, for which interest deductions can be claimed, is used to pay down non-deductible debt like a mortgage over the IPP's residence.[16]

The second high-risk feature is where there are mismatches between taxable and accounting income, particularly where trust income is smaller than taxable income. An example of this is where intangible assets are impaired under accounting standards, creating a non-cash accounting expense that does not give rise to a tax deduction.[17] This could allow a beneficiary in a lower tax bracket to receive all of the trust's income and thereby be assessed on the trust's entire taxable income, while another beneficiary in a higher tax bracket receives the excess cash that does not form part of the trust's income, as a result of the accounting expense following the impairment, as a tax-free distribution of corpus.[18]

The third high-risk feature is issuing shares or units without voting rights to "non-equity" partners so that they can receive dividends or distributions linked to personal performance. The ATO specifically identifies dividend access share arrangements in this context as being the type of shares that would prevent gateway 2 from being satisfied.[19] This, combined with the final high-risk feature, shows that PCG 2021/4 is squarely directed at arrangements that are trying to split non-equity partners income among the partner's associated entities.

The final high-risk feature is non-equity partners undertaking an *Everett* assignment. The ATO considers that such assignments, by partners who are not required to make a capital contribution, have a fixed draw, and minimal rights to participate in management are materially different in principle to *Everett* and *Galland* assignments. However, this not easily reconcilable with the decisions in *Everett*[20] and *Galland*.[21]

In *Everett*, the Commissioner made similar arguments to those raised in PCG 2021/4, namely, that the partner in issue could not alienate any part of their interest in the partnership income as it was income from personal exertion. In rejecting that argument, the majority held that this proposition was "not true of partners in general", and:[22]

> "[e]ven if it were accurate to so describe it, we cannot think that this in itself would constitute a reason for saying that an assignment of a share in the respondent's interest carrying with it the right to a proportionate part of the partnership profits would not be immediately effective to vest the right to future income in his wife."

In *Galland*, Brennan J stated:[23]

> "If it were open to regard the net income of the partnership as the fruit of the partners' exertions rather than as the fruit of their shares, it would be open to argue that at least so much of the taxpayer partner's interest in the net income of the partnership of the year of income as reflected the assessable income of the partnership earned prior to the assignment was unaffected by the assignment. But that argument is inconsistent with the governing hypothesis."

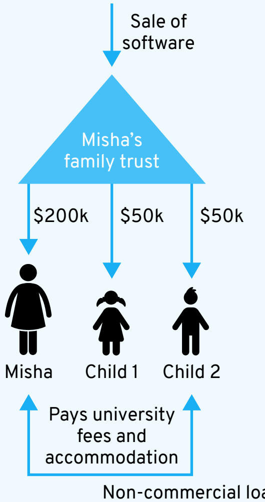
As the "governing hypothesis" is the principle laid down in *Everett* and that does not seem to accord with the Commissioner's position in PCG 2021/4, this aspect of PCG 2021/4 could be open to challenge.

Reimbursement agreements: s 100A

Example 3 highlights that s 100A can apply to all types of income, not just personal services income, and therefore must be considered when the PSI rules and PCG 2021/4 are not applicable. Moreover, the discussion that follows shows that s 100A may apply to arrangements that appear to satisfy gateways 1 and 2 in PCG 2021/4 and that may not invoke Pt IVA.

Example 3

Following on from example 2, Misha decides that it's all too hard being a professional adviser and instead develops engineering software that she sells through a business conducted under Misha's Family Trust. The trust earns $300k and distributes $50k to child 1 who is studying at Sydney University to cover her educational expenses, $50k to child 2 who is on a gap year, and $200k to Misha. Child 2 lends the $50k to Misha on a non-interest, no set time to repay basis.



Does Misha have anything to be concerned about with respect to s 100A?

Historically, no, but with the release of TR 2022/4 on the application of s 100A, coupled with the ATO's compliance approach in PCG 2022/2 in December 2022, along with the recent decisions in *BBlood Enterprises Pty Ltd v FCT*[24] (*BBlood*) and *Guardian AIT Pty Ltd ATF Australian Investment Trust v FCT*[25] (*Guardian*), things have certainly changed.

Dissecting these publications and cases in detail would be a full article in itself. As such, what this section of the present article aims to achieve is to distil some of the key points as to how each of the requisite elements of s 100A are to be applied to assist with determining when s 100A could have application to a particular factual situation. First, coming back to example 3, it is likely that there would be no issue with the distribution to child 1 if all of the distribution is used to cover university fees and associated costs.[26] However, the ATO would likely apply s 100A to the arrangement with child 2 such that Misha's family trust would be taxed on that $50k distribution.[27]

Element 1: agreement

An "agreement" for s 100A purposes is broadly defined to include arrangements and understandings that can be informal or implied, and need not be enforceable or even intended to be enforceable.[28] Importantly, an agreement can include a series of interconnected transactions or steps intended to operate in conjunction with each other.[29]

In *BBlood*, one overarching agreement was found to exist in relation to a series of transactions involving the amendment to the definition of income in the trust deed, the introduction of a new corporate beneficiary, a share buy-back, the injection of income into a trust, and the distribution of that income to the new corporate beneficiary.

As such, it appears in practice that there will, in all but exceptional cases, be an agreement for s 100A purposes, unless the agreement is entered into in the course of an ordinary family or commercial dealing.

Element 2: not an "ordinary family or commercial dealing"

The taxpayer bears the onus of establishing that the agreement was entered into in the course of an ordinary family or commercial dealing.[30] While the individual steps will be relevant, they cannot be viewed in isolation. Rather, the agreement as a whole must be considered.[31]

In construing the first part of this element, "ordinary family", the word "ordinary" is to be "used in contradiction to 'extraordinary'".[32] However, the Commissioner notes that "[w]hat is commonplace is not the test", if the arrangement does not achieve family or commercial objectives.[33] In that respect, the agreement must not have aspects which lack commercial motivation and justification.[34] Indicators of this are where a beneficiary's entitlement is lent without any intention of being repaid or where it is gifted to an associate, or other arrangements where a party does not advance their own interest.[35]

While unusual and complex agreements can tend to intimate that this element will be satisfied, they will not if the complexity can be shown to be necessary to achieve a specific family or commercial outcome.[36] By way of comparison, the complex arrangements in *BBlood* involving the buy-back of the trust's shares for over $10m, the establishment of a new corporate beneficiary and the distribution of trust income to it were not explicable on the basis of family succession. The alleged family succession was based on individuals holding shares in the new corporate beneficiary to which the funds were to be directed, rather than the trust holding shares in the company with the funds as was previously the case. However, after the agreement was implemented, the vast majority of funds were retained as corpus of the trust and not distributed to the new corporate beneficiary.[37]

In contrast, in *Guardian*, it was accepted that the introduction of a new corporate beneficiary to receive amounts other than franked distributions paid to the trust from trading companies that the trust held shares in, and from other investments of the trust, was an ordinary

family or commercial dealing. Logan J in the first instance accepted that this was a legitimate asset protection strategy in connection with the retirement of the controller of the entities in issue.[38] It allowed for wealth to be shielded from creditors of the trading entities and avoided the need to make large distributions to individuals.[39]

Unlike in *BBlood*, the evidence showed that the newly introduced corporate beneficiary was actually used for the stated purpose as it accumulated wealth of $3.18m.[40] This test therefore appears to gain greater clarity in hindsight. In addition, it shows that the introduction of a new beneficiary will not always invoke the operation of s 100A, despite the fact that s 100A was specifically introduced to address trust stripping.[41]

Element 3: reimbursement/benefits to another requirement

For an agreement to constitute a reimbursement agreement pursuant to this criterion, as set out in s 100A(7), the agreement must provide for the payment of money, the transfer of property, and the provision of services or other benefits[42] to someone other than the presently entitled beneficiary. This was the central criterion on which *Guardian* was decided. In *Guardian*, it was held that this agreement to provide benefits, namely, the reimbursement agreement, must precede the provision of the benefit and importantly the present entitlement of the beneficiary.[43]

In relation to the first year in issue in *Guardian*, at the time the corporate beneficiary was made presently entitled to income from the trust, there was no contemporaneous evidence that the parties had contemplated that the corporate beneficiary would subsequently provide the benefit of that entitlement, less the tax it paid on it, back to the trust by declaring a fully franked dividend in favour of the trust, which would in turn distribute that dividend to a non-resident beneficiary on a tax-free basis.[44] The controller of the corporate beneficiary had not been advised of the possibility at that time. Accordingly, s 100A had no application in that year, as no agreement for the corporate beneficiary to provide the benefit for which it had been made entitled back to the trust, by way of a dividend, existed when the corporate beneficiary was so made presently entitled to that benefit.[45]

In later years, the fact that the payment of a dividend to the trust and the distribution of that dividend to the non-resident beneficiary, following the same corporate beneficiary receiving trust income, was not "wholly conjectural", was not enough to show that a reimbursement agreement existed.[46] There had to be "consensus and adoption" of the agreement to provide the benefit.[47] Where that reimbursement comes from the beneficiary, that consensus and adoption must come from the beneficiary or those in control of it.[48]

In *BBlood*, the taxpayer proffered that s 100A(7) should be construed on the basis that a reimbursement agreement only ensues in situations in which the beneficiary made presently entitled to trust income does not retain that income (or the majority of it), but instead, through an agreement for a payment, provides the benefit of that income to someone else.[49] On that basis, the taxpayer argued that there was no reimbursement agreement, as the presently entitled beneficiary retained all of the income to which it was entitled for its own benefit.[50]

However, Thawley J held that "[t]he phrase 'reimbursement agreement' is no more than a convenient label" and does not require that the payment referred to in s 100A(7) be a reimbursement of the beneficiary's present entitlement.[51] Accordingly, the payment of buy-back proceeds to the trust that were not distributed to the beneficiary, but on which the beneficiary was assessed,[52] due to the mismatch between treating that payment as corpus for trust purposes and income for tax purposes, was held to constitute a reimbursement agreement for the purposes of s 100A(7).[53]

Element 4: tax avoidance

As things stand, following the *Guardian* and *BBlood* decisions, there is little clarity as to how this element is to be applied. There appears to be no question that the taxpayer bears the onus of establishing that the reimbursement agreement was not entered into for a tax avoidance purpose.[54] It is from here that matters become somewhat murky.

In *BBlood*, Thawley J held that, unlike to invoke an application of Pt IVA, it is not necessary, for s 100A(8) purposes, that an "alternative postulate" be established so as to identify a specific amount of tax that would be avoided by entering into the reimbursement agreement.[55] Rather, "it is sufficient if it can be said that the purpose [of entering into the reimbursement agreement] was one of securing that a person not be liable to income tax or be liable to less income tax".[56] Moreover, the tax reduction purpose need not be the sole or dominant purpose of the parties or a party for entering into the agreement.[57] Instead, it only needs to be one of the purposes of the parties or a party for entering into the agreement.[58]

In determining the purpose of a party, Thawley J held that enquiries should not be limited to objective facts but can include the subjective evidence of the parties involved.[59] Furthermore, his Honour held that, although the controller of the taxpayer entities did not understand the detail of the transactions that gave rise to the reduction in tax, the relevant purpose was still established. This was on the basis that either:[60]

- the controller, on the balance of probabilities, understood that the overall effect of the transactions was to reduce the tax payable on the distribution of retained profits from a company to a trust; or
- the advisers who formulated those transactions for that purpose were a party to the agreement or understanding to implement the transactions.

That advisers may not enter into the individual transactions making up the reimbursement agreement does not mean they are not a party to the agreement or understanding to implement those transactions. They will be if there is an understanding that they, along with the entities they are

advising, will each do what they need to do to implement the transactions.[61] The Commissioner goes further and states that, even where an adviser is not a party to the agreement, their purpose may be attributed to another party if that other party acts in accordance with the adviser's advice.[62]

Although in *Guardian*, both in the first instance and on appeal, it was not strictly necessary for the courts to consider the interpretation of s 100A(8) as it was held that no reimbursement agreement existed, Logan J did provide some observations. His Honour, relying on Hill J's comments in *East Finchley Pty Ltd v FCT*[63] as to how s 100A(8) should be applied, considered that it does require an alternative postulate to be formulated as to what tax would become payable if the reimbursement agreement had not been entered into.[64] Logan J considered that this test is an objective one, and that evidence from the parties may be relevant but is in no way determinative.[65] As such, his Honour put far lower weight on the parties' own evidence than Thawley J in *BBlood*.

The Full Federal Court did not provide any direct comments on s 100A(8) and gave no indication to suggest that Logan J's comments in that regard were incorrect.[66] However, of relevance, and apparently contrary to *BBlood* and the Commissioner's position in TR 2022/4, the court held that the scope for attributing the purpose of an adviser to a taxpayer is far more limited than in the context of Pt IVA, such that there will be difficulty in finding that a reimbursement agreement exists based solely on the intention of the adviser.[67]

Accordingly, until the judgment of the Full Federal Court is handed down in the appeal to *BBlood*, the application of this element is troublingly uncertain.

Element 5: connection requirement

The final requirement is that the relevant beneficiary's present entitlement arose out of the reimbursement agreement found, or arose by reason of any act, transaction or circumstance in connection with that reimbursement agreement.[68] This element was not considered in *Guardian* but was considered in *BBlood*.

Thawley J held that this element:[69]

> "… does not pose the question whether, 'but for' the reimbursement agreement, it 'could reasonably be expected' that the beneficiary would have been presently entitled to the same share of trust income …"

His Honour therefore dismissed the taxpayer's argument that, but for the reimbursement agreement, the trust would have still distributed the same amount to the bucket company as the bucket company kept that income.[70] Thawley J instead observed that making the bucket company presently entitled to the trust's income was central to create "the mismatch between trust income and net income on which the tax result depended", and as such, it plainly arose out of the reimbursement agreement.[71] It follows that it is sufficient if there is an identifiable connection between the present entitlement and the reimbursement agreement or some other act, transaction or circumstance pertaining to, or resulting from, the reimbursement agreement.

TD 2022/11

In late 2010, the Commissioner forever changed the utility of trusts for tax planning purposes when he released TR 2010/3 and PS LA 2010/4 to provide practical guidance on TR 2010/3. In TR 2010/3, the Commissioner for the first time ruled that a UPE could constitute a loan for Div 7A purposes.[72] However, in PS LA 2010/4, the Commissioner accepted that a UPE will not constitute a Div 7A loan if the funds representing it are held on a sub-trust and lent to the main trust, on the basis that the main trust pays certain commercial interest rates over a seven- or 10-year term, with the principal being repaid at the end of that term to the sub-trust.[73]

This concession of sorts was provided in the expectation that the treatment of UPEs for Div 7A purposes would be dealt with through legislative or judicial intervention. However, this was not forthcoming. Nevertheless, the release of PCG 2017/13, where the Commissioner stated that the approach in PS LA 2010/4 will cease in respect of sub-trust arrangements maturing at 30 June 2018, provided a conspicuous forewarning of what was to come for sub-trust arrangements.[74]

This time came on 13 July 2022 with the release of TD 2022/11. In TD 2022/11, the Commissioner departed from his previous view that no financial accommodation will be provided where a sub-trust, of the funds representing the UPE, is invested with the main trust on terms entitling the sub-trust to commercial interest and repayment of principal after seven or 10 years.[75]

Instead, he determined that, where a sub-trust arrangement is put in place, the private company beneficiary will be taken to provide financial accommodation where, by arrangement, understanding or acquiescence, they consent to the sub-trustee using the funds of the sub-trust for the benefit of a shareholder of the company or an associate of a shareholder.[76] Importantly, this will be the case regardless of whether the sub-trust receives a commercial return for the provision of the funds.[77] This means that sub-trust arrangements, consistent with the requirements in PS LA 2010/4, will result in the provision of financial accommodation, and will therefore constitute a loan for Div 7A purposes.

The loan will be taken to be provided at the point in time when the private company has knowledge of the use of the sub-trust fund for the benefit of its shareholder/s or their associate/s and does not call for payment.

As such sub-trust arrangements arise in the context of family discretionary trusts, the main trust will invariably be a shareholder or an associate of a shareholder in the company beneficiary. Moreover, the company beneficiary and trustee will usually have the same directing mind. Therefore, the company beneficiary will be deemed to have knowledge of the use of the sub-trust fund when the trustee does.[78] Accordingly, the only likely occasion where the use

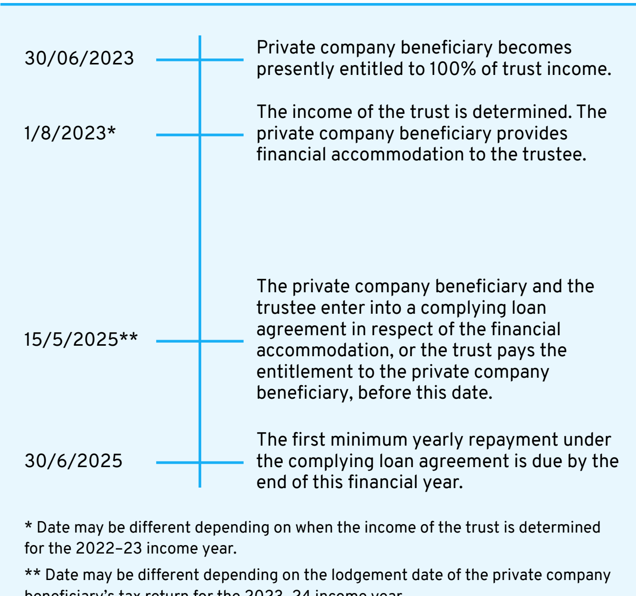
of a sub-trust will not give rise to a Div 7A loan is where the funds are not intermingled with the funds of the main trust or used to benefit the main trust (such as by being used as security for loans of the main trust), but are instead held with a third party for the absolute benefit of the company beneficiary.[79]

TD 2022/11 only applies to trust entitlements arising on or after 1 July 2022.[80] The Commissioner has also indicated that he will not devote resources to sub-trust arrangements conducted in accordance with PS LA 2010/4 that commence after 30 June 2022, where the entitlement to which the sub-trust relates arose before 1 July 2022.[81] Further, TD 2022/11 does not apply to UPEs that arose before 16 December 2009.[82] Such UPEs therefore, for the time being at least, remain quarantined from the application of Div 7A.

In most cases, the actual amount of the beneficiary's entitlement will not be known until after the end of the financial year in which it is declared. This is because the distributable income of the trust for a financial year can usually only be determined when the accounts are finalised after year end.[83] In addition to having knowledge of the amount that they can demand, the company beneficiary also needs to make a choice or acquiesce to not demanding payment of that amount. So, the beneficiary needs to be given an opportunity to make that decision. Again, in most cases, it would be reasonable for the company beneficiary to call for that payment in the financial year following the entitlement.[84] Practically, what this means is that TD 2022/11 will apply to entitlements that arise on 30 June 2023 or later, such that the earliest time financial accommodation will arise on the basis of the Commissioner's position in TD 2022/11 is the 2023–24 financial year.[85]

The timeline in Diagram 1 shows that no compliance action will likely be required by way of paying the UPE to the company, or the trust and the company entering into a complying loan agreement, before the company's lodgment day for the 2023–24 financial year.

Diagram 1. Compliance timeline: 30 June 2023 entitlements



Carter: disclaiming distribution of income

In *Carter*, the trustee of a family discretionary trust failed to appoint or accumulate any income of the trust prior to 30 June of the relevant financial year. This enlivened a default distribution clause in the trust deed governing that trust, resulting in the income of the trust being automatically distributed to five default beneficiaries, who were the children of the controller of the trust, seemingly without their knowledge.[86] Some months after the end of that financial year, those default beneficiaries sought to disclaim their default distributions.[87] Accordingly, the issue to be decided was whether this disclaimer, made after the end of the relevant financial year, was effective to prevent the default beneficiaries from being assessed on the distributions made to them in that financial year.[88]

The High Court held that:[89]

> "... the question of the 'present entitlement of a beneficiary to income of a trust must be tested and examined 'at the close of the taxation year', not some reasonable period of time after the end of the taxation year."

To hold otherwise:[90]

> "... would give rise to uncertainty in the identification of the beneficiaries presently entitled to a share of the income of a trust estate and the subsequent assessment of those beneficiaries."

The High Court recognised that the construction they adopted might give rise to some unfairness in that a beneficiary might be presently entitled to an amount at the end of a financial year that they will be taxed on for which they are unaware.[91] However, the High Court noted that this unfairness is built into the way in which s 97 ITAA36 is drafted through taxing a beneficiary "by reference to present entitlement, not receipt".[92] Therefore, care needs to be taken when drafting trust deeds as to who should be named, and deeds in existence should be reviewed to determine who should remain, as default beneficiaries to avoid what will be unintended irreversible tax consequences.

Foreign beneficiaries

Greensill: gains on non-tap assets

The Greensill case involved the appeals from two decisions[93] where family discretionary trusts, of which the trustees were resident in Australia, sold shares in companies that were non-TAP and distributed the gains from the sale of those shares to individual beneficiaries of those trusts who were foreign residents.[94] The issue for determination was whether s 855-10 ITAA97, which disregards a capital gain made by a foreign resident or the trustee of a foreign trust in relation to non-TAP, operated to disregard the gain assessed to:

- the trustees pursuant to s 98 ITAA36 via the operation of s 115-220 ITAA97; and
- the foreign resident beneficiaries under s 115-215(3) ITAA97.

The Full Federal Court held that s 855-10 had no application in the circumstances. First, the gains made by the trusts could not be disregarded under s 855-10 as the trusts were not foreign residents or foreign trusts.[95] Second, s 855-10 could not apply to disregard any capital gain in the calculation of the "amount" mentioned in s 115-225 ITAA97 which is: (1) assessed to the trustees under s 98 via s 115-220; and (2) treated as the foreign beneficiary's capital gain under s 115-215(3). Section 855-10 can only apply to disregard a capital gain from a CGT event as described in Div 104 ITAA97, and the amount attributed under s 115-225 is not a capital gain from such a CGT event.[96]

Following *Greensill*, the Commissioner has issued two tax determinations, TD 2022/12 and TD 2022/13. In TD 2022/12, the Commissioner, on the back of arguments unsuccessfully raised by the appellants in *Greensill* (that Subdiv 115-C ITAA97 does not assess foreign beneficiaries on what they termed "non-Australian gains"[97]), held that the source concept in s 98(2A) is not relevant to determining whether an amount of a resident trust's capital gain is assessable to a trustee under s 98 when a foreign beneficiary is made specifically entitled to those gains. Section 115-220 is the provision which causes the trustee to be assessed under s 98 on gains attributed to a foreign beneficiary. That section:[98]

> "…does not test whether the beneficiary's attributable gain satisfies the conditions in section 98 … Rather, it increases the amount assessable to the trustee under section 98 without regard to those conditions."

In TD 2022/13, the Commissioner, applying *Greensill*, determined that the only provision which applies to disregard a capital gain that a foreign resident beneficiary is taken to have as a result of a CGT event happening to a non-TAP asset of a trust is s 855-40 ITAA97, and that s 855-40 only applies to fixed trusts, not discretionary trusts.[99] This provides foreign beneficiaries of fixed trusts with comparable treatment to that which would apply if they had directly owned the asset.

That foreign beneficiaries of a discretionary trust are not entitled to the same treatment may be seen as arbitrary and giving rise to anomalous results.[100] This apparent unfairness is compounded by the fact that the trustees of such resident discretionary trusts will be denied the benefit of the 50% CGT discount on the sale of non-TAP assets, the gains from which are distributed to foreign beneficiaries.[101]

However, it must be noted that *Greensill* and TD 2022/13 do *not* specifically address or consider the interpretation of any of Australia's double tax agreements (DTAs). As DTAs take precedence over Australian taxation laws in the event of a conflict,[102] to the extent that a DTA exists between Australia and the country of residence of the foreign beneficiary, its terms may be able to override the effect of Subdiv 115-C and prevent the gains from being taxed in Australia. The Commissioner appeared to accept as much in a private ruling issued in 2018, which he has since withdrawn as it does not represent the ATO's view of the relevant law.[103]

Entitlement loaned to Australian resident controller

The Commissioner has made it clear that the following arrangements will be "red-zone arrangements" under PCG 2022/2, to which the Commissioner will look to apply s 100A. Namely, arrangements where non-resident relatives of the resident controller of a trust are made presently entitled to the income of that trust, and the funds representing that entitlement are made available to a resident taxpayer by way of a non-commercial loan or gift. This will especially be the case where the income distributed is comprised of fully franked dividends which will not be subject to Australian tax in the non-residents' hands.[104] This is evident from example 15 in PCG 2022/2.

