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Taxation *in* Australia

Trusts and distributions: avoiding disasters
Greg Russo

Tax accounting and livestock in Australia
Lex Fullarton, CTA, and Dale Pinto, CTA

Contents

Cover article

487

Trusts and distributions: avoiding disasters

Greg Russo, Principal Lawyer, Greg Russo Law

Feature article

509

Tax accounting and livestock in Australia

Lex Fullarton, CTA, Adjunct Professor, and Dale Pinto, CTA (Life), John Curtin Distinguished Professor of Taxation Law, Curtin Law School, Curtin University

Insights from the Institute

470 President's Report

471 CEO's Report

472 Associate's Report

Regular columns

469 Tax News – at a glance

474 Tax News – the details

479 Tax Tips

483 Higher Education

485 Member Spotlight

513 A Matter of Trusts

516 Superannuation

518 Events Calendar

519 Cumulative Index

Invitation to write

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Tax News – at a glance

by TaxCounsel Pty Ltd

March – what happened in tax?

The following points highlight important federal tax developments that occurred during March 2024. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 474 (at the item number indicated).

Public country-by-country reporting

The government has released exposure draft legislation (and explanatory material) in relation to the proposal for multinational entities to prepare for public release certain tax information on a country-by-country basis and a statement on their approach to taxation. **See item 1.**

Corporate limited partnership: "credit" an amount

The Commissioner has released a final ruling that sets out his view on when a corporate limited partnership "credits" an amount to one of its partners within the meaning of s 94M of the *Income Tax Assessment Act 1936* (Cth) (TR 2024/2). **See item 2.**

Self-education expenses

The Commissioner has released a final ruling that sets out the principles that are relevant to the deductibility of self-education expenses by an individual under the general deduction provision (s 8-1) of the *Income Tax Assessment Act 1997* (Cth) and also discusses the types of expenditure that can be deductible as a self-education expense, as well as those that cannot (TR 2024/3). **See item 3.**

Input tax and fuel tax credits: time limits

The Commissioner has released a draft ruling that sets out his preliminary view on the time limits that apply to the entitlement to claim an input tax credit under the GST legislation or a fuel tax credit under the *Fuel Tax Act 2006* (Cth) (MT 2024/D1). **See item 4.**

Default assessments upheld

The AAT has rejected an individual taxpayer's challenge to default assessments (and penalty assessments) made by the Commissioner for the 2014 to 2017 (inclusive) income years (*The Counsellor and FCT* [2024] AATA 220). **See item 5.**

Residence status: individual

The AAT has rejected an individual taxpayer's contention that he was not a resident for income tax purposes for the 2016 to 2020 income years and has held that he was a resident by virtue of the ordinary concepts test and also by virtue of the domicile test in s 6(1) of the *Income Tax Assessment Act 1936* (Cth) (*Quy and FCT* [2024] AATA 245). **See item 6.**

GST: supplies of combination food

The Commissioner has released a final determination that considers when, under s 38-3(1)(c) of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GSTA99), a supply is a supply of food that is a combination of one or more foods at least one of which is food of a kind specified in the third column of the table in cl 1 of Sch 1 GSTA99 (GSTD 2024/1).

President's Report

by Todd Want, CTA

Continuing development at the Institute

President Todd Want reflects on his experience attending CPD events and chatting to members this year.

CPD events are an incredibly important part of what we do here at the Institute, and I've recently enjoyed going along to a number of events around the country. From the Private Business Tax Retreat in Queensland and the Women in Tax Congress in NSW, to the WA Tax Forum and, most recently, the VIC Tax Forum, I've had the privilege of joining delegates for excellent tax technical and soft skills sessions and enjoyable networking with some incredibly talented and passionate tax practitioners.

These events were a wonderful showcase of the expertise, thought leadership and innovation coming out of our community. I am consistently impressed by the high quality of the programs, the sessions and the speakers. Our thanks, as always, go to the organising committees who put much time, thought and effort into designing events for the tax community. The support of delegates – without whom our CPD events wouldn't have the electrifying atmosphere they do and, in fact, wouldn't exist – is also valued and appreciated.

Equally as important as the tax technical program, these events are an exceptional opportunity for our community to connect and build stronger networks. The networking function built into most events is, I feel, an important part of the experience. It's easy to sweep it aside in favour of the hard-hitting tax technical side of a CPD event. However, these opportunities to build bridges with peers and experts are what open doors to the future of your career. I encourage you to come along next time you attend an event – and please come by to say hello if you spot me there too.

For me, coming to CPD events this year has also been vital in fulfilling our commitment to engaging even more closely with our members and what you need from the Institute. I've had many insightful conversations with delegates who are both members and prospective members, sharing their stories of not just the amazing things that the tax community achieves, but also the challenges currently being faced in their lives. Hearing these candid insights is crucial to being able to better support our members.

We are making considerable efforts to engage with you, as Scott will outline in his report this month. But there is no better way to understand how our members are feeling than to hear it straight from the horse's mouth. I'm incredibly grateful to have CPD events as an opportunity to sit down and discuss with members what they want to see from us, and grateful to the members who take time out of what can be very busy days to have those conversations.

Having "taken the temperature" at events these past couple of months, I'm pleased to hear positive feedback regarding our increase in local engagement, although I acknowledge that we are just getting started and there is more to do in this area. We continue to work to meet – and exceed – your needs and expectations.

Increased engagement with you and providing more resources, opportunities and support as part of your membership continue to be a key focus for me and for the broader Tax Institute team.

The first half of this year has started with some wonderful opportunities for connection and development. I look forward to seeing you all at future events and continuing to hear from you about how the Institute can support you going forward.

CEO's Report

by Scott Treatt, CTA

Acting on your feedback

CEO Scott Treatt discusses some of the ways we are making member benefits more accessible this year.

This year, my number one priority and that of my leadership team at the Institute is in listening to and engaging with our members. We are already in the thick of this work, acting on the generous feedback received from members.

One insight from the feedback that we have received was that it isn't always clear how to get the best value from your membership. There are all of these resources, opportunities and benefits on offer – but how do you access them? How do you know about them?

We have heard you and are working on various ways to make your member benefits more accessible.

A number of the challenges in accessing your member benefits can be traced back to the need for continuing development and improvements to our website and overall digital experience. Rest assured, this is work that is underway and ongoing.

As part of this ongoing work on our digital experience, I am pleased to share a hub for all of your member benefits, where member exclusive resources, announcements and other benefits will be housed, so you can access them all in one place. Please bookmark this hub as it will help you to keep up with the various resources coming your way from the Institute.

As always, please also make sure to read your *TaxVine* newsletter. Not only is this a beloved source of tax news updates, but we also use *TaxVine* to keep you informed of member benefits, member surveys and other opportunities like upcoming events.

As Todd touched on in his report, CPD events are one huge way to get value from your membership. Not only are they a wonderful way to build CPD, sharpen your tax technical knowledge and network with peers, but members also get special discounted pricing on all of our events, from The Tax Summit through to small, local discussion groups.

We are also developing a program of free, member-only webinars which