That example involves an Australian resident discretionary trust (Oberon Trust) which is controlled by an Australian resident, Titan. The Oberon Trust derives $400,000 of income comprised of fully franked dividends. The trust makes Titan's parents, Sylvia and Sylvester, presently entitled to $200,000 each of that $400,000 of income. The Oberon Trust is not required to pay or withhold tax in respect of those distributions to Sylvia and Sylvester as they are both foreign residents. Sylvia and Sylvester agree to lend the $400,000 to Titan on interest-free terms. The Commissioner concludes that this arrangement would be in the red-zone and the ATO would look to apply s 100A in these circumstances.[105] Diagram 2 illustrates this example.

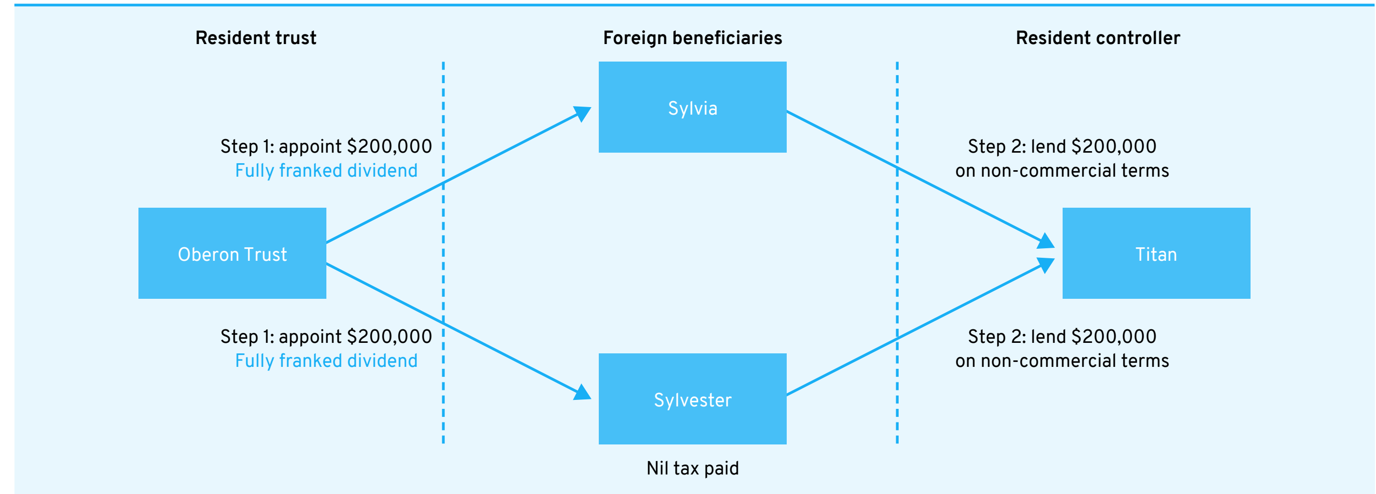
In TR 2022/4, the Commissioner specifically noted that there could be cases where the arrangements creating the present entitlement are a sham such that the purported present entitlement is of no legal effect.[106] This suggests that the Commissioner will also look to rely on the doctrine of sham as an alternative to s 100A in certain situations. One of those could certainly be an arrangement like that discussed above in example 15 in PCG 2022/2 (where foreign beneficiaries who are relatives of the controller of an Australian trust never call on their present entitlements from the trust), given that the Commissioner has successfully run such an argument previously in *Re Faucilles Pty Ltd (In Its Capacity As Trustee of the John Kakridas Family Trust)*.[107] This should be borne in mind as the sanctions imposed may be more severe than under s 100A.

Foreign beneficiary surcharges

In South Australia, there is a 7% surcharge on the value of the interest acquired by a foreign trust in residential land, in addition to the stamp duty otherwise payable on the acquisition.[108] A discretionary trust will be a foreign trust for this purpose where one or more of the following is a foreign person: (1) a trustee; (2) an appointor; (3) an identified object; or (4) a taker in default of the capital.[109]

Helpfully, RevenueSA has clarified that an "identified object" under the trust and a person who takes capital in default must be identified in the trust deed by name.[110] Neither term

Diagram 2. Non-commercial loan to resident controller



is "a blanket reference to a class or range of beneficiaries under a discretionary trust deed who are not identified by name".[111] Assuming that neither the trustee or the appointor is a foreign person, the operation of the surcharge can therefore be avoided, even if some potential beneficiaries in the class of beneficiaries under the trust deed are foreign residents, so long as those individuals are not specifically named as beneficiaries or takers in default in the deed. If the trustee is an Australia company, attention also needs to be given as to whether any foreign persons hold 50% or more of the shares in it or control the casting of more than 50% of the votes because, if they do, the trustee will be a foreign person.[112]

Similar surcharges can apply in addition to the duty otherwise imposed where discretionary trusts with foreign beneficiaries acquire residential land in Queensland,[113] New South Wales,[114] Victoria[115] and Western Australia.[116] In Tasmania, discretionary trusts with foreign beneficiaries may have to pay a surcharge if they acquire residential and/or primary production land.[117] The reach of these provisions in NSW, Victoria and Tasmania is far greater than in SA as discretionary trusts will be considered to be foreign trusts if *any* potential beneficiary, whether named in the trust deed or not, is a foreign person.[118]

Furthermore, discretionary trusts with foreign beneficiaries may be subject to a land tax surcharge on residential land held by the trust in NSW,[119] the Australian Capital Territory[120] and Tasmania,[121] and all land (that is not otherwise exempt from land tax) in Queensland.[122] Additionally, discretionary trusts with foreign beneficiaries may be subject to an absentee owner surcharge on all land in Victoria where a foreign beneficiary specifically named in the deed was absent from Australia on 31 December of, or for more than six months in total in, the calendar year prior to the tax year.[123]

Asset protection developments

The decisions in *Kennon v Spry*[124] and *Australian Securities and Investments Commission v Carey (No. 6)*[125] (*Richstar*) showed a willingness of the courts to bust open a discretionary trust to allow access to its corpus in the context of family law and bankruptcy actions. However, the recent decision in *Owies* shows a further willingness to dilute the once inviolability of trust assets through invalidating distributions ostensibly made within the terms of the deed and removing the trustee responsible for such distributions, on claims by made disgruntled beneficiaries.

Owies involved a discretionary family trust established by the parents of three adult children. The recitals of the deed governing the trust provided that the settlor was "desirous of making provision for the Primary Beneficiaries and the General Beneficiaries".[126] The primary beneficiaries were the three children, and the parents comprised the general beneficiaries. The three children were also the default beneficiaries, with each being entitled to an equal share in default. The parents and three children were the only potential objects of the trust.

Two of the children had a difficult relationship with the parents and the other sibling. The trustee was controlled at different times by the parents, the mother with the favoured sibling, and that sibling with the parents' solicitor. In nearly all of the years in issue, the trustee had distributed the income as to 40% each to the parents, and 20% to the favoured sibling. However, in one year, all of the income was distributed to the father.[127] All of these distributions were made pursuant to an apparent unconstrained discretion. Actions were brought by the other two children for breach of trust by the trustee in failing to give real and genuine consideration to the position of those children and for the trustee to be removed.

The court considered that widely expressed discretionary distribution powers are not without bounds and must be exercised in good faith, taking into account the purpose of the trust.[128] Additionally, as the class of beneficiaries was small, the trustee should be informed about the differing circumstances and needs of each beneficiary, and give adequate consideration to same.[129]

In this case, it was clear from the recitals and particularly the make-up of the default beneficiaries that the purpose of the trust was to provide for each of the three children.[130]

With that purpose in mind, the following factors collectively were held to be sufficient to allow the court to hold that the trustee did not give real and genuine consideration to the position of the two complainant beneficiaries:[131]

- the trustee made no enquiries of those two beneficiaries;[132]
- the trustee paid substantial distributions in a uniform fashion over numerous years with no distributions to those two beneficiaries, despite one of them suffering from serious health and financial difficulties;[133]
- the trustee paid the father the entirety of the distribution in one year when he had no need for the income;[134] and
- there was a lack of independent processes to manage the broken relationship between those in control of the trust and the two complainants.[135]

The court held that these distributions were not void (automatically set aside), but may be voidable if the adversely affected beneficiaries could establish that they should be set aside.[136]

In relation to removing a trustee, the court, after referring to the High Court decision in *Miller v Cameron*,[137] noted that, to justify the removal of a trustee, the court must find something which induces it to consider that the trust property will not be safe, or that the interests of the beneficiaries require protection.[138] As the court was of the view that the trustee failed to act impartially, failed to give genuine consideration to the complainants, and the relations between the complainants and those who control the trustee were "irreconcilably damaged", it was not in the best interest of the beneficiaries for the trustee to continue in office.[139]

The facts on which this decision was made were unique in that none of the adult children had any children of their own, so the class of potential beneficiaries at the time it was decided were limited to the three children.[140] Whether other courts will adopt a similar approach to discretionary trusts with a larger class of beneficiaries remains to be seen. Nonetheless, based on this decision, advisers would be wise to advise clients, keen on protecting trust assets from certain estranged beneficiaries, to review their deeds and consider whether amendments need to be made and/or clauses added, like the ability to exclude a beneficiary, to avoid any unintended consequences. Who wants the future ex-son-in-law making claims for distribution under the trust that ex's parents-in-law established for their family?

Conclusion

The above discussion demonstrates how in recent times the utility of discretionary trusts as an effective tax planning tool has been notably circumvented. This is particularly the case for professional service providers (like lawyers, accountants, health professionals and so on) running a business. Where the exact ability of trusts to split income will lie will not be known until the *BBlood* appeal is decided. The end of the use of sub-trust arrangements to maintain tax rates for trust income at 30% further curtails the use of discretionary trusts as an effective tax vehicle.

Cross-border dealings involving discretionary trusts will be closely examined under the Commissioner's updated approach to s 100A. Furthermore, the use of discretionary trusts to acquire shares and real estate in Australia to benefit foreign beneficiaries will, by and large, be avoided going forward due the *Greensill* decision and the stamp duty and land tax surcharges.

Finally, the decision in *Owies*, following from the *Kennon v Spry* and *Richstar* decisions, appears to have further eroded the ability of discretionary trusts to isolate and protect assets from persons other than those in control of the trust.

Accordingly, it is safe to say that recent developments have reduced the utility of discretionary trusts.

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2 [2021] FCAFC 99.
3 [2022] VSCA 142.
4 Para 34 of PCG 2021/4.
5 S 86-15 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).
6 S 86-30 ITAA97.
7 This will require: (1) at least 75% of Misha's family trust's income to be for producing a result; (2) Misha's family trust to supply its own equipment; and (3) Misha's family trust to be liable to fix defects. See s 87-18(3) ITAA97.
8 Paras 75, 160 and 161 of TR 2022/3.
9 Para 5 of IT 2121. At para 160 of TR 2022/3, the ATO specifically refers to IT 2121 as providing guidance on the application of Pt IVA where a personal services entity is considered to be conducting a personal services business and the PSI rules do not apply.
10 [1978] FCA 28.
11 Para 4 of TR 2006/2.
12 Issue number 1 of PCG 2021/4EC.
13 Para 10 of PCG 2021/4.
14 Issue number 17 of PCG 2021/4EC.
15 [2004] HCA 26.
16 Example 1 in PCG 2021/4.
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19 Para 59 of PCG 2021/4.
20 *FCT v Everett* [1980] HCA 6.
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22 *Everett* at [27].
23 *Galland* at [5].
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28 S 100A(13) ITAA36.
29 *BBlood* at [83].

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31 *BBlood* at [91] and [102].

32 *Guardian AIT Pty Ltd ATF Australian Investment Trust v FCT* [2021] FCA 1619 at [144] (*Guardian* (first instance)).

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34 *Prestige Motors* at 4263.

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36 *BBlood* at [100].

37 *BBlood* at [205]–[209].

38 *Guardian* (first instance) at [150].

39 Ibid at [151] and [152].

40 *Guardian* (first instance) at [153].

41 Pages 5–6 of the explanatory memorandum to the Income Tax Assessment Bill (No. 5) 1978.

42 Hereinafter referred to collectively as "benefits".

43 *Guardian* at [108] and [117]; see also *Guardian* (first instance) at [128]–[130] and [132].

44 *Guardian* (first instance) at [132].

45 *Guardian* (first instance) at [133].

46 *Guardian* at [125].

47 *Guardian* at [124].

48 *Guardian* at [117].

49 *BBlood* at [113].

50 *BBlood* at [107] and [109].

51 *BBlood* at [120].

52 The beneficiary, being a corporate beneficiary, paid no tax on the buy-back proceeds as they were fully franked.

53 *BBlood* at [116]–[127].

54 *BBlood* at [178]; see also *Guardian* (first instance) at [163].

55 *BBlood* at [153]–[166]. The Commissioner supports this position: see para 84 of TR 2022/4.

56 *BBlood* at [166].

57 *BBlood* at [132].

58 *BBlood* at [133]. The Commission supports this position: see para 85 of TR 2022/4.

59 *BBlood* at [133]–[135]. The Commission supports this position: see para 87 of TR 2022/4.

60 *BBlood* at [237] and [238]. The Commission supports this position: see para 88 of TR 2022/4.

61 *BBlood* at [138].

62 Para 98 of TR 2022/4.

63 [1989] FCA 481 at [74].

64 *Guardian* (first instance) at [158].

65 *Guardian* (first instance) at [163].

66 In *Guardian* at [85], the court merely noted that Logan J undertook a counterfactual analysis and that he concluded that, objectively, what would have occurred is that the bucket company would have received and retained in full its UPE in cash, or it would have invested it with the trust in accordance with a Div 7A compliant loan agreement. Neither of those counterfactuals entailed any tax consequences for the controller of those entities compared to the Commissioner's counterfactual, which was rejected, that the trust would have paid the income directly to the controller which would have resulted in tax consequences for the controller that exceeded the tax paid by the corporate beneficiary under the arrangement that took place.

67 *Guardian* at [122]–[124].

68 S 100A(1) ITAA36.

69 *BBlood* at [273].

70 *BBlood* at [272].

71 *BBlood* at [270].

72 Para 23 of TR 2010/3.

73 Paras 49–58 of PS LA 2010/4.

74 Para 17 of PCG 2017/13.

75 Paras 113 and 114 of TR 2010/3, and paras 49 and 58 of PS LA 2010/4.

76 Paras 15 and 16 of TD 2022/11.

77 Paras 16 and 74 of TD 2022/11.

78 Para 19 of TD 2022/11.

79 Example 2 in TD 2022/11.

80 Para 46 of TD 2022/11.

81 Para 48 of TD 2022/11.

82 Ibid.

83 Para 90 of TD 2022/11.

84 Para 91 of TD 2022/11.

85 Para 104 of TD 2022/11.

86 *Carter* at [6]–[10]; and the decision of the Full Federal Court, *Carter v FCT* [2020] FCAFC 150 at [66].

87 *Carter* at [12].

88 *Carter* at [4].

89 *Carter* at [25].

90 *Carter* at [24].

91 *Carter* at [26].

92 Ibid.

93 *Peter Greensill Family Co Pty Ltd (Trustee) v FCT* [2020] FCA 559; and *N & M Martin Holdings Pty Ltd v FCT* [2020] FCA 1186.

94 One resident in the UK, the other in China.

95 *Greensill* at [43] and [78].

96 *Greensill* at [50] and [78].

97 *Greensill* at [64].

98 Para 15 of TD 2022/12.

99 Paras 14 and 21 of TD 2022/13.

100 See the arguments raised in this respect by the appellants: *Greensill* at [69].

101 S 115-120 ITAA97. This assumes that the non-TAP assets were acquired after 8 May 2012. The trustees *may* be entitled to a less than 50% discount in accordance with the methodology set out in s 115-115 ITAA97 for any non-TAP assets acquired prior to 8 May 2012.

102 S 4 of the *International Tax Agreements Act 1953* (Cth).

103 PBR 1051376428100.

104 The dividends would be non-assessable non-exempt income of the foreign resident beneficiaries pursuant to s 128D ITAA36. The dividend would also not be subject to withholding tax under s 128B(3)(ga) ITAA36.

105 Para 170 of PCG 2022/2.

106 Para 64 of TR 2022/4.

107 [1989] FCA 524.

108 S 72 of the *Stamp Duties Act 1923* (SA).

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110 RevenueSA, *Foreign Trust*. Available at www.revenuesa.sa.gov.au/stampduty/FOS/foreign-trust.

111 Ibid.

112 S 2(14)(a)(ii) of the *Stamp Duties Act 1923* (SA).

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114 Ch 2A of the *Duties Act 1997* (NSW).

115 Ss 3(1), 3B and 28A of the *Duties Act 2000* (Vic).

116 Ch 3A of the *Duties Act 2008* (WA).

117 Pt 3A of Ch 2 of the *Duties Act 2001* (Tas).

118 S 104JA of the *Duties Act 1997* (NSW); s 3B(2) of the *Duties Act 2000* (Vic); and s 4B(3) of the *Duties Act 2001* (Tas).

119 Ss 5A and 5D of the *Land Tax Act 1956* (NSW).

120 Pt 2A of the *Land Tax Act 2004* (ACT).

121 Div 1A of Pt 2 of the *Land Tax Act 2000* (Tas).

122 Ss 18C and 32(1)(b)(ii) of the *Land Tax Act 2010* (Qld).

123 Div 2AB of Pt 3 of the *Land Tax Act 2005* (Vic).

124 [2008] HCA 56.

125 [2006] FCA 814.

126 *Owies* at [110].

127 Who was 96 years old and in no need of income.

128 *Owies* at [81] and [112].

129 *Owies* at [95] and [111].

130 *Owies* at [113].

131 *Owies* at [130].

132 *Owies* at [115].

133 *Owies* at [120], [121] and [125].

134 *Owies* at [126]–[129].

135 *Owies* at [123] and [124].

136 *Owies* at [147]. In this case, as the complainants did not seek an order for the distributions to be set aside in their initial pleadings in the first instance, and did not challenge the judge's decision in the first instance to not allow their pleadings to be amended, they were unable to obtain an order for the distributions to be set aside despite the findings of the court that a breach had been committed by the trustee.

137 [1936] HCA 13.

138 *Owies* at [154].

139 *Owies* at [158].

140 Both parents had passed away.

Maximising value from corporate structures

by John Langford, FTI, Senior Manager, Mutual Trust

Family succession journeys are unique to each family and what works for one family may not necessarily work for another. The same goes for the best way to extract wealth out of family entities when needed, ie when a business is sold, when wealth is needed for personal commitments, or if assets are being divided and restructured as part of a larger succession planning project. This article will focus on the challenges and opportunities in extracting value from private companies, and the various options to consider when determining the most tax-effective way for the family or group of private investors. Specifically, this article covers several tax strategies to extract value from companies. As there are many ways for companies to return value to shareholders, it is important for tax advisers to understand and compare these different approaches in order to meet the clients' commercial objectives and achieve the best overall tax result.

Ordinary dividends

It is common knowledge that dividends are one of the primary ways for shareholders to receive value from a company. Dividends can be an effective way to facilitate a family or group of private investors' lifestyles or further business ventures.

Effectively, a dividend by nature is a distribution made to shareholders of a company from the profits of the company. "Dividend" has the meaning given by ss 6(1) and (4), 6BA(5) and 94L of the *Income Tax Assessment Act 1936* (Cth) (ITAA36).

To that end, the main defining provision for dividends is s 6(1), with s 6(4) as an exception, s 6BA(5) as a specific inclusion for bonus shares, and s 94L for distributions from corporate limited partnerships. The most commonly relevant provisions that the reader will be familiar with are s 6(1) and s 6(4).

"Dividend" is defined in s 6(1) as including any distribution made by a company to any of its shareholders, whether in money or other property, and any amount credited by a company to any of its shareholders.[1] Importantly, a dividend does not include, inter alia:

> "(d) moneys paid or credited by a company to a shareholder or any other property distributed by a company to shareholders (not being moneys or other property to which this paragraph, by reason of subsection (4), does not apply or moneys paid or credited, or property distributed for the redemption or cancellation of a redeemable preference share), where the amount of the moneys paid or credited, or the amount of the value of the property, is debited against an amount standing to the credit of the share capital account of the company."

Effectively, the s 6(1) definition of "dividends" is an inclusive one, meaning it starts with the ordinary meaning of the term. This inclusive approach allows other provisions to consider certain amounts as dividends paid to shareholders and assessable to the taxpayer.

While the definition of a "dividend" catches most distributions by companies, the ITAA36 also deems distributions to be dividends in a number of other circumstances. The five most common circumstances where company distributions or payments are "deemed" dividends are:

1. the streaming of bonus shares and other capital benefits;[2]
2. distributions made under a liquidation;[3]
3. distributions from private companies;[4]
4. excessive payments to shareholders, directors and associates;[5] and
5. off-market share buy-backs.[6]

Stepping back to the basics, a dividend by nature is a distribution made to shareholders of a company from the profits of the company. It follows that a company cannot at law distribute capital to its members by way of dividend or in any other way not authorised by the *Corporations Act 2001* (Cth).

The circumstances in which a company can pay a dividend is a legal matter governed by s 254T of the *Corporations Act 2001*. This section prescribes that a dividend may be paid when the following three conditions are satisfied:

1. the company's assets exceed its liabilities immediately before the dividend is declared and the excess is sufficient for the payment of the dividend;
2. the payment of the dividend is fair and reasonable to the company's shareholders as a whole; and
3. the payment of the dividend does not materially prejudice the company's ability to pay its creditors.

Accordingly, these requirements impose a solvency-based hurdle for companies to meet before paying dividends.

Although companies are able to pay dividends other than out of profits in certain circumstances, it is important to note that, from a tax perspective, a dividend will only be able to be franked to the extent that it is paid out of profits.

Dividends paid to a shareholder are assessable to the shareholder under s 44 ITAA36. The taxing event for dividends is when they are paid (not declared). That said, the term "paid" is extended to include dividends that are "credited" to the shareholder.[7]

In light of the above, it is fundamental to keep in mind the distinction between assessable dividend payments and non-assessable returns of capital when seeking to access value from companies in a tax-effective manner (discussed further below).

Franking of dividends

The franking of dividends is optional for a company. However, where a distribution is considered to be a dividend for income tax purposes and is paid out of profits, the company may generally choose to attach a franking credit to the distribution to the extent of their franking account balance. This allows the company to pass credits for income tax paid by the company to its shareholders and, in turn, provide a more tax-effective outcome for the recipient. Depending on the profile of a group's individuals and their respective marginal income tax rates, the tax savings can be significant.

> "... the franking benchmark rule ensures that all shareholders are treated fairly ..."

When determining the amount of franking credits to attach to a dividend, a company will need to consider the implications of the franking benchmark rule. This rule requires that all frankable distributions made within a particular period must be franked to the same extent as the first frankable distribution made in that period.[8] Effectively, the franking benchmark rule ensures that all shareholders are treated fairly and no one shareholder is given preferential treatment by sudden changes in the franking percentage within a short period of time. This rule is enforced during a franking period which is a company's income year for private companies, or a six-month period for other companies. In the case of most companies, this referenced period will be based on the entity's income tax year (ie year ended 30 June 202X).

The rule is contained in s 203-25 ITAA97, which provides:

> "An entity must not make a frankable distribution whose franking percentage differs from the entity's benchmark franking percentage for the franking period in which the distribution is made. This is the ***benchmark rule***."

A company's "benchmark franking percentage" is determined according to the franking percentage of the first frankable distribution made by the company in the franking period.[9]

If a company fails to comply with the franking benchmark rule, the consequences will vary depending on whether the distribution that caused the breach had a higher or lower franking percentage than the benchmark in the franking period.

The consequences of these two scenarios are outlined by s 203-50(1) ITAA97 as follows:

> "(1) If an entity makes a frankable distribution in breach of the benchmark rule:
>
> (a) the entity is liable to pay over-franking tax imposed by the *New Business Tax System (Over-franking Tax) Act 2002* if the franking percentage for the distribution exceeds the entity's benchmark franking percentage for the franking period in which the distribution is made; and
>
> (b) a franking debit arises in the entity's franking account if the franking percentage for the distribution is less than the entity's benchmark franking percentage for the franking period in which the distribution is made."

Accordingly, if a company franks a distribution above its benchmark franking percentage in the franking period, it will be liable to pay over-franking tax. This tax is equal to the additional franking credits attached to the distribution, meaning that the company is effectively paying twice for those credits.

On the other hand, if a company under-franks a distribution, a franking debit will be applied to its franking account. This debit is equal to the additional franking credits that would have been debited if the distribution had been franked at the benchmark franking percentage. This means that the company loses any benefit that it would have gained from under-franking the distribution.

Importantly, shareholders are not affected in either scenario described above, and are still entitled to the franking credits determined by the company.

Additionally, as significant variations between benchmark franking percentages may indicate the presence of streaming, franking entities must disclose to the Commissioner in writing if the benchmark percentage varies by more than 20% between successive franking periods in which frankable distributions are made. If there has been more than one franking period since a frankable distribution was made, the threshold increases in multiples of 20% for each franking period in which there has been no distribution. For example, if a franking entity makes a frankable distribution in period 1, followed by no frankable distribution in period 2, followed by a frankable distribution in period 3, the variation threshold for notifying the Commissioner is 40%. The entity must make the disclosure by lodging a franking account return by the last day of the month following the end of the income year.

For completeness, the reader should also consider TR 2012/5 in respect of the Commissioner's views of the above.

Dividend administration

To be an effectively franked dividend pursuant to the ITAA97, the company must provide each shareholder with a distribution statement in the approved form.[10] This distribution statement should state the following information:[11]

- the name of the entity making the distribution;
- the date on which the distribution is made;
- the amount of the distribution (including the franked amount and the unfranked amount, where applicable);
- the amount of franking credit allocated to the distribution;
- the franking percentage for the distribution;
- the amount of any withholding tax that has been deducted from the distribution;
- the name of the shareholder; and
- any other information required by the approved form that is relevant to imputation generally or the distribution.

The company will need to provide a distribution statement on or before the day on which the distribution is made.[12] The amount of the franking credit attributed to the distribution will be evidenced by the amount stated in the distribution statement unless it exceeds the maximum franking credit, in which case, it is taken to be the amount of the maximum franking credit.[13]

Share buy-back

Overview

A share buy-back is a transaction often contemplated when it is necessary to return value to shareholders and it can be an effective means in many situations but, as always, it is dependent on the facts.

Ordinarily, a share buy-back is a transaction where a company buys back some of its own shares from shareholders. The shares are then cancelled once the transfer to the company is registered.[14]

Share buy-backs may require a reduction in share capital and are only allowed if the conditions in the *Corporations Act 2001* are met. These conditions are broadly that:[15]

- the buy-back must not materially prejudice the company's ability to pay its creditors; and
- the company must follow the procedures contained in Div 2 of Pt 2J.1 of the *Corporations Act 2001.*

Importantly, the company's constitution should also be reviewed to ensure that the relevant power enabling the company to buy back its shares exists, as a company's constitution may prohibit or limit the company's ability to purchase its own shares.

The *Corporations Act 2001* recognises five categories of share buy-back, of which selective buy-backs are the most relevant for small-to-medium enterprises and, in particular, family entities. Accordingly, this article provides commentary regarding selective private company off-market share buy-backs exclusively.

Selective share buy-backs

Selective share buy-backs are used to acquire the shares of specific shareholders and will likely involve unequal treatment among shareholders. Therefore, they are subject to strict requirements under the *Corporations Act 2001*, including the need for special or unanimous resolution of shareholders, as well as notification and documentation requirements from the Australian Securities and Investments Commission (ASIC).

In contrast, Div 16K ITAA36, which sets out the income tax rules that apply to share buy-backs, only distinguishes between on-market purchases and off-market purchases. On-market purchases relate to the buy-back of shares that are listed on an official stock exchange (outside the scope of this article).[16] A buy-back that is not an on-market purchase is an off-market purchase.

Accordingly, off-market selective share buy-backs are the subject of this section of the article, in the context of extracting value from family private companies.

For completeness, it is noted that, following its announcement in the October 2022–23 Federal Budget, the government released the Treasury Laws Amendment (Off-Market Share Buy-Backs) Bill 2022 (exposure draft legislation) on 17 November 2022. The exposure draft legislation proposes to amend the share buy-back provisions in Div 16K specifically for listed public companies, in order to align the tax treatment of off-market share buy-backs undertaken by these companies with the tax treatment of on-market share buy-backs. However, this is outside the scope of this article.

Tax treatment of selective off-market share buy-backs

Section 159GZZZP ITAA36 applies to an off-market share buy-back. Specifically, s 159GZZZP provides the following:

> "(1) For the purposes of this Act, but subject to subsection (1A), where a buy-back of a share or non-share equity interest by a company is an off-market purchase, the difference between:
>
> (a) the purchase price; and
>
> (b) the part (if any) of the purchase price in respect of the buy-back of the share or non-share equity interest which is debited against amounts standing to the credit of:
>
> (i) the company's share capital account if it is a share that is bought back; or
>
> (ii) the company's share capital account or non-share capital account if it is a non-share equity interest that is bought back;

is taken to be a dividend paid by the company:

(c) to the seller as a shareholder in the company; and

(d) out of profits derived by the company; and

(e) on the day the buy-back occurs.

(1A) If the dividend is included to any extent in the seller's assessable income of any year of income, it is not taken into account to that extent under s 118-20 ITAA97.

(2) The remainder of the purchase price is taken not to be a dividend for the purposes of this Act."

Accordingly, the income tax implications for a shareholder are that the share buy-back proceeds will be split into a capital component and a dividend component (see Diagram 1).

Disposal consideration and the market value rule

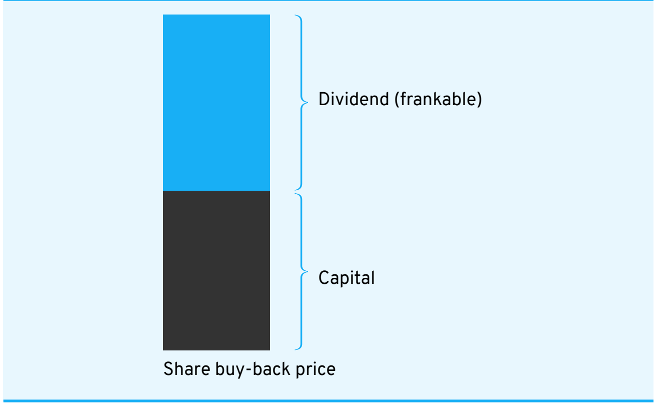
For the purpose of calculating the ordinary income or capital gain or loss realised as a result of an off-market selective share buy-back, the amount treated as the disposal consideration is the full purchase price for the share.[17]

The amount treated as the disposal consideration is subject to a deemed disposal consideration rule in relation to share buy-backs for below market value. The market value of the share is the amount that would have been the market value of the share at the time of the buy-back on the assumption that the buy-back had not been proposed or implemented.[18] If the purchase price is less than the market value of the share, the full market value is nevertheless treated as the disposal consideration for ordinary income or capital gain purposes.[19] If the purchase price exceeds market value, no adjustment is made to the disposal consideration or to the calculation of the dividend component, but, as mentioned, the part of the deemed dividend that is attributable to the excess over market value is not frankable.[20]

Dividend component

If the amount of the purchase price exceeds the part, if any, of the purchase price that is debited to the share capital account, the excess is taken to be a dividend paid to the seller as a shareholder out of profits of the company.[21] This causes it to be assessable under s 44 ITAA36.

Diagram 1. Share buy-back components



The dividend portion of the purchase price is taken to be a distribution paid "on the day the buy-back occurs".[22] This is consistent with s 960-120 ITAA97, which provides that a distribution is made when paid or "taken to be paid". This need not necessarily be the date on which the purchase price is paid. The Commissioner considers that the buy-back occurs at any time on the day the entities enter into the buy-back contract (and not the day the purchase price is paid).[23] If the purchase price exceeds the market value of the shares, the full purchase price remains a deemed dividend but the excess over market value is not frankable.

Capital component

The amount debited to the company's share capital account is generally the consideration for the disposal of the shares for CGT purposes. When a vendor shareholder is disposing of their shares in a company, share buy-backs will typically result in CGT event A1.[24]

Regarding the calculation of capital gains or losses for shareholders, it is important to take note of the following:

- if the buy-back results in an assessable dividend to the shareholder, the consideration that the shareholder is taken to have received in respect of the buy-back is reduced by the amount of the assessable dividend (referred to as the "reduction amount");[25]
- the application of the reduction amount is an "anti-overlap" measure designed to prevent the shareholder from being taxed twice (ie on both the assessable dividend itself and on the capital proceeds for disposal of its share);
- this anti-overlap measure does not generally impose restrictions on any additional amounts of a capital loss that can be generated by the shareholder by virtue of applying the reduction amount against their capital proceeds from the buy-back; and
- the general anti-overlap provision in s 118-20 ITAA97 does not apply in respect of amounts taken to be a dividend by virtue of the off-market buy-back of shares.[26]

In practice

In practice, it is the accounting treatment of the buy-back that prima facie determines the dividend and capital split for income tax purposes. However, the reader should be aware that the Commissioner may seek to make a determination that one of the capital benefit anti-avoidance rules in ss 45A and 45B may apply to deem some or all of the capital component of the buy-back price to be a dividend.[27]

In the context of share buy-backs in family enterprises, a significant portion of the purchase price will typically result in it being considered as a frankable dividend. While there may be a capital gain, it is likely to be significantly or completely reduced by the reduction amount (discussed above) applied to the purchase price. Accordingly, a selective share buy-back may be most appropriate in circumstances such as where:

- the entity has sufficient franking credits to fully frank the dividend component of the distribution, and either:

- the vendor shareholder is a company; or
- the vendor shareholder is a trust that can distribute the franked dividend to a corporate beneficiary.

In both instances, the tax liability associated with the dividend will be deferred. Additionally, the recipient company, whether as a shareholder company or the corporate beneficiary of the trust, will receive a credit to its franking account balance.

Calculating the capital component

There are a number of methods that can be used to determine the split between the dividend and the capital component of the share buy-back proceeds. This article will discuss the two most common approaches with respect to the author's experiences with family entities.

Average capital per share

The method favoured by the Commissioner according to PS LA 2007/9 is the average capital per share (ACPS) approach.

Under this method, the capital component is calculated by dividing the ordinary issued capital by the number of shares on issue. The balance of the share buy-back price would be taken to be a dividend.

PS LA 2007/9 states the following at para 62:

> "One method used to determine the 'split' is for the company to work out its average capital per share (ACPS). This is obtained by dividing a company's ordinary issued capital by the number of shares on issue. The amount so derived is a reasonable estimate of any capital component of the split. The balance of any buy-back price would be a dividend. This method does overcome the dilution issue discussed at paragraph 63 of this practice statement. Another clear advantage is that ACPS gives rise to a strong presumption that sections 45A and 45B of the ITAA 1936 would not apply to the buy-back. Tax officers should examine recent financial year data as well as projected movements in the average. Evidence of recent capital injections just before a share buy-back may attract the anti-avoidance provisions. ACPS should, prima facie, be applied to determine the capital component in an off-market share buy-back. The other methods discussed below may have particular relevance or application in specific instances only."

Accordingly, this approach can be summarised in the following example.

Example

In this example, for illustrative purposes, OpCo Pty Ltd has 100,000 ordinary shares on issue, with a total paid-up share capital of $200,000. OpCo Pty Ltd has retained earnings of $1,000,000. Total shareholder funds therefore equate to $1,200,000.

The shares in OpCo Pty Ltd have a market value of $3,000,000, so the market value of each share is $30. This would be the buy-back price per share.

Example (cont)

Under the ACPS methodology, the capital component of the buy-back price per share would be $200,000 (paid-up share capital) divided by $100,000 (ordinary shares), equating to $2. The dividend component of the buy-back price per share would be $30 less $2, equating to $28.

Slice approach

Another currently accepted methodology for established companies is the "slice approach".

The approach is the ratio of share capital to retained earnings on the company's most recent balance sheet. It is clear from PS LA 2007/9 that the Commissioner believes that the slice approach will be more appropriate for established companies with a history of making a profit.

Specifically, PS LA 2007/9 states the following at para 63:

> "Another acceptable method of determining the capital/dividend split, in an established company, is to calculate the ratio of share capital to retained earnings on a company's most recent balance sheet. It is sometimes referred to as the 'Slice Approach'. This ratio should then be reflected in any capital/dividend split proposed. This method seems to more accurately reflect splits in established companies as newer companies do not have a history of retained earnings. However, companies that conduct successive off-market share buy-back may contribute to significant dilution of share capital over time if they continue to use this method. This may require an examination for possible breaches of section 45B of the ITAA 1936. For this reason, it is preferable to use the ACPS method."

Furthermore, paras 64 and 65 provide the following:

> "There may be particular circumstances where the use of the 'Slice Approach' is appropriate. For instance, a decision by a taxpayer company to sell-off a particular business and return that capital to shareholders is a case in point. Should the proceeds from that sale be comprised of both capital and profits, and the company proposed a distribution reflective of that capital/profits split, the ATO would probably consider that split more appropriate than ACPS. Any distribution should be capital and dividend proportionately to the interest of the shareholder in them.
>
> There may be other instances where a 'Slice Approach' would be acceptable to the ATO. Tax officers should fully and critically examine the commercial rationale behind a buy-back proposal for these reasons."

While the Commissioner appears to have a preference for the ACPS methodology, it would seem that he is willing to consider using the slice approach in specific situations. One such situation is when there has been a sale of a significant asset that was funded by a combination of capital and retained earnings.

The slice approach has the advantage of not affecting the distribution of buy-back proceeds towards dividends due to unrecorded gains on assets. This makes it a useful option in certain circumstances. As an illustrative example, if the slice approach was applied to in the example 1 above (see "Average capital per share"), the capital component of the buy-back price would have been: $200,000/$1,000,000 x $30.00 = $6, instead of $2 as calculated above, with the dividend amount also being reduced proportionately.

Where is the risk?

Given the difficulties in determining the correct buy-back price and the allocation of capital and dividends from the proceeds of an off-market buy-back, it is important to keep in mind the potential consequences if the taxpayer makes a mistake and what impact this may have.

What if the buy-back price is too high or too low?

All parties must be aware that there are specific provisions which govern the tax treatment if the share buy-back price is either above or below market value as they will have a significant impact on the outcome of the transaction and the impact felt by the stakeholders.

In the context of a family business, if the price for an off-market share buy-back is lower than market value, s 159GZZZQ(2) ITAA36 provides that the selling shareholder is deemed to have received that market value. Accordingly, this will increase the amount counted towards the capital proceeds for the CGT event.

In contrast, if the price for an off-market share buy-back is higher than market value, s 202-45 ITAA97 provides that the excess over that market value is an unfrankable dividend. Accordingly, the following are unfrankable:

> "(c) where the purchase price on the buy-back of a share by a company from one of its members is taken to be a dividend under section 159GZZZP of that Act – so much of that purchase price as exceeds what would be the market value (as normally understood) of the share at the time of the buy-back if the buy-back did not take place and were never proposed to take place ..."

Effectively, this provision can be illustrated in Diagram 2.

Section 45A

When discussing the topic of accessing value from corporate structures for shareholders, it would be remiss to not mention ss 45A and 45B ITAA36.

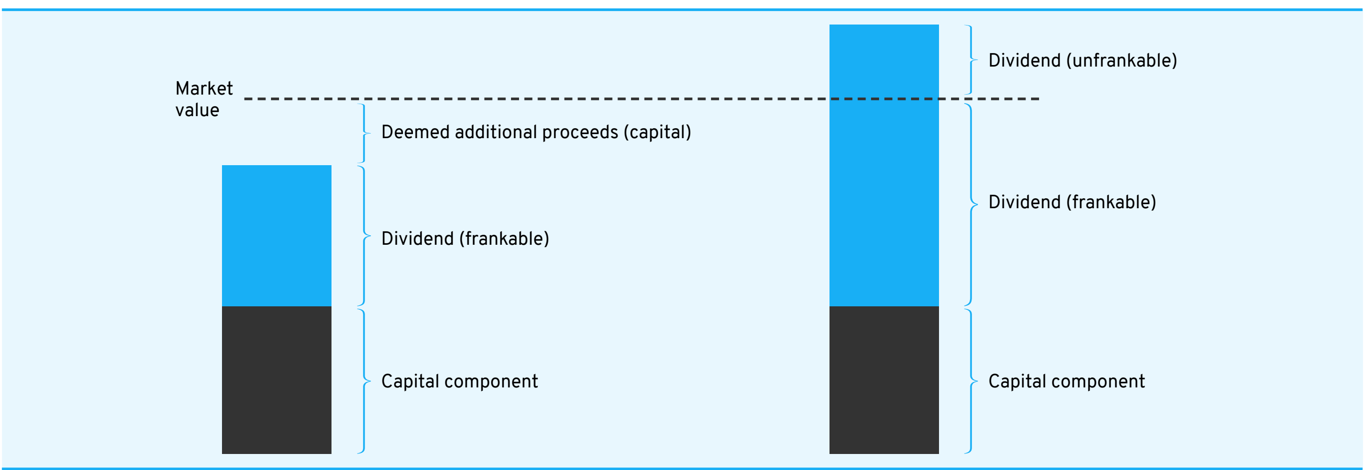
Section 45A ITAA36, added by the Taxation Laws Amendment (Company Law Review) Bill 1998 (the Bill), deals with the tax implications of a company unfairly distributing capital benefits and dividends to some shareholders to their advantage and to the disadvantage of others. As a result of changes to the *Corporations Act 2001*, the Bill amended the ITAA36 and associated tax laws to prevent dividend substitution and capital streaming arrangements, and to make various consequential amendments to the tax laws. Section 45A applies when a company distributes such benefits to favoured shareholders, and it can be reasonably assumed that other shareholders have or will receive dividends.

Section 45A(3) defines what is meant by the provision of a capital benefit, outlining the relevant requirements:

- the provision to the shareholder of shares in the company, namely, bonus shares;
- a distribution of share capital (return of capital or share buy-back) or, where applicable, the provision of share premiums; or
- certain action that is done in relation to a share that has the effect of increasing the value of a share held by the shareholders; this may include altering the rights attached to the shares.

Accordingly, for s 45A to be triggered, the provision of a capital benefit must fall within one of the categories outlined in s 45A(3). No other situations can trigger the provision. Section 45A(5) exempts the provision of shares from the operation of s 45A if it is reasonable to assume that the disadvantaged shareholders will receive fully franked dividends. Section 45A(6) clarifies that, if the capital benefit is bonus shares and the disadvantaged shareholders will receive partly franked dividends, the Commissioner can only make a determination relating to the unfranked part of the dividend.

Diagram 2. Share buy-back components



Ultimately, in order to fully comprehend the issues surrounding the provision of capital benefits in this context, it is important to understand the *Corporations Act 2001*. The provision of these benefits can be made to shareholders, but it is crucial to consider the impact on those shareholders who do not receive them. If the disadvantaged shareholders receive fully franked dividends, s 45A will not apply, even if the streaming of the capital benefit in question was the provision of shares.

As can be seen, the effect of s 45A becomes limited when the other shareholders receive only partly franked dividends. If the partly franked dividend is minimal, s 45 may apply, but s 45A may not. However, if the partly franked dividend is not minimal, s 45A could still apply. As a result, s 45A is unlikely to be relevant to an equal access share buy-back and would likely be more relevant to a selective share buy-back.

For example, if a partially franked dividend was paid to one group of shareholders and a fully franked dividend and a bonus share were paid to another group of shareholders, s 45A may apply. Section 45 would not apply if it is not a minimally franked dividend. Section 45A may apply if the shareholders receiving the bonus share benefit more from the capital benefit than other shareholders. As to what is meant by "greater benefit", s 45A(4) sets out certain, but not exclusive, relevant circumstances as:

- some or all of the shares held are pre-CGT shares;
- the first shareholder is a non-resident;
- the first shareholder has a cost base for the relevant shares that is not substantially less than the capital benefit;
- the first shareholder has neither capital losses nor income tax losses;
- the first shareholder is a private company that would be denied an intercompany dividend rebate under s 46F ITAA36; and
- the first shareholder has income tax losses.

Section 45B

Where capital benefits are provided to shareholders in lieu of dividends, any tax benefits obtained by advantaged shareholders may be cancelled. Accordingly, s 45B ITAA36 is of significant relevance to a selective share buy-back in the context of family groups.

Section 45B is an integrity measure that can apply to treat certain amounts as assessable unfranked dividends for taxation purposes, or "deemed" dividends, if they are made in substitution for dividends.

The operation of s 45B requires that a person participated in the scheme with the intention of obtaining a tax benefit, even if this was not their primary purpose. The tax benefit must be more than just a minor part of the reason for their participation.

For this anti-avoidance measure to apply in relation to a capital benefit (such as a return of capital), the following must exist:

- a scheme under which an entity is provided a capital benefit by a company;
- under the scheme, a taxpayer obtains a tax benefit; and
- the scheme was entered into for a purpose (other than an incidental purpose) of enabling a taxpayer to obtain a tax benefit.

However, it must be noted that the consequences of breaching s 45B will not arise until a determination is issued by the Commissioner. As such, the Commissioner is likely to closely review the return of capital distributions made by companies.

The law prescribes a number of factors to consider when determining if a reasonable person would conclude that the scheme was entered into for a purpose, other than an incidental purpose, of enabling a taxpayer to obtain a tax benefit. A taxpayer's purpose is to be determined objectively. These factors include the extent to which there are profits from which dividends may be paid, the tax and CGT profile of the shareholder, and the tax that would be paid if a dividend were paid instead of the return of capital. An exhaustive examination of each of the relevant circumstances is outside the scope of this article. However, it is noted that paras 59 to 125 of PS LA 2008/10 provide useful commentary.

Other anti-avoidance rules

There are a number of anti-avoidance rules that advisers and taxpayers should be aware of, even if the share buy-back price is not too high or too low. While a detailed discussion of these rules is beyond the scope of this article, the following provides a brief summary:

- as part of the share buy-back price can be deemed to be a frankable dividend, shareholders need to have held their shares at risk for the requisite 45 days in order to be entitled to the benefits of the franking credits attached to the buy-back;[28]
- the anti-avoidance rule contained in s 177EA ITAA36 is intended to remove imputation benefits where a scheme involving the disposition of membership interests in a corporate tax entity was entered into and one of the purposes for doing so was to obtain an imputation benefit;
- Subdiv 204-D ITAA97 is intended to prevent the streaming of franking credits to one or more shareholders of a company in preference to others:
  - the provisions can apply where a company pays a franked dividend to one set of shareholders and provides an equivalent benefit without franking credits to another set of shareholders, where, in doing so, the company has provided an imputation benefit to the first set of shareholders;
  - in order for the provisions to apply, the Commissioner must make a determination; and
  - these provisions allow the Commissioner to either penalise the company by way of a franking debit (or exempting debit) in respect of a distribution or

other benefit provided to a disadvantaged member, or to penalise an advantaged member by removing the imputation benefits received in respect of a distribution from the company; and

- the general value-shifting provisions should be considered. A value shift usually occurs when something is done that results in the value of one thing (eg a share) decreasing and another increasing. Buying back shares at other than market value is an example of such an action. The general value-shifting rules aim to prevent:[29]
  - distortion of gains and losses when equity or loan interests in companies and trusts are sold, rendered worthless or otherwise come to an end; and
  - opportunities for inappropriate deferral or avoidance of tax where the value shift results in an interest decreasing or increasing in value.

Share capital reduction

Overview

Share capital reduction is an effective way to allow shareholders to access value from a company by reducing the company's issued share capital and returning paid-up share capital to shareholders. A share capital reduction can be either selective or equal, with equal reductions limited to ordinary shares. The approval process for the two types of reduction is different and specified by s 256C of the *Corporations Act 2001*, since an equal share capital reduction, once approved by an ordinary resolution of shareholders, is binding on all shareholders regardless of whether they voted in favour of it or not, ie in simpler terms, a share capital reduction can take away a portion of a shareholder's shares without their approval, whereas a share buy-back must have a shareholder's consent before it can reduce their shareholdings and the rights attached to them.

Accordingly, unlike share buy-backs, capital reductions may or may not lead to the cancellation of shares, depending on the preference of the shareholder to maintain their shareholding in the company. Furthermore, it should be noted that a reduction in capital can be imposed on ordinary shareholders without their consent through an ordinary resolution of the shareholders. This is in contrast to share buy-backs where the shareholder must accept the buy-back offer. The key differences between share buy-backs and share capital reductions are detailed in Table 1. For a detailed summary of the key differences between share buy-backs and share capital reductions, refer to the Appendix.

Table 1. Key differences between a share buy-back and share capital reduction

Attribute	Share buy-back	Share capital reduction
Shareholder acceptance	The act must be accepted by each shareholder individually.	An equal share capital reduction can be imposed following an ordinary resolution of shareholders.
Status of shares	Shares bought back are cancelled automatically.	Shares are not cancelled.

Conditions

The *Corporations Act 2001* outlines the conditions under which a company can perform a capital reduction and the steps required to be followed for a lawful and transparent reduction process.

Under s 256B of the *Corporations Act 2001*, a company may reduce its share capital (other than by a buy-back or redemption of redeemable preference shares) if the reduction:

- is fair and reasonable to a company's shareholders as a whole;
- does not materially prejudice the company's ability to pay its creditors; and
- is approved by the shareholders by ordinary resolution if the reduction is an equal reduction or by special or unanimous resolution if the reduction is a selective reduction.

Tax impact for shareholders

A share capital reduction will ordinarily result in a non-assessable distribution to the shareholder and/or a capital gain. The return of capital as a non-assessable distribution arises on the basis that:[30]

- the definition of "dividend", for the purposes of the tax law (as previously discussed), is defined as including any distribution made by a company to its shareholders; and
- a dividend does not, however, include moneys or property distributed to a shareholder to the extent that the distribution is debited against an amount standing to the credit of the share capital account of the company.

Accordingly, to the extent that the distribution is debited against the company's share capital account, the return of capital to the shareholder should be tax-free. However, the reader should be mindful if the cost base of shares is less than the return of the capital amount.

However, for completeness, it should be noted that it is possible for a distribution to shareholders to be considered a dividend in the context of a share capital reduction, rather than a reduction in capital, if it is not debited against the company's share capital account. In this case, the nature of the transaction would be the payment of a dividend from the company's retained earnings, rather than a reduction in the share capital of the company. This is due to the exception to the general definition of "dividend" contained in s 6(1) ITAA36. Specifically, para (d) provides:

> "(d) moneys paid or credited by a company to a shareholder or any other property distributed by a company to shareholders (not being moneys or other property to which this paragraph, by reason of subsection (4), does not apply or moneys paid or credited, or property distributed for the redemption or cancellation of a redeemable preference share), where the amount of the moneys paid or credited, or

> the amount of the value of the property, is debited against an amount standing to the credit of the share capital account of the company."

As such, considering this definition, a reduction in share capital by way of moneys paid or credited to a shareholder will result in a dividend to shareholders, to the extent that those moneys were not debited against the company's share capital account. As a result, the distribution may have both a dividend and a capital component.

Ultimately, care must be taken to ensure that a company's share capital account is not tainted, as what would otherwise be a company's share capital account will not be a "share capital account" if it is "tainted".[31]

Share capital tainting rules

Share capital tainting rules have been in place since 1 July 2002, with the current tainting rules operative from 25 May 2006.[32] The rules exist to prevent a company from transferring profits to its share capital account and then distributing those profits as a non-assessable capital distribution.[33]

In summary, the current share capital tainting rules apply as follows:

- the tainting rules will apply if an Australian resident transfers an amount of its share capital account from another account. The rules will not apply if the amount transferred is share capital;
- the first transfer to an untainted share capital account will result in the account becoming tainted;
- further transfers will increase the amount by which the account is tainted;
- transfers will result in franking debits arising to the company's franking account;
- any distribution from a tainted share capital account will be treated as an unfranked distribution; and
- a company can make an irrevocable choice to "untaint" its share capital account. However, if this choice is made, the company must make a debit posting to the franking account and/or untainting tax can be payable.

The implications of a tainted share capital account are that, instead of distributing funds to shareholders as both a dividend and a return of capital, the whole distribution could be deemed an unfranked distribution.

Tax treatment of a share capital reduction

A capital reduction may have CGT implications for the shareholder (assuming that their shares are held on capital and not revenue account). The CGT outcomes differ depending on whether or not the shareholder's shares are cancelled.

If a shareholder holds their shares as capital and not as revenue, a reduction in share capital will have an impact on that shareholder under CGT event G1, provided it does not result in the cancellation of shares. When CGT event G1 occurs, the non-taxable (capital) component of the shares is subtracted from the cost base, leading to a capital gain if the amount received is greater than the cost base. A capital loss cannot be realised in this scenario.[34]

However, if the share capital reduction does involve the cancellation of shares, CGT event C2 occurs instead. In this case, a capital gain will be realised if the capital proceeds (ie the non-taxable capital component of the payment) exceed the cost base of the shares. If the capital proceeds are less than the reduced cost base of the shares, a capital loss may be realised.[35]

Ultimately, share capital reductions can provide a tax-efficient way for shareholders to access value in a private company that has a substantial amount of paid-up share capital. It can result in more favourable tax outcomes than share buy-backs when the company does not have sufficient franking credits to fully frank a significant dividend, or when the shareholder prefers to receive a capital gain rather than a dividend on the basis that they can access relevant CGT concessions.

However, from the author's experience, family enterprises often have limited paid-up share capital, which poses a significant obstacle to utilising share capital reductions as a tax-efficient mechanism. In many cases, the paid-up capital is nominal, which makes it less useful to consider a capital reduction, and a share buy-back may be a better option.

Members' voluntary liquidations

Overview

Distributions to shareholders by liquidators by way of a members' voluntary liquidation (MVL) can be, dependent on the facts, an effective way to access value from companies. However, it is noted that the use of an MVL was predominately preferred in the past for releasing pre-CGT gains by way of allocating more consideration for shares (usually pre-CGT (subject to s 104-230 ITAA97 (CGT event K6) and Div 149 ITAA97)), rather than a dividend. However, given the time that has passed since the CGT regime was introduced, the effectiveness of an MVL has somewhat decreased. The small business CGT concessions have an important part to play in respect of an MVL (see below under the heading "Small business CGT concessions")).

Processes of liquidation can be applied to a solvent company.[36] More specifically, the members of a solvent company may decide to wind up the company by special resolution.[37] This has the effect that the company must cease to carry on its business and is deregistered.

Ultimately, an MVL is a process under the *Corporations Act 2001* in which a liquidator is appointed to a company to distribute the surplus value to shareholders in accordance with their rights to receive capital. The liquidator subsequently applies to deregister the company.

There are several advantages of liquidating a company, which are detailed further below. In order to carry out a tax-efficient liquidation, it is essential to take into account the differing levels of income tax, being the tax position of the company and the tax position of the shareholders. This is particularly important in the case of private

companies and other closely held entities, where clients tend to be more concerned with the overall tax outcome rather than the individual taxpayer. Additionally, the tax treatment at one level can significantly impact the other in real-world scenarios.

For completeness, as alluded to above, it should be noted that an MVL may be unnecessary where a company has only post-CGT assets and no access to concessions, and its shareholders only hold post-CGT shares. Depending on its franking account balance, it might be possible for all surplus value to be distributed to shareholders as franked dividends without the need to appoint a liquidator. If the company has only nominal paid-up capital and less than $1,000 of assets after the dividend has been paid, it may then be deregistered under s 601AD(1) and (2) of the *Corporations Act 2001.*

Advantages of an MVL from the company perspective

It is the members who appoint the liquidator, fix their remuneration, and exercise a general power of supervision and control over their duties. This puts the members in "the driving seat", giving them the right to control the affairs of their company when winding up:

- an MVL is the only process for fully winding up the affairs of a solvent company and is a much more thorough way of winding up a company;
- an MVL ensures that outstanding creditors are paid in full and protects the members' interests while the company structure is dismantled, and any surplus assets are distributed to its members;
- due to the formal advertising that occurs during an MVL, any creditor claims which arise post-liquidation cannot be enforced, and the company cannot be reregistered unless the creditor applies to the court and shows cause as to why the company should be reinstated;
- the court will be less inclined to restore a company that has been through a winding-up than it would be to reinstate a company removed from the register by ASIC as a purely administrative measure;
- after an MVL, a company is given the opportunity to apply for early destruction of its books and records;
- the liquidator completes most of the work; and
- this process results in a higher level of assurance that the company cannot be reinstated.

Disadvantages of an MVL from the company perspective

The following points summarise some of the key disadvantages of an MVL:

- in some cases, control of the company's remaining assets is transferred to the liquidator – the directors cease to have any authority;
- the company will incur costs relating to the external liquidator;
- this process can also incur administration, legal and other costs. However, these are unlikely to be significant if it is a clean MVL; and
- the process is relatively longer than deregistration, normally between six to nine months, because of the processing time taken in obtaining clearances from the ATO and other authorities.

Mechanisms of an MVL

The role of a liquidator is to collect all debts owed to the company, sell its assets, pay off any outstanding liabilities, determine the surplus value of the company, distribute the surplus to shareholders (including the return of the paid-up share capital), and finally deregister the company which leads to its termination.[38]

As stated above, the liquidation or winding-up of a company eventually results in the dissolution of the company and the cancellation of shareholders' shares. The company ceases to exist, and the liquidator's distribution of the company's surplus funds (if any) is considered to represent a capital distribution at common law.

For income tax purposes, s 47(1) and (1A) ITAA36 deem certain liquidator's distributions to be dividends, which are frankable. This will be the case where a liquidator is distributing amounts to shareholders that represent ordinary income or assessable income that was derived by the company. This would include any assessable capital gain.

On the other hand, a tax-free profit on the sale of a pre-CGT asset by the company, or a capital gain made by the company that is sheltered from CGT by a market value uplift under Div 149 ITAA36 (where pre-CGT assets are deemed to be post-CGT assets due to a change in majority underlying interests), will not give rise to a deemed dividend. This is because these profits and gains are not income or assessable income of the company.

It is very important, therefore, that tax practitioners understand the source of a liquidator's distributions so that the deemed dividend under s 47 ITAA36 is calculated correctly.

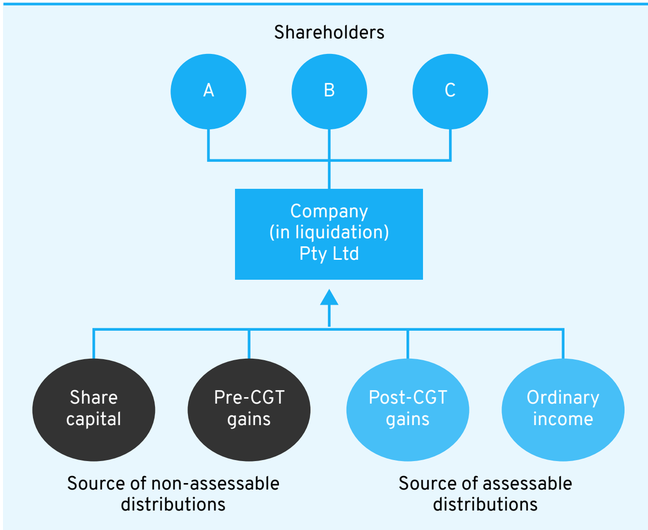
The starting point for identifying the source of the distributions is how they are accounted for by the liquidator (Diagram 3 illustrates how a liquidator would account for distributions).[39]

Accordingly, before considering the issues relevant to companies and shareholders, it is necessary to briefly consider the "Archer Brothers principle" and its ramifications.

Archer Brothers principle

The Archer Brothers principle is a well-known concept in tax law, specifically in regard to MVLs. While detailed commentary is outside the scope of this article, this principle states that, through proper record-keeping, a liquidator can distribute profits from specific sources without altering the character of the profits. This is provided that the sources are properly identified.[40]

Diagram 3. Source of liquidator's distributions



One of the key implications of the Archer Brothers principle is that tax-free amounts can be distributed to shareholders before taxable amounts, to the extent of the company's available funds for distribution. This means that, as long as the liquidator has identified the tax preferences, these amounts can be distributed as part of the available funds, potentially taking up a greater share of these funds than taxable amounts. There is no need to distribute the funds in a pro-rated manner across different sources.

For this reason, it is important to have detailed financial statements prior to liquidation. These statements can aid in identifying the character of the liquidator's proposed distributions, including the tax-free components. As a matter of practice, this generally involves crediting the equity side of the balance sheet to recognise the various tax preferences as reserves. This will make the liquidator's task more efficient when identifying the correct amounts in the liquidator's distribution statements.

Cancellation of shares

Having calculated the deemed dividend under s 47 ITAA36, the next step is to consider the CGT implications associated with the cancellation of shares in a liquidated company.

Assuming that shareholders acquired the shares after 19 September 1985, a range of interrelated tax provisions come into consideration. Specifically, two CGT events are relevant, as previously discussed:

- CGT event C2 is the specific CGT event applicable to the ending of an asset (ie the cancellation of shares);
- CGT event G1 could also apply where the liquidator's distributions have a non-assessable component (eg a return of share capital or is sourced from pre-CGT gains (see Diagram 3)); and
- where there is a deemed dividend under s 47 ITAA36 and a capital gain arises regarding the shares, the capital gain will be reduced under s 118-20 ITAA97 (the anti-overlap provision) by the amount of the dividend.

Within 18-month time frame

CGT event C2 happens when ownership of an intangible asset ends.[41] TD 2001/27 confirms that CGT event C2 applies to the cancellation of shares under the *Corporations Act 2001*. The event happens when a company is deregistered.

Where a company is dissolved within 18 months of the liquidator's distribution, only CGT event C2 is applicable.[42] The capital proceeds (ie the interim and final distributions from the liquidator) are compared to the taxpayer's cost base or reduced cost base and the gain or loss is calculated accordingly.[43] The anti-overlap provision in s 118-20 is then applied to prevent double taxation.

Compliance with the 18-month time frame allows interim distributions to be made without attracting the operation of CGT event G1. This means that:

- the CGT cost base of the shares in the company will not be eroded by any non-assessable distribution from the liquidator;
- no gain under CGT event G1 can arise; and
- where available, the CGT discount and small business CGT relief can be utilised when CGT event C2 occurs (as distinct from CGT event G1 which erodes cost base).

Outside 18-month time frame

Where a company cannot be dissolved within the 18-month time frame, the non-assessable component of the liquidator's distributions will trigger CGT event G1, thereby:

- eroding the CGT cost base of the shares in the company by the amount of the non-assessable distribution from the liquidator;[44] and
- triggering a gain by the amount of any further non-assessable distribution once the cost base has been eroded to nil.[45]

Income tax consolidation considerations

While consideration of an MVL and the income tax consolidation rules are outside the scope of this article, it is important at this stage to note that the liquidation of a subsidiary within a tax consolidated group should not attract the consequences discussed above.

Under the single entity rule, the existence of the subsidiary and the membership interest in that subsidiary are generally ignored when considering the application of the income tax law to the consolidated group.[46] In short, the shares in the subsidiary do not exist for income tax purposes under the single entity rule.

Summary of key tax issues

A detailed explanation of the tax issues relating to liquidator's distributions is beyond the scope of this article. However, the following points should be considered by all advisers to ensure that families are best placed during this process.

Company tax issues

Several of the significant tax issues at the company level are as follows:

- on the basis that the assets are held on capital account, the disposal of these assets or their distribution in specie/in kind to shareholders will trigger a CGT event for the company;
- any net capital gain which results in a tax liability for the company will add to the company's franking account balance;
- any pre-21 September 1999 assets will need to be indexed up to 30 September 1999 (there is no choice); and
- any pre-CGT assets (subject to analysis of Div 149 ITAA97) will give rise to a potential tax preference and might be booked as a pre-CGT reserve in the pre-liquidation financials.

Accordingly, preparation of the pre-liquidation financial statements and updating the franking account balance, including projections, play a critical role in this process and directly impact the strategic planning decisions and outcome for the shareholders.

Summary of key shareholder tax issues

There are a number of significant tax issues at the shareholder level, including:

- a liquidator's distribution will be a deemed dividend to the extent that the amount distributed represents income of the company, whether during or before liquidation;[47]
- an amount that is or will be assessable income to the company or a net capital gain (which itself is assessable income) is also deemed to be income of the company and will therefore also amount to a deemed dividend;[48]
- the abovementioned net capital gain needs to be calculated by ignoring any capital losses of the company and ignoring indexation;[49]
- the deemed dividend that arises from a liquidator's distribution is frankable. As such, it may be partly or fully franked, depending on the company's franking account balance and the benchmark franking rule;
- the amount of the liquidator's distribution representing a return of the paid-up share capital will not be a deemed dividend, consistent with other provisions of the tax legislation;
- the liquidator's distribution will also amount to the capital proceeds for a capital gain/capital loss which normally arises as a result of CGT event C2 applying, or CGT event G1 can sometimes apply;
- CGT event C2 applies where an intangible asset, in this case shares, are cancelled or extinguished. Normally, the mechanics of an MVL will involve the liquidator cancelling the shareholders' shares in consideration of the liquidator's distribution; and
- the anti-overlap provisions under s 118-20 ITAA97 apply to disregard any net capital gain to the shareholder to the extent that the same receipt is otherwise assessable (as in the case of the deemed dividend).

Key planning considerations

When it comes to tax planning with regard to an MVL, it is crucial for an adviser to consider not only specific anti-avoidance provisions, but also the general anti-avoidance provisions outlined in Pt IVA ITAA36. It is, therefore, the view of most practitioners that the most effective tax planning is achieved by the commercial aspects of the transactions, ie the Commissioner tends to pursue tax outcomes that lack a legitimate commercial justification. Furthermore, the author suggests that these planning issues often arise due to the need to prevent adverse tax impositions. Specifically, several of the most common planning issues that arise in an MVL include the following:

- Has enough analysis been done into alternative methods of extracting value besides using an MVL?
- An MVL may not always be required to extract value and achieve the company's and shareholders' goals in a tax-efficient manner.
- Is it advantageous to distribute fully franked or partially franked dividends before the appointment of a liquidator and before the start of the next fiscal year in order to reduce the risk of franking deficit tax under the benchmark franking regulations?
- Is it appropriate for the liquidator's distributions to go to the shareholders of the company? If not, what is the extent to which these shareholders can transfer or roll over their shares to another entity before the appointment of the liquidator?
- If the company holds "revenue assets", such as trading stock and depreciating assets, which are to be distributed to shareholders in specie, are there tax-effective opportunities through the utilisation of roll-overs as part of the liquidator's distributions to achieve a deferral of the tax liability on these assets?
- Has Div 7A been considered in the context that, although a loan advanced by a liquidator to a shareholder instead of an interim distribution being made is effectively exempt from the effects of Div 7A in the year that it is advanced in accordance with s 109NA ITAA36, s 109D(1A) ITAA36 recaptures that loan as a deemed dividend at the end of the next financial year if it is not fully repaid by then. Accordingly, advisers need to be mindful of the progress of a liquidation if such loans are made in order to avoid the possibility of unfranked dividends being deemed.

Restructure considerations pre-MVL

Before starting an MVL, it is important to evaluate whether the shareholders of the company targeted for liquidation need to be altered. This is because it is common for a liquidating company to have either pre-CGT assets or pre-CGT shares. This means that any planning must consider CGT event K6 and changes in the majority underlying interests under Div 149 ITAA97.

If the shares in the liquidating company are owned by individuals, it is possible to transfer them to a company or the trustee of a trust without adverse CGT consequences. This can provide better opportunities for investing the proceeds of the liquidation or holding any assets received in specie. However, this will still result in the same structure, but each shareholder will no longer be tied in their investment, business activities, and commercial decision-making.

If the shares are held by individuals or trustees of trusts, there is an opportunity to roll over these shares to wholly-owned companies under Subdiv 122-A ITAA97 If the shares in the liquidating company are pre-CGT shares, they can be maintained in their pre-CGT status. This is important when the shares are cancelled as part of the liquidation process. If the shares are post-CGT shares, then the roll-over company will inherit the cost base, which may still result in a deferred capital gain, depending on the anti-overlap rules and whether the same receipt is assessable as a dividend.

Having a company as a shareholder has several advantages, such as the ability to pay fully franked liquidator distributions without any further tax being payable and receiving a credit to the franking account balance. Pre-CGT shares can be transferred from an individual to the trustee of a discretionary trust, which will lose their pre-CGT status but have a market value cost base.

Care must be taken with transferring pre-CGT shares to avoid CGT event K6, which happens when pre-CGT shares in a company are disposed of and 75% or more of the company's property consists of post-CGT assets.[50] This can result in an imputed gain on the post-CGT assets being attributed to the shareholder. The impact of CGT event K6 can be reduced by transferring shares after the company has converted all of its assets to cash or when the post-CGT assets have no unrealised gain. This is because the cost base of the cash and loans should be equal to their market value. Therefore, if the transfer of shares is necessary as part of a pre-liquidation structure, this might be done after the company has converted all of its assets to cash or in circumstances where the post-CGT assets have no unrealised gain.

For a liquidating company with pre-CGT assets, pre-liquidation restructuring must also take into account changes to majority underlying interests under Div 149. This applies if the company with pre-CGT assets fails to maintain 50% or more of the shares it had before 20 September 1985. This will result in the liquidating company having a market value cost base for the assets in question, and no capital gain should arise if the assets are realised by the company/liquidator or distributed by the liquidator in-kind a short time later.

Having a company as a shareholder also provides a deferral of tax payable on franked distributions and caps the tax payable on any unfranked dividend/unfranked component of a dividend to the corporate tax rate. Distributions made out of pre-CGT reserves should maintain their character in the hands of a shareholder company and can be distributed tax-free if later liquidated, subject to detailed analysis.

With regard to having trusts as shareholders, the material benefit of this is the flexibility it affords in terms of the distributions of receipts from a liquidator, summarised as follows:

- franked dividends might be distributed to corporate beneficiaries so that the effective tax rate is capped at the corporate tax rate, with further tax payable being deferred;
- pre-CGT reserves may be distributed as capital distributions to individual beneficiaries; and
- unfranked dividends can either be distributed to entities within a shareholder's group that have carried forward tax losses or distributed among a number of family members and associated beneficiaries.

In the context of family groups, the above will be effective in addition to the other benefits associated with trusts, including effective succession planning and asset protection.

Dividend access shares

Overview

Dividend access shares offer companies the ability to be flexible with their dividend payments and thereby may, on the surface, appear as an effective way of extracting value from a company.

A typical dividend access share arrangement involves a company which has accumulated significant profits and has previously issued ordinary shares to individual shareholders. The profits would have been subject to income tax at the company tax rate, for example, 25% to 30%. The company then issues a new class of shares, being dividend access shares, to new shareholders for nominal consideration. The holders of these shares may receive dividends at the discretion of the company, separate from other shareholders. However, these shares ordinarily lack any voting rights or the right to participate in the surplus assets of the company on its winding up. They are therefore a potentially valuable means of getting value out of companies and into the hands of shareholders who, for example, may have lower exposures to commercial risks.

In practice

For a private company engaging in a dividend access share arrangement, the flow of transactions is typically as follows:

- fully franked dividends are paid to the dividend access shareholders;
- the dividend access shareholders are closely related to the ordinary shareholders and apply the dividend in such a way that it ultimately reaches the ordinary shareholders in a tax-effective way; and
- examples of entities which may be new shareholders include non-residents, individuals or trusts with carry-forward losses.

Dividend access shares may be used as an effective way of achieving a commercial objective beyond any tax benefit. These might include:

- asset protection, as the company is able to distribute its profits to lower-risk entities and thereby reduce its retained earnings on an as-needed basis;
- estate planning, as the company is able to redistribute company profits to manage potential claims arising from estate or family disputes; and
- remuneration, reward and retention, as the company is able to distribute profits to directors or employees without granting additional voting rights.

The Commissioner's view

The Commissioner considers that the use of dividend access shares can constitute a scheme by way of or in the nature of dividend stripping in certain circumstances.[51] The nature of these concerns is outlined in TD 2014/1. Accordingly, significant care must be taken if they are being considered for use.

TD 2014/1 states broadly the Commissioner's view that a dividend access share arrangement of the type described in the determination is a scheme "by way of dividend stripping" or "in the nature of dividend stripping" within the meaning of s 177E of Pt IVA ITAA36. As a consequence, it states that Pt IVA is capable of applying to such arrangements.[52]

Specifically, para 4 of TD 2014/1 states that the Commissioner will deem an arrangement as a scheme "by way of or in the nature of dividend stripping" within the meaning of s 177E where the following exists:

"(a) A private company (the 'target company') has accumulated significant profits which have been subject to income tax at the company tax rate.

(b) The target company's ordinary shares are held by an individual, or individuals (the 'original shareholder(s)'), one or more of whom is also the director of the target company.

(c) The target company's constitution is amended to allow for the creation of a new class of shares (the 'Z class shares') which have the following characteristics:

- a right to receive a dividend distribution at the discretion of the target company's director(s);
- no voting rights or rights to participate in the surplus assets of the target company upon its winding up; and
- a right by the target company to redeem the Z class shares within four years of the share's issue date. If the Z class shares are not redeemed, they will cease to exist at the expiration of four years from their issue.

(d) The original shareholder may incorporate new companies and establish new discretionary trusts or employ existing companies and trusts to implement the remaining steps of the arrangement. The interposed companies and trusts will typically be controlled by the original shareholder and the beneficiaries of the trusts will likely comprise the original shareholder and his or her associates.

(e) The target company issues Z class shares for nominal consideration to either the company controlled by the original shareholder or to a company acting as trustee of a discretionary trust.

(f) The target company declares and pays a fully franked dividend on the Z class shares of an amount approximately equal to the accumulated profits in the target company. The dividend payment is satisfied by way of a promissory note issued by the target company.

(g) A series of transactions are then carried out that have the effect of ensuring that the original shareholder(s) and/or associates receive the economic benefit of the target company's profits in a tax-free or substantially tax-free form. Examples of this include:

- where the Z class shares are issued to a company, the company need not pay tax on the fully franked dividend as it gets enough franking credits to offset any tax liability. In many of these arrangements, the company is wholly owned by a discretionary trust. This allows the original shareholder to direct any subsequent dividend distributions by the company to tax-preferred entities such as non-resident associates of the original shareholder, other related individuals exposed to a lower marginal tax rate or entities with carried forward tax losses.
- where the Z class shares are issued to the trustee of a discretionary trust, the trustee appoints the net income of the trust to a second trust without immediately paying out that entitlement. This amount will represent an unpaid present entitlement (a 'UPE') of the second trust. The trustee of the second trust then appoints its net income to a private company beneficiary without immediately paying out that entitlement. This amount represents a UPE of the private company beneficiary. Absent any consequences under Division 7A , the UPE will remain an asset of the private company beneficiary indefinitely. In many of these arrangements, the assets represented by the fully franked dividend on the Z class shares are lent by the trustee of the trust to the original shareholder and/or his or her family for their personal use under an interest free loan repayable only on demand by the trustee company, which is controlled by the original shareholder."

Consequently, it seems that the Commissioner may view the use of dividend access shares as a scheme by way of or in the nature of dividend stripping.

Unfortunately, TD 2014/1 does not address the Commissioner's view if the dividend access shares had been in place well-ahead of any dividends. The determination states that an assertion of some non-tax-related purpose for the arrangement by taxpayers will not be accepted

by the ATO unless it is consistent with the objective facts of the case having regard to all of the evidence, and in any case, there is a good reason why the alleged purpose could not have been achieved in some "simpler and more commercially usual manner".

Accordingly, advisers must ensure that due diligence is undertaken prior to entering into this type of arrangement to extract value from a private company.

Dividend stripping considerations

Section 177E ITAA36 is an anti-avoidance provision that is designed to prevent tax benefits being obtained as part of a dividend stripping scheme or a scheme with substantially the same effect as a dividend stripping scheme.

The first requirement of s 177E is that there is a scheme by way of or in the nature of dividend stripping or, in the alternative, there must be a scheme having substantially the same effect.

First limb

There are two limbs to s 177E(1) ITAA36. The first limb (s 177E(1)(a)(i)) requires there to be "a scheme by way of or in the nature of dividend stripping".

Dividend stripping is not a defined term. However, its meaning is considered in IT 2627. The ruling elucidates at para 9:

> "… in its traditional sense a dividend stripping scheme would include one where a vehicle entity (the stripper) purchases shares in a target company that has accumulated or current years' profits that are represented by cash or other readily-realisable assets. The stripper pays the vendor shareholders a capital sum that reflects those profits and then draws off the profits by having paid to it a dividend (or a liquidation distribution) from the target company."

As such, in a broad sense, a dividend stripping arrangement will likely involve the following:[53]

1. a target company which had substantial undistributed profits, creating a potential tax liability either for the company or its shareholders;
2. the sale or allotment of shares in the target company to another party;
3. the payment of a dividend to the purchaser or allottee of the shares out of the target company's profits;
4. the purchaser or allottee escaping Australian income tax on the dividend so declared;
5. the vendor shareholders receiving a capital sum for their shares in an amount the same as or very close to the dividends paid to the purchasers (there being no capital gains liability at the relevant time); and
6. the scheme being carefully planned, with all the parties acting in concert, for the predominant if not the sole purpose of their vendor shareholders, in particular, avoiding tax on a distribution of dividends by the target company.

With regard to items 5 and 6 above, the vendor shareholders must receive consideration which is in a tax-free or largely tax-free form, and, for the arrangement to be a scheme to which the dividend stripping rules apply, a tax avoidance purpose is required.[54] Put simply, the first limb captures a scheme which can be said objectively to have the dominant purpose of avoiding tax. What is important is the nature of the scheme, not the subjective motives or intentions of any of the participants or the beneficiaries.[55]

In *Consolidated Press Holdings*,[56] the court held that:

> "125. … [A] scheme will only be a dividend stripping scheme if it would be predicated of it that it would only have taken place to avoid the shareholders in the target company becoming liable to pay tax on dividends out of the accumulated profits of the target company. It is that matter which distinguishes a dividend stripping scheme from a mere reorganisation."

Therefore, in order to determine whether a scheme will possess the ordinary characteristics of a dividend stripping scheme, it must be determined whether it would only have taken place to avoid the shareholders becoming liable to tax on dividends that they otherwise would have. This requires a consideration of the amount of tax, and the quantum of dividends, that would ordinarily have resulted.

Although a plain reading of the words contained in s 177E does not require determining the purpose for which the scheme was entered, the High Court has held that, to constitute dividend stripping, the scheme must have as its dominant purpose the avoidance of tax on the distributions of dividends by the target company.[57]

Second limb

The second limb (s 177E(1)(a)(ii)) requires there to be a scheme having substantially the effect of a scheme by way of or in the nature of dividend stripping. This limb effectively assesses the effect of the arrangement and captures arrangements akin to dividend stripping. Ultimately, as held in *Lawrence v FCT*,[58] the effect of a dividend stripping operation is that retained profits of a target company are diverted from the original shareholders to another entity (whether by dividend or otherwise) and their economic benefit is released (by whatever means) to those same shareholders (or associates) in a manner which results in less tax being payable.

Accordingly, shareholders of private family enterprises need to carefully consider the impact of dividend access shares. Ordinarily, dividends declared in accordance with rights attached to dividend access shares may arguably be seen as a dividend stripping operation by virtue of the specific outcomes (ie the retained earnings being distributed to these specific stakeholders, even though the shares in the company are held by a different class of stakeholder).

Understanding the risks and opportunities

While the application of Pt IVA depends on the facts of the particular case, the Commissioner considers that a dividend access share arrangement that includes all of the elements

described in para 4 of TD 2014/1 (discussed above) is a scheme "by way of or in the nature of dividend stripping" within the meaning of s 177E where the relevant purpose exists.

It is the author's view that the engaging in dividend access share arrangements creates a substantial risk. This risk is particularly acute as there are numerous provisions that must be considered, many of which are broad and may apply across wide-ranging circumstances. In the author's view, before entering into a dividend access share arrangement, taxpayers should consider all other methods for extracting value to shareholders.

Should a dividend access share arrangement be the preferred option, it would be prudent for the taxpayer to seek a private binding ruling on all of the potential adverse tax risks, including Pt IVA. Obtaining a private binding ruling provides for highly effective risk mitigation, as the taxpayer can proceed with the certainty of the status of their arrangement and, if successful, can be assured that the decision binds the Commissioner in future.

Small business CGT concessions

Overview

When discussing the topic of accessing value from companies, especially private family companies, it is important to consider the impact of the small business CGT concessions. These concessions not only have an effect on the company, but they can also provide benefits to shareholders. As discussed earlier, share buy-backs, share capital reductions, and liquidators' distributions can cause capital gains to arise in the hands of the company's shareholders. These capital gains are potentially eligible for reduction under Div 152 ITAA97 in the same way as any other capital gains. Although a detailed discussion on the small business CGT concessions goes beyond the scope of this article, the following provides preliminary commentary in relation to how a shareholder might benefit from the concessions and on what conditions.

The CGT concessions for small business entities are contained in Div 152. For the concessions to apply to a taxpayer on the disposal of business assets, the taxpayer must first satisfy the basic eligibility conditions in s 152-10. Broadly, these basic conditions require that:

- condition 1: a CGT event happens in relation to a CGT asset;
- condition 2: apart from Div 152, the CGT event would have resulted in a capital gain;
- condition 3: the taxpayer is either:
  - a CGT small business entity for the income year;
  - satisfies the maximum net asset value test; or
  - is a partner in a partnership that is a CGT small business entity for the income year; and
  - the CGT asset is an interest in an asset of the partnership.

Alternatively, the asset is a qualifying passive asset:

- condition 4: the CGT asset satisfies the active asset test.

If the basic eligibility conditions are satisfied, the next step is to consider the four small business CGT concessions that are available, which are:

- the 15-year CGT asset exemption;[59]
- the 50% reduction;[60]
- the retirement exemption;[61] and
- roll-over relief.[62]

The four CGT concessions are subject to further specific eligibility conditions. Where these are satisfied, the small business entity taxpayer can apply the particular concession. The CGT concessions are available in many situations. However, they are particularly useful when small business owners are winding down or exiting their small business.

Application to distributions of share capital

As previously discussed, selective share buy-backs, share capital reductions, and liquidators' distributions can cause capital gains to arise in the hands of the private company's shareholders. These capital gains are potentially eligible for reduction under the small business CGT concessions.

Assuming conditions 1 to 3 mentioned earlier are satisfied, it is then necessary to consider the active asset test.

Active asset test

A CGT asset satisfies the active asset test if:[63]

- you have owned the asset for 15 years or less and the asset was an active asset of yours for a total of at least half of the period specified; or
- you have owned the asset for more than 15 years and the asset was an active asset of yours for a total of at least 7.5 years during the period specified.

The specified period begins when you acquired the asset and ends at the time of the CGT event.[64]

A CGT asset is an active asset at a time, if at that time:[65]

- you own the asset (whether the asset is tangible or intangible) and it is used, or held ready for use, in the course of carrying on a business that is carried on by:
  - you;
  - your affiliate; or
  - another entity that is connected with you; or
- if the asset is an intangible asset, you own it and it is inherently connected with a business that is carried on (whether alone or in partnership) by you, your affiliate, or another entity that is connected with you.

A CGT asset is also an active asset at a given time if, at that time, you own it and:[66]

- it is either a share in a company that is an Australian resident at that time or an interest in a trust that is a

resident trust for CGT purposes for the income year in which that time occurs; and

- the total of:
  - the market values of the active assets of the company or trust;
  - the market value of any financial instruments of the company or trust that are inherently connected with a business that the company or trust carries on; and
  - any cash of the company or trust that is inherently connected with such a business,

  is 80% or more of the market value of all of the assets of the company or trust.

A share in a company, or an interest in a trust, is an active asset at a time if:[67]

- the share or interest was an active asset at an earlier time; and
- it is reasonable to conclude that the share or interest is still an active asset at the later time.

Also, a share in a company, or an interest in a trust, is an active asset at a time if:[68]

- the share or interest fails to meet the requirements to be an active asset at that time; and
- the failure is of a temporary nature only.

Additionally, the test in respect of shares is further modified so that:[69]

- the financial instruments and cash must be inherently connected with the business and were not acquired for a purpose that included assisting an entity to satisfy this test; and
- all shares and units held by the company or trust are excluded and instead a look-through approach will be taken with the underlying assets of the company or trust.

Accordingly, there may be some difficulty in meeting the above requirement where some or all of a company's active assets are sold before the cessation of the business and the cash is held by the company. In these circumstances, cash would represent a significant portion of the company's assets and cause the failure of the 80% rule. There are some private rulings that discuss what it means for an asset to be inherently connected to a business. PBR 1051609910268 provides:

> "Inherent connection requires more than just some form of connection between the cash or financial instrument and the business … Also, when an asset is a permanent or characteristic attribute of the business, such as goodwill or trade debtors it is considered to have an inherent connection."

PBR 1051437721326 adds:

> "Where a business is holding excess funds arising from a temporary spike in trading activity or the sale of a business asset, the excess funds might also reasonably be regarded as inherently connected with the business."

Ultimately, detailed tax planning should be undertaken prior to the sale of any assets prior to liquidation to ensure that the shareholders are not adversely impacted.

Additional basic requirements

The following additional basic conditions must be satisfied if the CGT asset is a share in a company, or an interest in a trust:[70]

> "(a) the CGT asset would still satisfy the active asset test (see section 152-35) if the assumptions in subsection (2A) were made;
>
> (b) if you do not satisfy the maximum net asset value test (see section 152-15) — you are carrying on a business just before the CGT event;
>
> (c) either:
>
> (i) the object entity would be a CGT small business entity for the income year; or
>
> (ii) the object entity would satisfy the maximum net asset value test (see section 152-15);
>
> if the following assumptions were made:
>
> (iii) the only CGT assets or annual turnovers considered were those of the object, each affiliate of the object entity, and each entity controlled by the object entity in a way described in section 328-125;
>
> (iv) each reference in section 328-125 to 40% were a reference to 20%;
>
> (v) no determination under subsection 328-125(6) were in force;
>
> (d) just before the CGT event, either:
>
> (i) you are a CGT concession stakeholder in the object entity; or
>
> (ii) CGT concession stakeholders in the object entity together have a small business participation percentage in you of at least 90%."

With regard to the CGT concession stakeholder test, an individual is a significant individual in a company or a trust at a time if, at that time, the individual has a "small business participation percentage" in the company or trust of at least 20%.

An entity's small business participation percentage in another entity at a time is the percentage that is the sum of:

- the entity's direct small business participation percentage in the other entity at that time; and
- the entity's indirect small business participation percentage in the other entity at that time.

The indirect small business participation percentage that an entity holds at a particular time in another entity is equal to that entity's direct small business participation percentage in any intermediate entities multiplied by the sum of:

- the intermediate entity's direct small business participation percentage in the test entity at that time; and

- the intermediate entity's indirect small business participation percentage in the test entity at that time.

An entity holds a direct small business participation percentage at the relevant time in a company equal to the smallest percentage of voting power, dividend entitlements, and capital distribution entitlements that the entity has because of holding the legal and equitable interests in shares in the company.

Accordingly, where a company is in liquidation, regard must be had as to whether the individual "has" voting power within the meaning of s 152-70(a) ITAA97 in order to be able to be or remain a significant individual in relation to the company. Further, it should be noted for completeness that the Commissioner has taken the view that the shareholders holding different classes of shares (such as dividend access shares) cannot qualify for small business CGT concessions.[71]

A simpler option

Sometimes the best options are the simplest.

Straight payment

A straightforward method of transferring value out of a company is to make a payment plain and simple in the right circumstances. The company would record a payment as an expense in the profit and loss. This payment could be for services such as consulting or management services. However, there are two concerns to take into account when considering such a payment:

1. whether the payment will be considered a tax-deductible expense for the company according to s 109 ITAA36; and
2. if the payment is made to a shareholder or related party, it may be classified as either a dividend under s 44 ITAA36 or a Div 7A deemed dividend under s 109C ITAA36.

However, an in-depth examination of these provisions is not covered in this article.

Conclusion

This article has discussed some of the strategies, opportunities and risks associated with extracting value from companies, without dwelling on the "why" but more on the "how". It is hoped that this article will provide some preliminary guidance for tax advisers and their clients in this challenging but crucial area of practice.

Ultimately, although the concept of extracting value from companies may initially seem straightforward, the numerous options accessible to taxpayers and the subjective interpretation of provisions by the Commissioner create various intricate risks that taxpayers and their advisers must evaluate and navigate.

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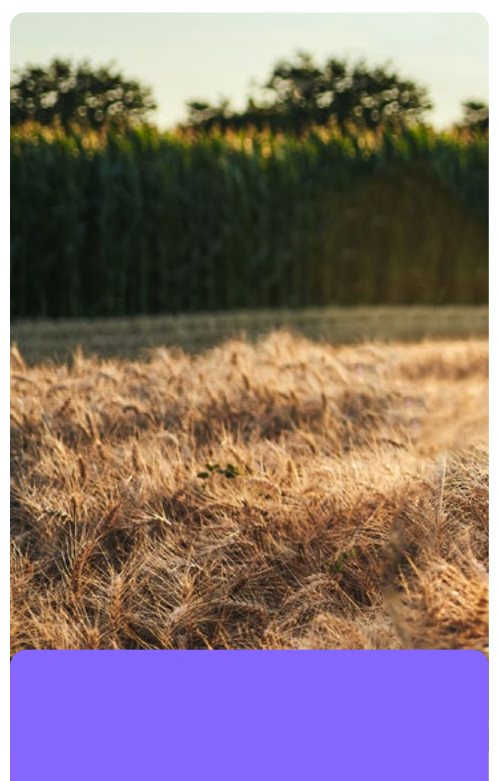
Appendix. Key differences between share buy-backs and share capital reductions

Attribute	Share buy-backs	Share capital reductions
Availability	• Must not materially prejudice the company's ability to pay creditors • Resolution of shareholders (for selective share buy-back)	• Fair and reasonable to company's shareholders • Not materially prejudice the company's ability to pay creditors • Shareholder resolution required
Process under the *Corporations Act 2001*	• Company makes offer to shareholders to acquire shares • Shareholders accept offer and sell shares to company • Company immediately cancels shares	• Share capital distributed to shareholder • Shares may or may not be cancelled
Income tax consequences	• Frankable dividend to extent purchase price exceeds amount debited to share capital • Non-taxable return of capital to extent payment is debited to share capital	• Not dividend to extent payment is debited to share capital
CGT consequences	• CGT event A1 occurs – capital gain equal to proceeds less cost base • Amount of consideration is reduced by the "reduction amount" • Application of anti-overlap rule (reduction amount) can generate or extend capital loss	• If shares are cancelled, CGT event C2 occurs. Capital gain/loss is equal to difference between proceeds for cancellation and cost base • If shares are not cancelled, CGT event G1 occurs. Capital gain is equal to excess of non-assessable payment over cost base (and cost base become nil). Otherwise, cost base is reduced by non-assessable part of payment • Section 118-20 ITAA97 avoids double taxation • Application of anti-overlap rule cannot increase or result in a capital loss
Circumstances when effective	Where dividend is preferred to capital gain, for example: • significant franking credits are available • shareholder is company • shareholder is trust with corporate beneficiary	• Where company has substantial paid-up share capital • Where capital gain is preferred to dividend, for example, if company has insufficient franking credits, or if there is access to concessions or general CGT discount



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Assorted problems with "payment"

by Adrian Cartland, Principal, Cartland Law

What constitutes a "payment" is a fundamental concept that is relevant to a diverse set of issues regarding the incidence and timing of tax. This article discusses an assortment of different practical issues and "war stories" in which the concept of "payment" was central, including: how an accountant became liable for their client's PAYG; the ATO's mixed record on cases arguing that a small business controller did not pay themselves; related party dealings and R&D; asset protection that did not protect the assets; and making SMSF contributions on time. There are some opportunities for clarification by the ATO of its interpretation of "payment", given that some positions taken on what constitutes a "payment" may be detrimental to its overall administration of the revenue.

The accountant who was liable

The following is a de-identified summary of a pattern of facts and legal arguments that have occurred to several bookkeepers and accountants. Some of these matters have concluded with the bankruptcy of the accountant involved, and other matters are ongoing at the time of writing. At essence is the question of what constitutes a payment.

The accountant operated a bookkeeping and payroll service. The accountant's usual payroll services and procedures were as follows:

- a client would send the accountant the details of their employees' timesheets and salaries for a payment period (typically a fortnight);
- the accountant would calculate from that information the client's payroll obligations, including gross wages per employee, net wages to pay each employee, superannuation guarantee for each employee to be paid into the superannuation fund's clearing house, PAYG withholding to be remitted to the ATO, and payroll tax (if applicable);
- the accountant would have third party access authorisation to the client's bank accounts and prepare an Australian Banking Association (ABA) file showing the net amount to pay to each payee that would allow all employee net wages to be processed for payment in one batch (rather than processing each individual payment);
- the accountant would send the payroll summary to the client for approval, and then upload the ABA into the client's bank account and request, via the bank, for the client to authorise the payment of the net wages and superannuation guarantee via the client's bank account in accordance with the ABA;
- the client would then organise the payments of PAYG withholding and payroll tax in accordance with the calculations of the accountant; and
- the accountant was paid their typical hourly charge rate (a modest sum).

One client of the accountant operated a labour hire business (the labour hire client):

- the accountant and the labour hire client were unrelated entities;
- the accountant was instructed by the director of the labour hire client (the director) to process payroll and do bookkeeping for employees of the labour hire client.

The accountant later found out that:

- the director was a puppet or patsy for some rogue operators; and
- the rogue operators were using the labour hire client as part of a PAYG scheme. Under this scheme, an amount of PAYG was not remitted and was instead pocketed by the rogue operators.

The accountant was scrupulous in their own affairs and paid their own employees, remitted the necessary withholding amounts, and disclosed and lodged their relevant PAYG withholding amounts through their monthly instalment activity statement by the lodgment due dates. The ATO did not assert that the accountant was one of the rogues behind the PAYG scheme.

The ATO investigated the rogue operators and sent out seven-figure assessments to all persons involved, including the director and the accountant:

- the Commissioner informed the accountant that the accountant had miscalculated their PAYG withholding obligations. The Commissioner stated that the amounts disclosed in the accountant's monthly activity statements were understated, as they did not include the amounts which relate to the labour hire client;
- the Commissioner pointed to the obligation to withhold PAYG under s 12-35 of Sch 1 to the *Taxation Administration Act 1953* (Cth) (TAA53) lies on the payer of the salary and wages. This section states that an entity must withhold an amount from salary, wages, commission, bonuses or allowances that it pays to an individual as an employee (whether of that or another entity);
- in the Commissioner's view, the accountant was the payer of salary and wages, by reason of uploading the ABA file, and therefore responsible to withhold PAYG;

- the entity responsible for withholding PAYG under s 12-35, Sch 1 TAA53 is also obligated to pay those amounts to the Commissioner under s 16-70, Sch 1 TAA53;
- s 16-70 requires a taxpayer to pay to the Commissioner all amounts withheld under Div 12, Sch 1 TAA53. This includes amounts of PAYG withholding payable;
- s 16-150, Sch 1 TAA53 states that an entity that must pay an amount to the Commissioner under s 16-70(1) must notify the Commissioner of the amount on or before the day on which the amount is due to be paid (regardless of whether it is paid). The notification must be in the approved form and lodged with the Commissioner;
- s 268-10, Sch 1 TAA53 empowers the Commissioner to estimate unpaid amounts of PAYG for entities required to withhold an amount under s 16-70 TAA53; and
- in the event that the PAYG estimates were incorrect, the Commissioner invited the accountant to provide a statutory declaration stating as such and the amount that the estimates should be reduced. Given that the PAYG estimates are an immediately enforceable debt, with no right of reply, objection or appeal, the provision of a statutory declaration to inform the Commissioner of an incorrect estimate is an important right of the taxpayer.

The accountant lodged a statutory declaration to the Commissioner, stating that the PAYG estimates that the Commissioner made by reference to the amounts transferred according to the ABA files were not subject to PAYG withholding per s 12-35, Sch 1 TAA53 because they were payments on behalf of another entity and that the accountant did not employ the staff the subject of the PAYG estimates.

The Commissioner disregarded the statutory declaration with the following reasoning:

- TR 2005/16 states:

  > "66. Where the payment is a reward for services provided by the employee to the employer in the capacity of employee, the payment would be incidental to the employment regardless of whether the payment is made by the employer or another entity. If the payment is a payment of salary, wages, commission, bonus or allowance then *the entity that made the payment* will be required to withhold under section 12-35 of Schedule 1 to the TAA 1953."

- in *David Cassaniti v FCT*[1] (*Cassaniti*), Edmonds J held that the obligation to withhold lies with the payer of the salary or wages, irrespective of whether that payer was the employer or otherwise;
- in *Sunraysia Harvesting Contractors Pty Ltd as trustee of the Sunraysia Harvesting Contractors Trust and FCT*[2] (*Sunraysia Harvesting Contractors*), Deputy President PE Hack provided an introduction to an arrangement between Sunraysia Harvesting Contractors and three other companies which were contracted to engage and pay employees, and, necessarily, to account for PAYG deductions and for payroll tax if necessary:

  > "38. For the present case the Commissioner alleges that the arrangements between Sunraysia and Danood, Jameron and Kigra were not as they appear to be. Those companies, it is said, were not genuine arm's-length entities, contracting with Sunraysia to provide the labour required by Sunraysia's customers and employing the workers required to meet its contractual obligations …
  >
  > 39. It is for Sunraysia to show that the assessments were excessive and it seeks to do so by showing that the arrangements with Danood, Jameron and Kigra were genuine and real and that there was no disconnect or inconsistency between appearance and reality of documents and actions.
  >
  > 40. In my view Sunraysia has failed to discharge that onus. For the reasons that follow, I am not satisfied, on the balance of probabilities, that payments by Sunraysia to Danood, Jameron and Kigra were made in accordance with a contract between those entities for the subcontracting company to provide labour to meet Sunraysia's obligations to growers. Indeed, were it necessary, I would have been affirmatively satisfied that Sunraysia's arrangements with Danood, Jameron and Kigra were never intended to create any legally enforceable obligation between Sunraysia and the subcontractor and were simply part of a scheme devised by SME's R Us to allow Sunraysia to avoid remitting PAYG deductions for persons who were, and remained throughout, its employees."

The problem with the Commissioner's reasoning is as follows:

- the Commissioner had drawn the wrong conclusion from the cases cited:
  - in *Sunraysia Harvesting Contractors*, the court held that the employer and the payer were not dealing at arm's length, and were operating together as part of a scheme. In the above discussion about the accountant who was liable, the Commissioner had not asserted that the accountant was dealing at anything other than arm's length with the labour hire client, and so this seems irrelevant. It would, however, be a reasonable basis to assess the rogue operators behind the labour hire client;
  - in *Cassaniti*, the employers were paying their employees indirectly through a third party. The third party made payments at the direction of the employers. In each instance, the employers were the relevant payers of the salary or wages of the applicant, and not the third party who merely acted as a conduit under the direction of the employers;
  - in the present case, the labour hire clients had a contractual obligation with the host employers to pay the employees on their behalf. Therefore, they were the payers of the salaries and wages as per the contractual agreement; and
  - even if the Commissioner's view in *Cassaniti* was to be applied to the current facts, the employers

would be the host employers, and the third party meeting the payroll obligations would be labour hire client as they were contracted by the host employers to pay the employees. Therefore, applying the Commissioner's interpretation of the case, the labour hire client, being the payer of the salaries and wages, is responsible for withholding PAYG amounts under s 12-35, Sch 1 TAA53, and subsequently responsible for paying these amounts to the Commissioner per s 16-70, Sch 1 TAA53. The accountant, on the other hand, had no contractual relationship with the host employers or their employees. Their only obligation was a contractual one with the labour hire client;

- it was said by Edmond J in *Cassaniti* that:

  "170. In the normal course, it could be expected that a payer of salary of wages who was making withholdings at the required rate would have in its possession, accounting and wage records showing an arithmetic subtraction from a gross amount and payment of the net amount …"

  The labour hire client would instruct for payment to be made by authorising such payments, which provided the amount (being the net wages) to be transferred to the payees;

- in *Cassaniti*, Edmond J further stated that:

  "164. Where an amount has been set aside by the payer and is quarantined in a bank account pending its remission to the Commissioner clearly the presence of the funds so designated will demonstrate that a withholding has been made."

  At the directions of the labour hire client, the accountant calculated the entirety of the PAYG withholding amounts so that the labour hire client could retain them. Therefore, the PAYG withholding amounts were set aside at the direction of labour hire client, and quarantined in their accounts to be remitted to the Commissioner;

- the labour hire client (or at least the rogues behind it) was aware of their responsibility to withhold PAYG amounts under s 12-35, Sch 1 TAA53. The labour hire client did withhold the payments required by them under s 12-35 — they just did not remit it to the Commissioner. Consequently, the labour hire client (not the accountant) had an obligation to pay these amounts to the Commissioner per s 16-70, Sch 1 TAA53;
- whether the accountant made the payment through an ABA file that was approved by the director, or had direct access to the bank account of the labour hire client with permission to make payments, or even if the salary and wages were paid from the bank account of the accountant, is of no relevance as it is *not* considered by the courts to be a determining factor as to who was responsible for the payments being made to the Commissioner under s 16-70:
- in *Naumcevski v DCT*,[3] White JA stated:

  "107. Thus, irrespective of the identity of the company from whose bank account moneys were withdrawn to pay the wages or salaries, the evidence demonstrates that Lucas Homes Administration withheld the amounts of PAYG tax and Medicare levy. The appellant was obliged to ensure that Lucas Homes Administration paid the amounts it withheld to the Commissioner …'

  Therefore, it is the entity who withheld the payments, in this case, the labour hire client, who is obligated under s 16-70, Sch 1 TAA53 to make those payments to the Commissioner; and

- suggesting that the accountant is responsible for PAYG withholding because it had transferred the payment to the employees is a misinterpretation of the law. If it were true that the transferer of the payment was responsible for PAYG withholding, then, by that argument, the bank or financial institution is responsible as they directly transferred the payment at the request of the accountant. That very argument, that the bank or financial institution is responsible as the direct transferer of funds, has previously been rejected by the courts in the case of *CLK Kitchens & Joinery Pty Ltd v FCT*,[4] where Derrington J said at para 102:

  "102. … The transfer by the financial institution does not, of itself, discharge anything. It is the mere mechanical transfer of money or credit. The *ability to discharge an obligation arises from the authority of the payer to do so.* Whilst the bank requires a mandate from its customer to transfer funds from an account, it is the customer's *authority to discharge a debt which is crucial to the efficacy of the transaction.* In the ordinary course, the transferring bank has no authority to discharge a debt; in this case a wages debt. Its authority is to transfer money. It is *only the customer with the relevant authority (in this case CLK Kitchens) which, through the medium of its bank, discharges the wages debt and can be said to have 'paid the wages'.*" (emphasis added)

  Therefore, it is not a question of who transferred the money or credit, but who authorised the discharge of the employee payment. The accountant did not have authority to discharge the wage debt on behalf of the labour hire client. Their authority was to transfer money at the instructions of the labour hire client. The labour hire client, through the medium of the accountant, discharged its wages debt and therefore was the entity who paid the wages.

The Commissioner's rejection of the statutory declaration is problematic because:

- the Commissioner has erred in his interpretation of the case law, with a position that makes ordinary professionals (and even banks) liable for the unremitted PAYG of their clients; and

- the failure to accept the statutory declaration has the result that the Commissioner is treating the PAYG estimates as an "incontestable tax", arguably rendering the tax invalid as described in *DCT v Brown*[5] and *DCT v Hankin*.[6]

In the author's view, the Commissioner's interpretation of who is making a payment should be revised. Otherwise, judicial or legislative intervention will be necessary.

Small business controller did not pay themselves

The fundamental question is whether a journal entry in an entity's accounts constitutes a constructive payment under s 11-5, Sch 1 TAA53, and, more broadly, what constitutes a constructive payment. This has been considered in some recent cash flow boost (CFB) cases, including *The Trustee for JC Mobile Sharpening Discretionary Trust*[7] (*JC Mobile Sharpening*) and *Robis Consulting Pty Ltd and FCT*[8] (*Robis Consulting*), with mixed outcomes.

Why payment matters

Although the question of constructive payment in the CFB cases was in relation to time-limited legislation, the issue of constructive payment was derived from more generally applicable legislation. It is common practice among trusts and companies to recognise payments to related entities via journal entries, including the payment of dividends, wages etc where a person would frequently draw on money for personal expenses from the entity and have journal entries record the payment into the loan account, akin to a bank overdraft facility. Whether a journal entry constitutes a constructive payment impacts at least the following areas:

- what constitutes a payment under s 11-5, Sch 1 TAA53;
- whether a journal entry constitutes a payment under s 11-5;
- what conditions, in addition to the journal entry, constitute a payment under s 11-5;
- PAYG withholding: if a journal entry does not constitute the payment of salary and wages, there are no requirements in ss 12-35 and 12-40, Sch 1 TAA53 for an entity to withhold PAYG on purported "transfers" of salary as this is treated as a recording of an amount of salary "payable" and not the actual payment;
- superannuation guarantee: if nothing more than a journal entry exists to substantiate the payment of salary and wages, whether a liability to superannuation guarantee arises;
- director penalty notices: if PAYG and superannuation have not accrued because there has been no payment, there is a delay on the Commissioner's ability to issue a director penalty notice until the payment occurs;
- if a journal entry does not constitute a constructive payment, this can have significant adverse consequences. For example, if a taxpayer trading out of a trust makes all payments of living expenses to a "loan account", and all net profit of the trust transferred to a "salary and wages payable" account that are never paid to the employer, a payment of salary and wages never occurs but rather remains recognised as being payable. The trust would have no obligation at law to withhold and remit PAYG withholding or pay superannuation guarantee on those amounts until, if ever, the "salary and wages payable" balance is paid to the employee:
  - adversely, such an arrangement may not be caught under Pt IVA of the *Income Tax Assessment Act 1936* (Cth) as there is no tax advantage achieved; arguably, tax on salary and wages is delayed until lodgment of the employee's tax return, but delayed payment (if ever) of the superannuation guarantee is not a tax advantage;
  - this would have a significant impact on the employer's cash flow when they lodge their income tax return and are required to pay a large income tax liability, possibly resulting in many taxpayers going bankrupt and thus failing the purpose of the PAYG withholding system; and
- although, for the purposes of the CFB cases, the Commissioner has argued *against* a journal entry constituting payment or constructive payment, it is not clear to the author that this is a wise policy. At the minimum, it would be disruptive to existing practices for PAYG and superannuation liability, and would reduce or delay the Commissioner's rights to issue a director penalty notice. Although the *amount* of tax is not altered because of the change in timing of a payment, the *timing* of that incidence of tax can be radically altered. In the author's view, it is important for the administration of the revenue to clear this issue up.

Payment for cash flow boost

There are a number of requirements in the CFB legislation, but at issue in both *JC Mobile Sharpening* and *Robis Consulting* are the following:

- s 5(1)(a)(i) of the *Boosting Cash Flow for Employers (Coronavirus Economic Response Package) Act 2020* states:

  > "the entity *makes a payment in the period and must withhold an amount* from the payment under Subdivision 12-B, 12-C *or* 12-D *in Schedule* 1 *to the Taxation Administration Act 1953 (regardless of whether the entity actually withholds the amount*;" (emphasis added)

- s 12-35, Sch 1 TAA53 states:

  > "An entity must withhold an amount from salary, wages, commission, bonuses or allowances it pays to an individual as an employee (whether of that or another entity)."

- s 11-5, Sch 1 TAA53 states that a constructive payment exists where money is dealt with on another entity's behalf; and
- there is also an anti-avoidance matter raised, but that is not relevant for present purposes.

Facts

In both of the cases:

- the taxpayers were small business entities that employed their sole controller;
- the taxpayers commenced paying or increased the amount of the salary that was being paid during the periods of the CFB. Unsurprisingly, this increase was flagged by ATO systems as a potential abuse of the CFB rules;
- the taxpayers, as well as many, if not most, eligible recipients of the CFB who report salary and wages quarterly, and lodge activity statements quarterly, would also have prepared pay slips, activity statements, made superannuation payments, and lodged income tax returns after the announcement of the CFB, part way through the March 2020 quarter;
- the taxpayers transferred money from the business bank accounts to their individual bank accounts or credit cards, on an ad hoc basis;
- some monies credited to the individual were retained by the business entity for business cash flow reasons; and
- the Commissioner argued that the commencement or increase in PAYG was unrelated to CFB and used similar legal arguments in both of the cases.

Commissioner's view: journal entry is not payment

The Commissioner claimed that, despite declaring payment of salary and wages, it does not necessarily mean that it is in fact salary and wages. The Commissioner relied on *Temples Wholesale Flower Supplies Pty Ltd v FCT*,[9] *FCT v Ross*[10] and *Greig v FCT*[11] as apparent authorities that the way in "which a taxpayer treats an amount for taxation purposes is not determinative of its proper characterisation at law". In the author's view, this is problematic for the following reasons:

- *Temples Wholesale Flower Supplies Pty Ltd v FCT* did not concern the taxation treatment of an outgoing, but "whether a mere journal entry, unsupported by any agreement, is enough to constitute a payment of salary and wages";[12]
- *FCT v Ross* considered whether the taxation treatment of the taxpayer's income as either assessable or non-assessable was conclusive to that fact. The issue in the present case is whether a journal entry constitutes a constructive payment of salary and wages (ie the classification of the transaction), not the deductibility of the payment which refers to the taxation treatment; and
- *Greig v FCT* considered that the way a taxpayer characterises a transaction as revenue or capital for income tax purposes does not determine its proper characterisation. Again, the issue is whether the transaction represents a payment of salary and wages, not how the transaction should be treated for taxation purposes.

Unconsidered authority

In the author's view, the Commissioner should have instead applied more relevant authority, none of which were cited in the respective judgments:

- *Equuscorp v Glengallan Investments*[13] concerned a tax-effective managed investment scheme that resulted in a dispute between the participants. A bank electronically debited its account and credited the account of the participants (structured together as a partnership). The partnership drew cheques on its account and paid management fees to two entities connected with the scheme. Those two entities then drew cheques equal to the fees and deposited them with the same bank as on-call deposits. This was all done on the same day and at the same time;

  As part of the dispute, the disgruntled participants claimed that the arrangement was a sham and that they had never been lent money to invest in the scheme. As they were never lent money, they had no obligation to repay (so they alleged). The High Court held that the arrangement was legally effective. The High Court held that the participants (and the junior courts beneath the High Court) focused too much on the economic substance of the transaction, not the legal effect. The fact that no "real money" (a term used in that case) did not change hands was not relevant. The debiting of the bank's account and the crediting of the partnership's account (which constituted the participants) effected an exchange of money. This electronic transfer was sufficient to create a legal obligation on the participants to repay the bank;
- *In The Matter of York Street Mezzanine Pty Ltd (in liq)*[14] discussed the law concerning promissory notes. The court considered that the ordinary rule is that to discharge a bill of exchange, and also a promissory note, the issuer is required to make a payment in money to the payee or bearer. In other words, the payment must be in legal tender (money) or by the transfer of a money fund;

  The court further went on to discuss that this method of payment is highly inconvenient, especially where large sums of money are concerned, and it is therefore not uncommon to see parties to a bill of exchange or promissory note agree that payment be made by some other means which is commercially acceptable. Not surprisingly, it has been held that parties to a promissory note may agree that the note can be satisfied by other means than legal tender (money). The result is that, by agreement, payment of money due under a bill of exchange or promissory note can be made by set off, by delivery of goods, by a bond, by cheque or bankers draft, or even by book entry.

  On book entries, the court stated that there is every reason to permit a payment to be made by book entry:

  > "26. … Often [book entry] is simply a short-hand for money or a cheque being handed across the table and money or a cheque being handed back. It would be entirely inconsistent with modern commercial life if

a payment due by one person to another could not be effected in this manner."

Accordingly, it would seem that all that is required is an agreement by the relevant parties that payment be made by means of entries in books of account. In the CFB cases, the taxpayer is both the employee and the controller of the employer, such self-agreement is evidenced by conduct of entry into the books of account.

In the author's view, the Commissioner's reasoning failed to properly address the issue of whether an actual payment of salary and wages has been made by citing *FCT v Ross* and *Greig v FCT*, which do not deal with this issue. However, *Temples Wholesale Flower Supplies Pty Ltd v FCT* was relevant. It was determined in that case that the circumstantial facts of an agreement to accompany the journal entry would be assessed when determining that question, and how it was treated in the income tax return would be considered part of that circumstantial evidence as it showed the intention that salary and wages were being paid.

Constructive payment

The Commissioner questioned whether a constructive payment of salary and wages had occurred, while contrasting each of the cases to the earlier CFB decision of *MJ and IT Holdings Pty Ltd and FCT*:[15]

- in *MJ and IT Holdings*, when discussing whether payments of wages via journal entry satisfied s 11-5, Sch 1 TAA53 and the withholding provisions, Senior Member K James stated:

  "31. In these circumstances, for the purposes of determining derivation of the income *there can be little argument that the director's remuneration has been constructively derived*. The facts and circumstances are very different to the taxpayer in *Brent* [*Brent v FCT* [1971] HCA 48] and the directors in *Temples Wholesale* where constructive payment was not held on the evidence. *The PAYG was withheld and remitted to the Commissioner. The director instructed that the balance was not to be paid in cash but recorded in her loan account*. The *decision to record it in the loan account was the director wearing the hat of the recipient of the remuneration and lender to the company. A payslip confirming the remuneration of $25,000 and the withholding was issued to the director*. The evidence in this matter is similar, if not stronger in nature, as was held to satisfy the constructive payment hurdle in the 2008 tax year in *Brent*." (emphasis added)

- in *MJ and IT Holdings*, it was concluded:

  "32. In the language of section 11-5 of the TAA, the $11,398 withheld on account of PAYG was applied or dealt with on Mrs Knight's behalf … *what is clear on the evidence is that she made the decision to have it recorded in her loan account, rather than have cash drawn from the company. This is in accord with both section 11-5(1) and section 11-5(2) of the TAA."* (emphasis added)

- it was further concluded in *MJ and IT Holdings*:

  "33. In summary, the Tribunal finds that the sole director determined, together with her husband, the other shareholder, that she was to be paid $25,000 remuneration for her services in March 2020. *She instructed the company's accountant to raise the appropriate accounting entries which included the attending to the appropriate PAYG withholding and recording the balance to her loan account. Upon the expensing of the directors' fee, the withholding of the PAYG, and the dealing with the balance in the loan account, there was a constructive payment of the $25,000 to her*." (emphasis added)

The issues in respect of the payment of wages in *MJ and IT Holdings* which ultimately led to the applicants receiving an unfavorable judgment were related to there being a scheme to achieve CFB. But there was still a constructive payment.

Comparison of JC Mobile Sharpening and Robis Consulting

Of particular relevance:

- in *Robis Consulting*, it was held that a mere lodgment of BASs and an income tax return amounted to constructive payment; and
- in *JC Mobile Sharpening*, it was held that a crediting of the directors loan account in the general ledger plus payslips plus lodgement of BASs and an income tax return was not constructive payment.

If forced to pick one case to be decided in favour of the Commissioner and one in favour of the taxpayer, the author would have reversed both of the decisions. In the author's view, *JC Mobile Sharpening* is clearly the stronger case, and the two sit uncomfortably next to each other. In any event, the author respectfully agrees with Senior Member Olding's decision in *Robis Consulting*. A controller of an entity, who on behalf of that entity contracts with themselves and then records in the books of accounts at the appropriate time payment made under that contract, is clearly making a *constructive payment*, if not an actual *payment*.

These cases highlight the uncertainty on what constitutes a *payment* and a *constructive payment*. This uncertainty extends to all liabilities for taxation (including PAYG and SG) that arise from a payment of wages, and not merely the CFB legislation on which these cases were decided.

Related party dealings and R&D

The necessity for a payment extends to many areas of tax law. One example is the ability to claim R&D expenditure paid to associates.

The relevant provision for R&D expenditure is s 355-205 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) which provides as follows:

"(1) An R&D entity can deduct for an income year (the ***present year***) expenditure it incurs during that year to the extent that the expenditure:

(a) is incurred on one or more R&D activities:

(i) for which the R&D entity is registered under section 27A of the *Industry Research and Development Act 1986* for an income year; and

(ii) that are activities to which section 355-210 (conditions for R&D activities) applies; and

(b) if the expenditure is incurred to the R&D entity's *associate* – is *paid* to that associate *during the present year*." (emphasis added)

It is interesting to apply the earlier views on what constitutes a *payment* to this requirement. It should be that *payment* can be made in a number of ways, including through journal entries. But anecdotal evidence suggests that the Commissioner does not look favourably on that view. Perhaps it will be tested once a taxpayer makes a mistake. Until then, taxpayers must draw out large sums of Australian legal tender (physical cash) in order to make payments. Or cause their banks to make journal entries on their behalf. Which, although simple in theory, can be administratively difficult, particularly where large sums of money are involved or there are international transactions, or both. Instead, it might simply be easier to pay by cheque, or a related instrument such as a promissory note.

"… the uncertainty on what constitutes a payment … extends to all liabilities for taxation that arise from a payment of wages."

Legal tender

Australian currency is legal tender in Australia. Legal tender is a concept whereby the offering of legal tender to meet a financial obligation is, in the eyes of the law, sufficient to extinguish that obligation:

- all payments to meet a financial obligation must be made in legal tender unless the parties agree otherwise. Thus, a purchaser is required to pay the purchase price in folding notes and physical coins, unless agreed otherwise. Of course, this is often highly impractical and therefore, for a large purchase such as real property, the parties agree that the purchase price may be met by the tender of a bank cheque or electronic transfer. A cheque (and other bills of exchange) are money but not legal tender (because a creditor is not obligated under the law to accept a cheque). In the absence of agreement, a creditor does not need to accept a cheque and can demand legal tender; and
- there are "limits" on legal tender. For example, 5 cent coins can only be used to meet financial obligations not exceeding $5 (s 16 of the *Currency Act 1965* (Cth)). Readers may recall a recent incident where a local resident, disgruntled with a parking fine handed out by the Council, attempted to pay the entire amount with 5 cent coins! The Council had the legal right to refuse all but $5 of that purported payment.

The amount tendered ought to be the precise amount to be paid unless a greater amount is tendered and change is requested but not demanded; it is arguable that a creditor is not obliged to give change.

When currency is deposited at the bank or with another financial institution, it loses its quality as currency. It becomes a chose in action, being a contract between banker and customer. Through that contract, the deposit holder can compel the bank to make payments to other banks.

Lower value, primarily consumer, fund transfers through ATMs, EFTPOS, and by means of internet payments, digital coins and stored value cards or similar mechanisms, are governed by contracts between relevant institutions, between each institution and its customers, and by self-regulatory codes of conduct which anticipate or forestall formal government regulation.

An electronic payment is therefore an activation of a series of legal relationships. It is not a payment of legal tender, and is not required to be accepted. However, it can be accepted by agreement between parties.

Promissory notes

A promissory note is not required to be accepted for payment: only Australian legal tender is. If the parties do *not* agree to use a promissory note, the presentment of one does *not* constitute payment. This is not a high threshold, but it is still a necessary condition.

Rocky Castle Finance Pty Ltd v Taylor[16] is a South Australian case where parties purported to make payments with promissory notes. It was a managed investment scheme and "advances" were purported to be made with a promissory note. However, boilerplate clauses within the relevant documentation provided that payments had to be made into a bank account. As such, it was not open to argument that payment could be made by promissory note as the parties had agreed in the documents to make payment into an account. It is likely that, in the design of the scheme, this was an oversight by the drafter of the documentation. *Rocky Castle Finance* demonstrates when payment in a form other than legal tender is not accepted.

A promissory note is as "an unconditional promise in writing made by one person to another, signed by the maker, engaging to pay, on demand or at a fixed or determinable future time, a sum certain in money, to or to the order of a specified person, or to bearer".[17]

This definition contains three elements which set the promissory note apart from other negotiable instruments. First, the note must be an unconditional promise in writing (compare with a traveller's cheque, for example). Second, the note is payable on demand or at a fixed determinable future time, which is different from an IOU which simply evidences the maker's agreement that they owe something to a certain person. Third, the note operates directly between the person making the promise and the person

receiving the note, whereas a bill of exchange, for example, involves a third party to whom the order to pay is given.

The default position with a promissory note is that the tender and acceptance of a promissory note is a conditional payment.[18] The condition is that, when it is presented, it is honoured. When it is received, the creditor's rights against the debtor are suspended (not extinguished, as is the case when legal tender is presented). If, on presentation, the promissory note is not honoured, the creditor's rights against the debtor revive.

The principle is that a promissory note is given and taken in payment as its face value in money. It is not as merely given a right of action for the creditor to litigate a counterclaim per Lord Denning MR in *Fielding & Platt Ltd v Selim Najjar*:[19]

> "We have repeatedly said in this court that a bill of exchange or a Promissory Note is to be treated as cash. It is to be honoured unless there is some good reason to the contrary."

A promissory note can also be an *absolute*, not just a *conditional*, method of payment. Whether it is absolute depends on the intent of the parties and is a question of fact.[20]

In the Victorian Supreme Court case of *Mobil Oil Australia Ltd v Caulfield Tyre Service Pty Ltd*,[21] the status of a bill of exchange as a payment instrument and the obligations of the person to whom the bill is "addressed" were considered. In the course of delivering his judgment in that case, Young CJ referred favourably to observations on the character of negotiable instruments, such as bills of exchange and promissory notes, made in several UK cases. These references include:

> "… the bona fide holder for value of a bill of exchange is entitled, save in truly exceptional circumstances, on its maturity, to have it treated as cash …[22]
>
> Bills of exchange are treated as cash, and unless there are exceptional circumstances where there is an action between the immediate parties to a bill of exchange judgment will not be held up by virtue of a counterclaim by the defendant and execution will not be stayed.[21]
>
> When one person buys goods from another … He may demand payment in cash; but if the buyer cannot provide this at once, he may agree to take bills of exchange payable at future dates. These are taken as equivalent to deferred instalments of cash.[23]"

Because of their use to effect immediate payment, promissory notes have found use in "round robin" transactions, and in particular a number of tax-driven schemes. This was noted by Hill J in *FCT v Sleight*:[24]

> "77 While a round robin is perfectly legally effective to create real relationships between parties, it must be said that it is a feature of many tax avoidance schemes where no real money is involved and may point to a tax avoidance purpose."

That a particular form of legal rights has been used in a number of tax-driven schemes does not impugn the broader commercial efficacy of those legal rights. Trusts, debts, contracts, partnerships, companies and nearly all aspects of commercial law have been used in tax avoidance schemes. That parts of commercial law have been used from time to time for a particular purpose does not more broadly colour that law.

Accordingly, providing the promissory note is honoured when it is presented for payment, there should be no issue with the payment of the services by way of promissory note.

Anecdotally, the Commissioner has been comfortable with the use of promissory notes to satisfy the requirement for payment for R&D expenditure. This accords with the Commissioner's comfort in a promissory note or bill of exchange constituting consideration in other contexts.[25]

Failed asset protection

Notwithstanding that a promissory note is a relatively simple instrument, it may be drawn incorrectly. Examples of this are *Re Permewan*[26] and *Turner v O'Bryan-Turner*,[27] both of which involved a "gift and loan back" scheme. A further analysis of these cases is set out in the paper "Keeping it in the family" by David Marks KC.[28] However, the present article focuses on the issues raised by the promissory note and whether payment was effected.

Re Permewan

The facts of *Re Permewan* are as follows:

- 17 months before her death, the deceased made a statutory declaration that she intended that certain payments by her, including those by a bearer promissory note to the trustee of the Lotus Trust, were to be "by way of gift";
- on the same day, the deceased signed a "bearer promissory note" under which she promised to pay the bearer the sum of $3m;
- on the same day, but this time on behalf of the trustee of the Lotus Trust, the deceased signed a receipt "as a gift";
- thus far, the deceased has by promissory note promised to pay $3m to the bearer, being the trustee of the discretionary trust which has accepted the promissory note as a gift;
- also on that day, the deceased, as sole director of the trustee company, resolved:
  - to note receipt of the bearer promissory note for $3m from herself by way of a gift of capital to the trustee to be held on trust;
  - to acknowledge receipt of the bearer promissory note by execution of the bearer promissory note;
  - to lend the money gifted by that bearer promissory note back to herself (ie in her personal capacity);
  - that such loan be repayable on demand and secured by mortgage over real property acceptable to the trustee company; and
  - to execute a loan agreement and mortgage security to effect the above resolutions;

- a loan agreement was signed that day between the deceased and the trustee of the Lotus Trust. The loan agreement referred to the trustee lending money to the deceased. It contained a covenant for provision of security over a nominated property, as and when required by the lender. The deceased was also to give on demand a security interest over shares in a company;
- it would seem that, on the same day, the deceased signed a "security deed" providing for a mortgage over the land and over the shares in question. A mortgage over the land was executed about a month later and was registered;
- also, on the critical day when all of the other documents (such as the bearer promissory note) were signed, the deceased gave a receipt in favour of the trustee as follows (referring to the promissory note):

  "Received by Prudence Veronica Permewan on 18 April 2018 as a loan and cancelled by her because of the merger of the right to be paid and the obligation to pay."
- Davis J describes the above as follows at para 24:

  "24. By this series of extraordinary documents:

  1. Prudence purports to gift, through the provision of the promissory note, $3 million to the Lotus Trust. This is despite the fact that Prudence clearly did not have $3 million in cash and would have to liquidate all of her assets to pay it.

  2. The Lotus Trust has loaned $3 million to Prudence. This is despite the fact that the Lotus Trust clearly did not have $3 million in cash to loan to Prudence.

  3. To secure the loan, so as to give effect to the gift evidenced by the promissory note, Prudence mortgaged or otherwise charged her assets.

  4. The result of the transactions is that Prudence, who before these transactions had assets worth net $3 million, now has a debt of that amount to the Lotus Trust secured over her assets."
- the applicant submitted that there should be an inquiry into the transactions, including that:
  - the "promissory note" was not a promissory note as defined in the *Bills of Exchange Act 1909*. It thus did not have legal effect as a promissory note; and
  - no gift had been perfected and that there was no consideration supporting a promise to pay. That is to say, no *payment* had been made.

Promissory note problems

There are a number of problems with the promissory note used in *Re Permewan*.

Note issues

In *Re Permewan No. 2*, the promissory note was described as follows:[29]

"30. The second document was headed 'Bearer Promissory Note' and contained three parts, each of which was signed by Prudence:

(a) a promise by Prudence to pay the bearer of the note the sum of $3 million;

(b) a receipt given by Zalerina as trustee of the Lotus Trust recording it as having received the promissory note from Prudence as a gift;

(c) a further receipt given by Prudence recording her as having received the promissory note back from Zalerina as a loan and the note having been cancelled by her because of the merger of the right to be paid and the obligation to pay."

A bearer promissory note is one that is not made to a specific person, but is instead payable to whoever bears the note.[30] It does not extinguish on presentment, unlike a note made to a specified person. An old one-pound note backed by gold is an example of a bearer promissory note. These old one-pound notes do no extinguish when the reserve bank (the maker) holds them. The author cannot understand, from the facts presented, why the note was said to have extinguished, other than that it was confused with a note made to a specified person.

A promissory note is not lent; it is conveyed. A promissory note typically does not come back, nor is it intended to come back other than on presentment. Instead:

- there should have been a loan from the Lotus Trust to Prudence and the payment of the sum advanced under the loan should have been made by way of passing the bearer promissory note (or, if the note was a made to a specified person, ie the Lotus Trust, by indorsement from that person); or alternately
- there should have been an accord and satisfaction agreement between the parties whereby the Lotus Trust agrees not to present the note in return for Prudence accepting that she owes the Lotus Trust the sum of $3m on the loan terms;

How can the bearer promissory note contain three parts? A note is a single instrument, being on one page. Further pages (called "allonges") can be added, but must be affixed to the note.

Future gifts

The statutory declaration that Prudence swore before her death provides:

"14. It is my intention that all payments whether in cash, by cheque or Bearer Promissory Notes or otherwise, that I make from myself to the trustee of the Lotus Trust being a trust constituted by Deed dated 14 February 2011 are by way of gift unless otherwise recorded in writing."

This is problematic because future gifts do not bind the donor. A statement made today does not bind the conscience of the donor tomorrow. In order to effect a future donation, there would need to be some consideration in order to bind the conscience of the donor.

The phrase "unless otherwise recorded in writing" is problematic because it is concerned with the records of the wrong person. Accounting records cannot be a statement of intention of another person. Whatever is written in the records of the Lotus Trust is irrelevant to the intentions of Prudence.

For Prudence to perfect the gift of the promissory note, she should have written *at the time* that she intended for the note to be a gift.

Turner v O'Bryan-Turner

The facts of *Turner v O'Bryan-Turner* are as follows:

- the transactions in 2010 began with the establishment of two discretionary trusts as an element of asset protection planning. There was a concern about claims that might be made by Mr John Turner's second wife;
- Ward CJ in Eq describes what happened:

  "15. John signed what are described as two promissory notes in favour of the trustee of those trusts … those notes together totalling around $2.5 million (that being said to be around about 90% of the value of the Trundle Properties at the time) … John executed statutory declarations at that time to the effect that all payments by him by promissory notes to the trustee were by way of gift … [At] the time that the notes were signed, there was no amount specified in them and there was no fixed date for repayment."
- Ward CJ in Eq continues:

  "16. John and [the trustee company] then entered into loan agreements whereby [the trustee company] in effect lent to John the $2.5 million that John had just 'gifted' to [the trustee company] under the promissory notes; and those two loans were secured by way of unregistered (and unstamped) mortgages … John then proceeded to cancel those promissory notes.

  17. The consequence of the 2010 Transaction … was that, unless disturbed, [the trustee company] thus had the benefit of security over the Trundle Properties and would, at some point in time, be able to obtain what was then estimated to be approximately 90% of the value of the Trundle Properties. The purpose of the 2010 Transaction was unashamedly to protect John's farming assets from a potential claim by his then *de facto*, Wendy …"

Inchoate promissory notes

The promissory notes, when executed, contained no sum.

Ward CJ in Eq provides an interesting discussion on the matter:

> "*Authorisation to a stranger to execute terms of the note*
>
> 355. With those observations in mind, I turn next to the question, adverted to above, whether the Bills of Exchange Act permits the maker of a note to authorise another to 'fill in', so to speak, those essential terms of the promissory note.
>
> 356. In my researches, I have been unable to locate any authority on this point (and, indeed, the parties have not referred me to any authority that is of assistance).
>
> 357. As an initial matter, I note that s 89(2) by its express terms provides that, '[a]n instrument in the form of a note payable to maker's order is not a note within the meaning of this section unless and until it is indorsed by the maker'.
>
> 358. This might tell toward a construction that the maker of a note cannot delegate or authorise another to execute a promissory note, or at least such execution will be ineffective until the note has been indorsed by the maker.
>
> 359. However, as a matter of statutory construction, and not least noting the terms of s 5 (see at [349] above), I do not see a basis for concluding that the legislative regime prohibits a maker of a note from delegating to another, or authorising an agent, to complete, or fill-in, essential terms of a promissory note, including delegating or authorising the act of indorsement itself. However, and that tentative view notwithstanding, there remains an issue, to my mind, as to the time by which such execution (and, as the case may be, indorsement) must be completed. It is convenient to deal with that under the third of the questions adumbrated above.
>
> *Retrospective validity?*
>
> 360. Again, in my researches, I have been unable to locate any authority on point (and, again, the parties have not referred me to any authority that is of assistance).
>
> 361. Nevertheless, I note that s 90 of the *Bills of Exchange Act* provides:
>
> > **90 Delivery necessary**
> >
> > A promissory note is inchoate and incomplete until delivery thereof to the payee or bearer.
>
> 362. To my mind, this provision tells toward a conclusion that a promissory note must be complete in its terms, whether executed personally by the maker or by a properly authorised agent, before delivery to the payee or bearer. This is, I think, also consistent with the authorities and principles that I have made reference to above. It is consistent with the legislative purposes (as to which, see the observations of Williams J that I have excerpted above).
>
> 363. It follows that, *whether the promissory notes were here later filled in or indorsed (whether personally or otherwise), they remained invalid as promissory notes* for the purposes of the *Bills of Exchange Act*." (emphasis added)

It is relevant to raise s 25 of the *Bills of Exchange Act 1909*, which provides as follows:

> "Inchoate instruments
>
> (1) Where a simple signature on a blank stamped paper stamped with an impress duty stamp is delivered by the signer in order that it may be converted into a bill, it *operates as a prima facie authority to fill it up*

as a complete bill for any amount the stamp will cover, using the signature for that of the drawer or the acceptor or an indorser.

(2) And in like manner when a bill is wanting in any material particular, *the person in possession of it has a prima facie authority to fill up the omission* in any way he or she thinks fit.

(3) In order that any such instrument when completed may be enforceable against any person who became a party thereto prior to its completion, it must be filled up within a reasonable time, and strictly in accordance with the authority given. Reasonable time for this purpose is a question of fact:

Provided that, if any such instrument after completion is negotiated to a holder in due course, *it shall be valid and effectual for all purposes in his or her hands*, and he or she may enforce it as if it had been filled up within a reasonable time and strictly in accordance with the authority given." (emphasis added)

Without the benefit of viewing the exact note used in *Turner v O'Bryan-Turner*, and reading only from the judgment, it seems that the missing attribute to the note was the authority to fill it up. Words to the effect of "this promissory note may be filled up to the sum of $2.5m" should have sufficed to ensure that it was clear on its face that it was valid once filled.

Without a valid promissory note to make payment, the loan behind the gift and loan back ultimately failed.

Payments into superannuation

A final interesting point relates to whether business real property can be contributed to an SMSF where that contribution is made under the small business CGT concessions. In particular, whether the retirement exemption under Subdiv 152-D ITAA97 which allows a taxpayer to disregard a capital gain from a CGT event that occurs in respect of CGT assets of their small business where the capital proceeds of the event are used in connection with the taxpayer's retirement.

Small business CGT concessions

In relation to the CGT retirement exemption:

- a taxpayer must meet the small business concession basic conditions for relief set out in Subdiv 152-A ITAA97;
- if the taxpayer is under 55 at the time of making the choice to use their retirement exemption to disregard a capital gain under Subdiv 152-D, s 152-305(1)(b) ITAA97 *requires* the individual to contribute an amount equal to the disregarded amount to a complying superannuation fund;
- a similar requirement exists where a company or trust has made the relevant capital gain and the individual taxpayer is a CGT concession stakeholder of the company or trust per s 152-325(7)(a) ITAA97;
- where the individual is over 55, they are not required to contribute to a complying superannuation fund. However, they may choose to contribute an amount that is disregarded under Subdiv 152-D to a complying superannuation fund;
- in ATO ID 2010/217, the Commissioner states that:

  "… a superannuation contribution can be made in a number of ways including by transferring an asset to the superannuation provider (an in specie contribution: refer section 285-5 of the ITAA 1997, and paragraphs 4, 10, 18-25 and 151 of Taxation Ruling TR 2010/1).

  A superannuation provider may breach section 66 of the SISA when an asset is acquired from a related party of the fund, such as a member (refer SMSFR 2010/1). Subsection 66(2) of the SISA does however provide an exception to the prohibition relating to the acquisition by a superannuation fund of assets from related parties where the asset is 'business real property' (as defined in subsection 66(5) of the SISA) and other conditions are satisfied.

  Accordingly, it is considered that a transfer of real property to a complying superannuation fund can satisfy the requirement of paragraph 152-305(1)(b) of the ITAA 1997 to contribute an amount if the transfer of the real property satisfies the relevant provisions of the SISA."
- this means that a contribution may be satisfied by an in specie transfer. However, there is a potential timing issue that causes a problem:
  - the National Tax Liaison Group Losses and CGT-Sub Committee, in its June 2011 meeting, contemplated the following:

    "Can a capital gain made on the in-specie transfer of an asset be disregarded under Subdivision 152-D on the basis that the payment required to be made has in fact been made as part of the in specie transfer?"
  - the response at the time was:

    "[The retirement exemption] requires that the choice that the exemption apply follows the happening of the CGT event. The Subdivision does not contemplate that the CGT event, choice and payment can all take place simultaneously."
  - it follows that, in the view of the ATO, the following must occur:
    - the CGT event occurs first;
    - the choice occurs second; and
    - the contribution occurs last;
  - it may be possible that the choice in fact occurs *before* the CGT event and contribution, which of course occur together in the in specie contribution scenario. The relevant choice must be made "by the day [the taxpayer lodges] their income tax return for the year in which the relevant CGT event happened".[31] The words "by the day" suggest that it may be possible

to make the choice *before* the CGT event. This view is supported by the following private binding rulings: PBR 1011277902229 and PBR 1011296278342;

- in the author's view, we do not need to argue such a fine point or come within potential grey areas of ATO interpretation but instead can separate out the transaction as follows:
  - step 1: trigger a CGT event by way of entering into a sale and purchase agreement;[32]
  - step 2: a payment is made under the sale and purchase agreement by way of cash or promissory note;
  - step 3: the cash or promissory note is passed to the member of the SMSF;
  - step 4: the choice to contribute to the complying superannuation fund under Subdiv 152-D ITAA97 is made;
  - step 5: the member contributes the cash or promissory note to the SMSF; and
  - step 6: the SMSF pays for the business real property under a sale and purchase agreement using the cash or promissory note (if it hasn't already under step 2); and
- variations to the above can be whether there is a sale of a business that gives rise to Subdiv 152-D, whether there is a separate business that gives rise to Subdiv 152-D, or whether the business is of commercial property. That is to say, where you are not selling a business separately, this transaction can be done by way of making a sale of the business real property to the SMSF. In which case, the order will be slightly adjusted:
  - step 1: the SMSF and the property owner enter into a sale and purchase agreement for the business real property;
  - step 2: the taxpayer makes a choice to contribute, under Subdiv 152-D, the proceeds of sale to their SMSF;
  - step 3: the SMSF draws a promissory note (or uses cash that it has) to the vendor of the business real property for the purchase price;
  - step 4: the vendor receives the promissory note (or cash) and passes this on to the member; and
  - step 5: the member contributes the promissory note (or cash) to the SMSF.

Promissory notes

The author makes the following comments about the use of promissory notes in these transactions:

- at para 25 of SMSFR 2010/1, the Commissioner sets out his view that there is no contravention of s 66(1) of the *Superannuation Industry (Supervision) Act 1993* (Cth) if funds are transferred by a related party to an SMSF by way of promissory note;
- where a promissory note is returned by presentment or endorsement to its maker, it is then extinguished (provided it is not a bearer note); and
- care should be taken if stamp duty is an issue as some states do not apply otherwise available exemptions for in specie distributions to SMSFs where there is a purchase. See, for example, *Landfall Pty Ltd v Chief Commissioner of State Revenue*[33] where an SMSF, using the strategy as outlined above and in line with accepted practice for SMSF law, was unsuccessful in obtaining a duty exemption in New South Wales.[34]

Payment required in connection to the exempt amount

One matter that is unclear is whether the payment that is required to be made into the superannuation fund (as required in s 292-100(4)(b) ITAA97) has to be made in connection with the exempt amount in s 152-125 ITAA97.

One interpretation is that there simply has to be a payment and that that payment does not have to be from proceeds from the CGT event. Therefore, although the in specie distribution cannot, in the view of the Commissioner, be the payment, so long as there is some other amount paid, the requirement is satisfied.

If the above view is accepted, care should be taken not to excessively exercise the power of the trustee of the trust making an in specie distribution and make a further payment for no valid reason.

Conclusion

The concept of "payment" is a live and important one, which has an impact on a multitude of transactions. There is a potential need for administrative clarity, if not also judicial or legislative clarification, on what constitutes a "payment".

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This article is an edited and updated version of "Assorted problems with payment" presented at The Tax Institute's SA Tax Forum held in Adelaide on 8 to 9 March 2023.

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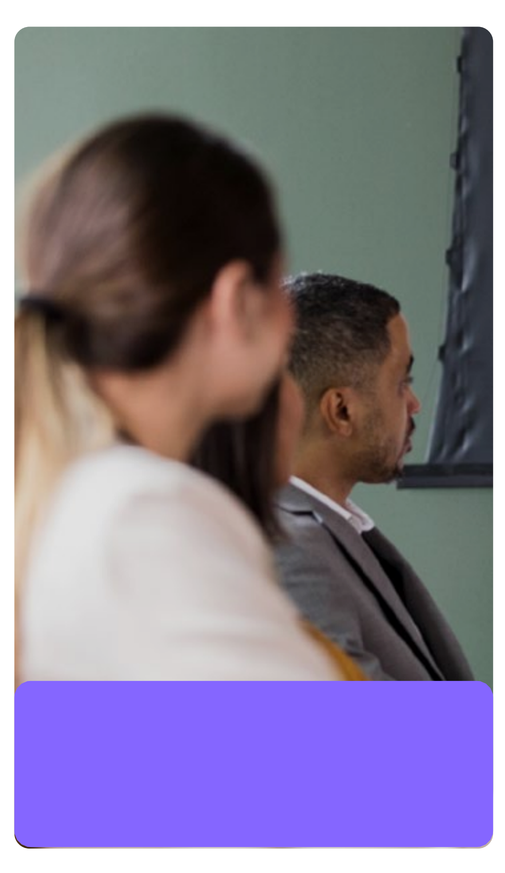

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A Matter of Trusts

by Edward Hennebry, FTI, Sladen Legal

Managing invalid distributions

Discovering that distributions have been made to an invalid beneficiary may only be the beginning of your problems.

When assessing who is a valid beneficiary of a trust, advisers may be tempted to look exclusively at the names listed in a schedule to the trust deed. However, in an age where variations to trust deeds are frequently implemented to exclude certain persons from being eligible objects of the trust (typically to manage state tax surcharge risks), considering the entirety of the trust deed (and the effect of any variations) is paramount.

Take the following scenario:[1]

- in each of the income years from 2008 to 2015, the trustee of a discretionary trust (the trust) made a private company (the company) presently entitled to a share of the trust's income. These amounts have remained unpaid (unpaid present entitlements (UPEs));
- some of these UPEs:
  - are quarantined "pre-2009" UPEs (therefore, apart from in limited circumstances, under TD 2022/11,[2] they are not exposed to Div 7A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36));
  - are post-2009 UPEs on sub-trust interest-only arrangements under PS LA 2010/4 (withdrawn); and
  - have been replaced with secured loans that comply with s 109N ITAA36 and are subject to minimum yearly repayments under s 109E ITAA36; and
- when preparing the 2022 accounts for the trust, the trust's newly appointed tax adviser realised that the company has never been an eligible object (beneficiary) of the trust.

Surely this should not cause too many problems and can be easily fixed?

Income tax

Disregarding the trust law issues, the income tax issues which arise from the above scenario are complex. Notably:

- the trust prepared its financial statements and income tax returns incorrectly;
- the wrong entity (the company) paid tax on amounts to which it has never been presently entitled;
- other beneficiaries (or the trustee?) have not declared the correct amounts as assessable income in their income tax returns;
- the pre-2009 UPEs are not in fact pre-2009 UPEs;
- it is not possible to put the post-2009 UPEs under interest-only sub-trust arrangements under PS LA 2010/4 (as they are not UPEs);
- it is not possible to convert the UPEs to Div 7A loans (for the same reason); and
- interest (deducted by the trust and assessable to the company) in respect sub-trust arrangements and Div 7A loans is incorrect.

Assessing the damage

So how can we tidy up this mess?

As the company could never have been presently entitled to a share of the trust's income, it will be necessary to ascertain which beneficiaries should have been presently entitled to that income. This should be possible by reviewing the trustee distribution minutes of the trust for the various income years, as well as the trust's trust deed.

Importantly, it will be essential to consider if the distribution minutes have been drafted in accordance with the requirements under the trust's trust deed.[3] Have the minutes been signed by the directors of the corporate trustee? Have the minutes been executed prior to 30 June (or another date)? Was capital distributed which required the consent of an appointor, guardian or other person(s)? Was there a specific entitlement to capital gains or franked dividends?

On these facts, it is likely that the amounts to which the company was made presently entitled would be assessable to either the default beneficiaries or the trustee of the trust. This is regardless of whether the trustee adopted a percentage or fixed income methodology in its distribution minutes. This might also be the outcome if the distribution minutes are invalid because a requirement under the trust deed was not followed.

However, if the trustee of the trust adopted a fixed income methodology in its distribution minutes and appointed the balance of the trust's income to a beneficiary (the balance beneficiary), it is likely that the balance beneficiary would be assessable on the amounts to which the company was purportedly made presently entitled as it would have had a present entitlement to that amount as at 30 June.[4]

TD 2012/22 (albeit under review following the decision in *Lewski v FCT*[5]) provides guidance on the percentage versus fixed income approach when drafting distribution minutes and the impacts which an amended assessment may have on tax liabilities.

Path to rectification

Following the above analysis, the question then becomes: is a path to rectification possible? This raises other issues, outlined below.

Issue 1: has the period of review expired?

Under s 170 ITAA 36, many small-to-medium business entities[6] are subject to a two-year period of review.[7] Beneficiaries of trusts are generally subject to a four-year period of review, unless the trust is a small or medium business entity.[8]

Accordingly, for some (or potentially all) of the income years in question, it may not be possible for the company or other beneficiaries of the trust to request amended assessments as the period of review may have expired.

An unlimited amendment period applies when there is fraud or evasion. However, based on these facts and having regard to PS LA 2008/6, it would seem unlikely that the actions of the parties constitute a blameworthy act or omission (particularly if the trust and the company have always recorded the UPEs in the accounts and acted at all times as if the UPEs were valid).

Issue 2: can the trustee of the trust be issued original assessments?

If a review of the trust deed and distribution minutes reveals that the trustee of the trust is assessable on the income to which the company was purportedly made presently entitled, there may be a risk that the trustee could be issued with an original assessment.

However, although it is acknowledged in PS LA 2015/2 that many trustees may be subject to an unlimited period of review, the ATO's practice is that, in the absence of fraud or evasion, the four-year period of review for a trustee starts with the lodgment date of the trust's tax return.

Does the ATO's practice under PS LA 2015/2 provide us with sufficient confidence? While there may be reputational risks for the ATO if it chooses to act contrary to a law administration practice statement, case law has confirmed that the ATO is not bound by practice statements – it does not have the same legislative force compared to a public ruling.[9]

For the above reasons, many practitioners adopt the practice of ensuring that a trustee is made presently entitled to a small portion of trust income so that the period of review is less uncertain.

Issue 3: can the ATO issue a default assessment?

If the period of review has not expired or commenced (and the ATO is not of the view that there has been fraud or evasion), s 167 ITAA36 permits the ATO to issue default assessments.[10]

A default assessment carries an automatic 75% administrative penalty on the tax shortfall and if there are multiple income years in question, that penalty can be as high as 90% (subject to ATO remission).

The risk of a default assessment might be particularly applicable to:

- retirees (and potentially retirees who are default beneficiaries) who only lodge a "non-lodgment advice" annually; and
- foreign resident beneficiaries who may not have lodged tax returns because they were only in receipt of income subject to withholding tax (such as franked dividends) or other forms of non-assessable non-exempt income.

Case law[11] has also highlighted the added complexities faced by taxpayers when discharging their burden of proof in the context of default assessments (as taxpayers need to establish what the actual taxable income should have been, rather than simply arguing that the assessment is excessive).

Issue 4: can s 100A apply?

Of course, how could we forget s 100A ITAA36, particularly as it is not subject to amendment periods? However, having regard to TR 2022/4 and PS LA 2022/2, it would seem the better view is that s 100A would not apply in the circumstance of a trustee inadvertently misinterpreting a trust deed. That is, there does not appear to be a "tax reduction purpose".

Furthermore, and as recently amplified in *FCT v Guardian AIT Pty Ltd ATF Australian Investment Trust*,[12] s 100A may not apply on these facts because the "reimbursement agreement" did not exist at or prior to the time the company was conferred a present entitlement to the net income of the trust.

Nevertheless, s 100A should never be discounted.

Issue 5: what about an out-of-time objection?

Even if amendment periods have expired, a taxpayer may still be "dissatisfied" with an assessment and therefore have objection rights. However, this requires an application to the Commissioner to exercise his discretion to treat the objection as if it were lodged within time.

PS LA 2003/7 outlines the Commissioner's practice in respect of out-of-time objections. Relevant considerations include:

- the taxpayer's explanation for not lodging the objection within time;
- whether the taxpayer has a good case for the objection to be allowed in full or in part; and
- any other relevant matters, such as prejudice to the Commissioner or injustice to the taxpayer.

On these facts, in the above scenario, an out-of-time objection might be a potential avenue for the company to consider, particularly as it has overpaid tax. The complication may be that the Commissioner may be out of time to issue amended assessments to the beneficiaries who should have been assessed on the amounts assessed to the company. So, obtaining the Commissioner's discretion may be difficult in light of the risk of prejudice.

Furthermore, even if the Commissioner is out of time to amend the company's assessments, could he still issue original or amended assessments to the correct beneficiaries or the trustee (on the basis that their periods of review have not commenced or ended)? Theoretically, this might be possible, but would he do this?

Issue 6: voluntary disclosure

Regardless of whether the parties are within or outside the amendment periods, there may be merit in submitting a voluntary disclosure to the ATO. This would help in mitigating penalty and interest exposure, particularly having regard to MT 2012/3.

The alternative might be to adopt a "do nothing" approach. However, the advantages of this approach should be questioned if the ATO audited the taxpayer's affairs. There may also be trust law issues associated with this course of action, and a deed of rectification may not be sufficient.

Conclusion

As the above demonstrates, a simple fact scenario can generate significant complexity in the tax world, and pathways to rectify inadvertent transgressions may not be so straightforward.

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1 This fact pattern in based on a scenario presented by Daniel Smedley of Sladen Legal at the Tax Institute's Rottnest Tax Retreat in November 2022.

2 On or for before 30 June 2022, this was under TR 2010/33 (withdrawn) and PS LA 2010/4 (withdrawn).

3 Trust formalities were considered by the Full Federal Court in *Advanced Holdings Pty Ltd as Trustee for The Demian Trust v FCT* [2021] FCAFC 135.

4 See example 3 in TD 2012/22.

5 [2017] FCAFC 145.

6 Entities carrying on a business and aggregated turnover of up to $50m.

7 The time starts from when the Commissioner gives notice of the assessment to the taxpayer. This is not necessarily the date recorded on the notice.

8 Note also that recent changes to s 14 of the *Income Tax Assessment (1936) Regulation 2015* (Cth) extend the limited amendment period to four years for certain fact scenarios, including entities with at least 10 other entities "connected with" or "affiliates of" the entity, and entities that have claimed a CGT roll-over under Div 615 of the *Income Tax Assessment Act 1997* (Cth).

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Superannuation

by Bryce Figot, CTA, and
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Employee or contractor — the application of SG to contractors: part 4

If a business engages a person who is not an individual, such as a partner in a partnership or a trustee of a trust, SG should not apply.

The Full Court of the Federal Court of Australia (the court) recently handed down a judgment regarding how the superannuation guarantee (SG) legislation applies to certain contractors (*Jamsek v ZG Operations Australia Pty Ltd (No. 3)* (*Jamsek*)).[1] This case has important implications for businesses that engage an individual where the payment is wholly or principally for the person's labour.

Facts

For nearly 30 years, Mr Martin Jamsek and Mr Robert Whitby drove delivery trucks for ZG Lighting Pty Ltd and its related companies or predecessors in business (collectively, ZG). They commenced proceedings against ZG claiming that they were employees of ZG for the purposes of the *Superannuation Guarantee (Administration) Act 1992* (Cth) (SGAA).

Both Mr Jamsek and Mr Whitby had to supply and maintain their own trucks and were not engaged in an individual capacity. Rather, Mr Jamsek was in partnership with his wife providing delivery services. Similarly, Mr Whitby was in partnership with his wife providing delivery services.

The primary judge of the Federal Court at first instance found that they were neither employees within the ordinary meaning of that term, nor "employees" within the expanded meaning in s 12(3) SGAA.

In the first appeal decision, the court held that Mr Jamsek and Mr Whitby were employees of ZG within the ordinary meaning of that term, and did not consider whether the expanded meaning of "employee" in s 12(3) applied.

On appeal, the High Court allowed ZG's appeal, holding that Mr Jamsek and Mr Whitby were not employees within the ordinary meaning of that term and remitted the matter back to the court to determine whether Mr Jamsek and Mr Whitby were ZG's employees within the expanded meaning in s 12(3).

The central question for determination in the second appeal hearing by the court was essentially: when Mr Jamsek and Mr Whitby drove trucks for ZG, were they (to adapt the words of s 12(3)) performing "work" under contracts (the other party to which was ZG) which were "wholly or principally for [their] labour"?

Whether an individual is engaged wholly or principally for their labour

The court held that the primary judge was correct to find that Mr Jamsek and Mr Whitby were not "employees" within the meaning in s 12(3).

The court confirmed the decision in *Dental Corporation Pty Ltd v Moffet*[2] (*Moffet*)) which held that s 12(3) has three elements, namely:

1. there should be a "contract",
2. which is wholly or principally "for" the labour of a person, and
3. the person must "work" under that "contract".

The court then proceeded to analyse each of these three elements in view of the facts and referring to relevant legislation and case law.

The contractual element

The court noted that the first element of s 12(3) (ie that there should be a "contract") requires a bilateral exchange of promises of labour and payment between two sides of the contract. On one side of the contract, a promise to provide labour, and on the other side of the contract, a promise to make payment. Thus, the first element was established (ie there was a contract involving at least two parties).

Due to the importance of the outcome of this decision (ie SG could have a much wider application than previously considered if it applies to partners, trustees and companies etc), the Commissioner was invited to be joined as a party to represent the ATO and the position for the revenue. The Commissioner helpfully submitted that s 12(3) only has application where the putative "employee" is an identified natural person who is a party to the contract in their individual capacity, rather than in any other capacity (such as a partner or trustee of a personal service trust).

The court also considered that the SGAA provisions (eg ss 11(1)(ba), 19(1) and 72) were consistent with this construction of the legislation.

The "for" the labour of a person element

In respect of the second element of s 12(3), ie "for" the labour of a person, the court noted that this is to be assessed from the perspective of the putative "employer" client, referring to *Moffet* as authority:[3]

> "[This question] 'is to be determined by reference to [the] terms' of the contract."

Importantly, in respect of the second "for" element, the court (referring to case law authority) confirmed that:[4]

> "36. Section 12(3) is not satisfied where a contract is properly characterised as being for the provision of a result and not for labour …
>
> 51. A contract that 'leaves the contractor free to do the work himself or to employ other persons to carry it out' is not 'wholly or principally for the labour of the person' …"

The person must "work" under that "contract" element

The court confirmed the primary judge's finding that the contracts between the drivers and ZG were not wholly or principally for the labour of the drivers. The court relied on seven reasons to reach this view, including:

- the contracts were for the provision of labour and equipment (being the trucks);
- the contracts required the partnerships to deliver goods using a substantial capital asset, the trucks, for which the partnerships were wholly responsible. The partnerships took on all costs and risks associated with the trucks, and as part of this service, the partnerships were also responsible for maintaining insurance;
- the partnerships were able to delegate the work to a substitute driver with agreement from ZG;
- the benefit received by ZG under the contracts was not divided into two separate components, one being labour to drive and the other being the use of a truck. What ZG received was a single integrated benefit, being a delivery service to be carried out by the partnership, using the partnership's resources at the partnership's risk and fully insured at the partnership's expense; and
- properly characterised, the benefit received by ZG was a delivery service which included a labour component which was not the "principal benefit".

Conclusion

The *Jamsek* decision, which confirms the court's analysis in *Moffet,* provides clarity to the extended meaning of "employee" in s 12(3) SGAA on whether a payment is wholly or principally for a person's labour.

Broadly, if the person engaged is not an individual (ie a natural person), such as a partner in a partnership or a trustee of a trust, SG should not apply. Furthermore, where the person is an independent contractor who is paid to produce a result or where they can substitute someone else to provide the service, then SG is less likely to apply.

Businesses and others that engage individuals might consider engaging a company that employs the individuals (ie an incorporated contractor) to minimise the risk of an individual constituting an "employee" for PAYG and SG purposes.

A review of contractor arrangements by every business is recommended to ensure that they are supported by comprehensive written agreements and supporting legal opinion.

Related articles

For guidance, refer to the earlier articles in this series.[5]

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2 [2020] FCAFC 118.

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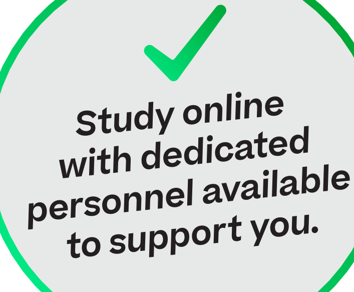

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Alternative Assets Insights

by James Nickless, Shahzeb Panhwar and Jillian Gardner, PwC

Proposed new interest limitation regime

Taxpayers will need to assess the impact of new interest limitation rules on their capital structure and any consequential impacts of refinancing.

Overview

On 16 March 2023, Treasury released for comment draft law and explanatory material to implement the federal government's proposed new interest limitation rules that will replace the existing thin capitalisation safe harbour, worldwide gearing and arm's length debt tests. These new rules will apply for income years commencing on or after 1 July 2023.

The measures included in the draft legislation will:

- replace the safe harbour test (an asset-based test) for most taxpayers with a new earnings-based "fixed ratio test" that limits an entity's net debt deductions to 30% of its tax determined earnings before interest, taxes, depreciation and amortisation (EBITDA), with the ability to carry forward denied deductions for up to 15 years subject to an integrity rule;
- replace the worldwide gearing test for most taxpayers with a new earnings-based "group ratio test" that allows an entity in a group to claim debt-related deductions up to the level of the worldwide group's net interest expense as a share of earnings; and
- replace the arm's length debt test with a new "external third party debt test" that allows interest expenses to be deducted where those expenses are attributable to genuine third party debt which is used wholly to fund Australian business operations, while entirely disallowing third party debt deductions that do not meet the requisite conditions and all related-party debt deductions.

The draft legislation released for consultation also included a few surprises in the form of previously unannounced proposed amendments. Some major surprises include:

- the repeal of interest deductions relating to the derivation of non-assessable non-exempt (NANE) distributions from foreign non-portfolio investments;
- amendments which require general class investors to demonstrate that their actual debt quantum is arm's length for the purposes of the transfer pricing provisions, even if debt deductions are less than the threshold under the fixed and group ratio tests; and
- amendments to narrow the scope of entities that are, and will continue to be, subject to the existing safe harbour and worldwide gearing tests as a "financial entity".

In detail

Unfortunately, for impacted entities, there is no change to the proposed start date. The new rules will apply from the first income year commencing on or after 1 July 2023, as was announced in the October 2022 Budget.

Who is affected by the new rules?

The new fixed ratio and group ratio tests will apply to a newly introduced category of entities referred to as "general class investors", which represents a consolidation of the existing inward and outward "general" classes of entities. In addition, the new external third party debt test will apply to general class investors as well as financial entities that are not authorised deposit-taking institutions (ADIs) (in other words, all entities that were previously eligible to apply the arm's length debt test).

Financial entities will continue to be able to access the existing safe harbour and worldwide gearing tests. However, as explained below, the definition of "financial entities" will be narrowed. ADIs, which are subject to a different thin capitalisation regime compared to non-ADI financial entities, will generally not be impacted by the proposed legislative changes.

Importantly, the de minimis exemption from the thin capitalisation rules (applicable where the total debt deductions of an entity and all its associate entities for an income year do not exceed $2m) is unchanged. The existing Australian asset-based exemption for outward investing entities (ie where average Australian assets of the entity and its associates represent, in the aggregate, at least 90% of the average total assets) will also continue to apply. In addition, the securitisation exemption continues to apply.

General class investors

Notwithstanding the introduction of a new concept, there is broadly no change to the scope of the entities subject to the thin capitalisation rules. As noted earlier, the new concept of "general class investors" represents a consolidation of the following existing general classes of entities:

- outward investor (general);
- inward investment vehicle (general); and
- inward investor (general).

In brief, an entity will be considered to be a general class investor for an income year provided:

- it is not, for all of the year, a financial entity or an ADI that is either an outward or inward investing entity; and

- on the assumption that the entity was a financial entity, it would be either an outward or inward investing financial entity that is not an ADI for the income year.

Revised definition of "financial entity"

An entity that previously was classified as a financial entity due to being a registered financial corporation under the *Financial Sector (Collection of Data) Act 2001* (Cth) will no longer meet the definition of a "financial entity" under the new proposals. This is explained to be an integrity measure to restrict the application of the existing financial entity thin capitalisation provisions to a limited number of taxpayers.

Those taxpayers that no longer qualify will be general class investors and subject to the rules summarised below.

How will the fixed ratio test work?

The draft rules replace the existing safe harbour test with a new earnings based "fixed ratio test" that limits an entity's net debt deductions for an income year to 30% of its tax EBITDA for the year. Debt deductions disallowed over the previous 15 years as a result of this test may be claimed under a "special deduction" rule (discussed later).

It is notable that the fixed ratio test operates only to reduce the allowable debt-related deductions and does not provide taxpayers with a safe harbour. In other words, a taxpayer will still need to consider other tax rules (eg the transfer pricing provisions) even if it has a total amount of debt-related deductions that is less than 30% of its tax EBITDA.

Net debt deductions

An entity's net debt deductions for an income year are determined by working out the sum of the entity's debt deductions and subtracting amounts included in the entity's assessable income relating to interest, amounts in the nature of interest, or any other amount that is calculated by reference to the time value of money.

Debt deductions

The existing definition of "debt deduction" will be amended so that a cost does not need to be incurred in relation to a debt interest issued by the entity in order to be treated as a debt deduction. In effect, the concept of "debt deduction" will be broadened to include both interest and amounts economically equivalent to interest.

Tax EBITDA

Tax EBITDA, which will be a new defined term, is broadly the entity's taxable income or tax loss adding back deductions for interest, decline in value, capital works, and prior year tax losses.

Carry forward of disallowed deductions

The new rules allow general class investors a "special deduction" for debt deductions disallowed under the fixed ratio test (FRT disallowed amounts) over the previous 15 years in certain circumstances. This will be particularly relevant to those entities that have low earnings in their earlier years of operation.

For an income year, the special deduction is calculated via the steps shown in Table 1.

Table 1. Special deduction for FRT disallowed amounts

Step 1	Work out the amount by which the entity's fixed ratio earnings limit exceeds its net debt deductions for the income year.
Step 2	Apply against that excess each of the entity's fixed ratio test disallowed amounts for the previous 15 income years (to the extent that they have not already been applied under this step in a previous income year).
Step 3	The amount of the deduction is the total amount applied under step 2.

Companies must pass a modified version of the continuity of ownership test (COT) in relation to each of the FRT disallowed amounts that they are seeking to apply. The test will be applied in the same manner as the COT rules for carried forward company tax losses, ie an FRT disallowed amount will broadly be prevented from being applied as a special deduction unless the company maintains the same majority owners.

There are also special rules to allow FRT disallowed amounts to be brought into a tax consolidated group when an entity joins the group. Such amounts will also reduce the entry allocable cost amount for a joining entity.

An entity will effectively forfeit its FRT disallowed amounts if it chooses to use an alternative method (either the group ratio rule or the new external third party debt test) in a subsequent year. That is, entities must continue to use the fixed ratio test every income year to maintain access to their carried forward FRT disallowed amounts.

The alternative group ratio rule

The worldwide gearing test will be replaced with a new earnings based "group ratio test" that allows an entity in a group to claim debt-related deductions up to the level of the worldwide group's net interest expense as a share of earnings. This test may be particularly relevant to a highly leveraged group.

This test will only be available if the entity is a member of a group ratio group (GR group) and the GR group EBITDA for the period is not less than zero. The entity will be required to make an irrevocable choice to apply this test (see further below regarding the choice to apply a test).

Where an entity chooses to use this test, its net debt deductions will be limited to its group ratio multiplied by tax EBITDA. There is no ability to carry forward denied deductions under this test and, if an entity uses the fixed ratio test and then changes to the group ratio rule, any brought forward denials from previous years calculated under the fixed ratio test will be forfeited.

GR group

A GR group is the group comprised of the relevant worldwide parent entity and, generally, all other entities that

are fully consolidated on a line-by-line basis in the parent's audited consolidated financial statements. The worldwide parent entity is referred to as the GR group parent and must have financial statements that are audited consolidated financial statements for the period. Each other entity in the GR group is referred to as a GR group member.

Group ratio

The group ratio is broadly calculated as the GR group net third party interest expense divided by the GR group EBITDA. At a high level, both of these amounts are derived from the GR group's audited consolidated accounts, as set out in Table 2.

Table 2. Components of group ratio calculation

GR group net third party interest expense	Broadly equal to the GR group's net third party interest expense, as disclosed in the audited consolidated financial statements.
GR group EBITDA	Broadly, the sum of the following amounts: • the GR group's net profit (disregarding tax expenses), • the GR group's net third party interest expense, and • the GR group's depreciation and amortisation expense, as disclosed in the audited consolidated financial statements.

There are a number of complex adjustments that are required to the amounts in Table 2 before calculating the group ratio. This includes:

- treating amounts in the nature of interest, or amounts calculated by reference to the time value of money, as interest for these purposes; and
- reducing the group's net third party interest expense for any payment made to an associate entity, using a relatively low threshold of only 10% ownership to determine who is an associate entity.

The new external third party debt test

The new "external third party debt test" effectively disallows an entity's debt deductions to the extent that they exceed the entity's debt deductions attributable to external third party debt and which satisfy certain other conditions. This new test is notably more limited in application than the arm's length debt test that it replaces (eg it will not be available for Australian businesses that raise external debt with a guarantee from their global parent, even if the debt amount is arm's length based on the standalone borrowing capacity of the Australian business, nor if any amount of the debt is used to acquire shares in a foreign entity).

If the external third party test applies for an income year, the test will disallow debt deductions for the amount by which the entity's debt deductions exceed the entity's "external third party earnings limit" for the income year.

External third party earnings limit

For an income year, the external third party earnings limit is the sum of each debt deduction of the entity for the income year that is attributable to a debt interest issued by the entity that satisfies the following external third party debt conditions:

- the entity issued the debt interest to an entity that is not an associate entity of the entity;
- the debt interest is not held at any time in the income year by an entity that is an associate entity of the entity;
- the holder of the debt interest has recourse for payment of the debt only to the assets of the entity; and
- the entity uses the proceeds of issuing the debt interest wholly to fund:
  - its investments that relate only to assets that are attributable to the entity's Australian permanent establishments or that the entity holds for the purposes of producing assessable income; and
  - its Australian operations.

Conduit financier arrangements

Additional rules allow certain conduit financier arrangements to satisfy the external third party debt conditions. Conduit financier arrangements exist where an entity (a "conduit financier") issues a debt interest to another entity (an "ultimate lender") and that debt interest satisfies the external third party debt conditions. The conduit financier then on-lends the proceeds of that debt interest to one or more associate entities on the same terms as the debt interest issued to the ultimate lender (other than as to the amount of debt).

The draft explanatory material acknowledges that conduit financier arrangements are relatively common commercial arrangements which are generally implemented to allow one entity in a group to raise funds on behalf of other entities in the group. It is noteworthy that many multinational groups may raise debt externally overseas and on-lend within the group on terms that are closely aligned with (but not the same as) the terms of the upstream external debt. These arrangements would not be able to benefit from the additional rules for conduit financier arrangements.

Restrictions on applying the test

The external third party debt test is available for general class investors as well as non-ADI financial entities. However, general class investors cannot make this choice if:

- it has one or more associate entities that are general class investors;
- those associate entities are not exempt from the thin capitalisation rules; and
- at least one of the associate entities does not make a choice to use the external third party debt test.

A modified definition of "associate entity", which replaces the requirement of an "associate interest of 50% or more"

with a "TC control interest of 10% or more", applies for the purposes of this restriction.

Choice of tests

The fixed ratio test is the default test that applies for general class investors that do not make a choice to use either of the two alternative tests.

For an income year, the entity can choose to either use the group ratio test or the external third party debt test on or before the earlier of the day it lodges its return for the relevant year or the day it is required to lodge the relevant tax return. A choice for an income year cannot be revoked, and the entity will not be able to revise or make a new choice in a tax return amendment as the time period for making the choice will have lapsed.

Taxpayers can choose to use a different test in each income year. However, if a taxpayer uses the fixed ratio test in an income year and does not use the fixed ratio test in a subsequent income year, the taxpayer loses the ability to carry forward any existing FRT disallowed amounts for income years going forward.

Removal of interest deductions for NANE dividends

Another large surprise included in the draft legislation is the proposed removal of deductions for interest incurred in respect of foreign equity distributions that are NANE income under Subdiv 768-A of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).

Broadly, a distribution is NANE income under Subdiv 768-A if:

- it is made by a non-resident company to an Australian resident corporate tax entity (directly or indirectly); and
- the Australian resident entity has at least a 10% interest in the non-resident company.

The ability to claim interest deductions in respect of distributions that are NANE income under Subdiv 768-A has been a longstanding feature of the income tax law, and previous attempts to repeal it have been unsuccessful.

This measure was not previously announced and will have application from as early as 1 July 2023 for June balancers. All entities with existing funding arrangements that relate to foreign corporate investments will need to review the after-tax cost of such arrangements, and regardless of whether or not they are subject to the new interest limitation rules.

Interaction with the transfer pricing rules

Section 815-140 ITAA97 modifies the operation of the transfer pricing law to debt deductions for entities that are subject to the thin capitalisation rules. This modification provides that, when working out the costs that are debt deductions if "arm's length conditions" applied and those costs involve applying a rate to a debt interest, the costs should be calculated by applying the arm's length rate to the debt interest actually issued (ie the actual quantum of debt). The effect of this is, putting aside the anti-avoidance provisions, that taxpayers do not need to demonstrate that their actual debt quantum is arm's length provided they are subject to the thin capitalisation rules and can demonstrate that they have had at least some amount (ie a dollar) of debt.

As a result of this change, general class investors will need to ensure that the quantum of cross-border related party borrowings is consistent with arm's length conditions under the transfer pricing rules, even though it is paying an arm's length rate of interest and its total debt deductions are less than the threshold under the fixed ratio or group ratio rules.

Consequential amendments included in the draft law indicate that s 815-140 will continue to apply only to entities that are not general class investors and have not made a choice to use the external third party debt test for the income year. In other words, the s 815-140 modification will continue to apply to ADIs and financial entities that have not chosen to use the external third party debt test.

What happens next?

The government is aiming to have these measures introduced into federal parliament in the winter sittings, which commence on 9 May 2023. However, it is possible that the law will not be enacted prior to 1 July 2023, the earliest start date of these measures.

The takeaway

With only a few weeks before the earliest start date, there is not much time for taxpayers to assess the impact that the new measures will have on their capital structure and any consequential impacts of refinancing, if required.

A key focus for many corporate taxpayers will be working out the quantum of related party debt that is permitted under the new limitation rules as well as, for the first time, the transfer pricing rules. Certain sectors like infrastructure and property, which historically have been heavily reliant on the asset-based safe harbour, may be negatively impacted given the changed focus on earnings. This is particularly relevant to greenfield projects where earnings may not arise for a number of years. The operation of the conduit financing rules will also need careful attention in light of how projects are currently financed.

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Events Calendar

Upcoming months

MAY
17–18
Wed–Thu

NSW

NSW Tax Forum

14 CPD hours

MAY
24–25
Wed–Thu

QLD

QLD Tax Forum

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JUNE
1–2
Thu–Fri

Online

Trusts Intensive

8 CPD hours

JUNE
7–8
Wed–Thu

NSW

National Infrastructure Conference

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JUNE
9
Fri

Online

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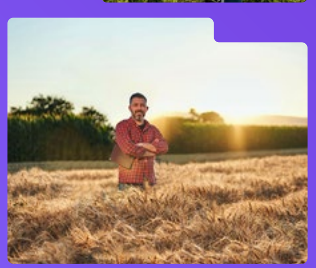
JUNE
15–16
Thu–Fri

QLD Online

Agribusiness Intensive



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Giving back to the profession

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

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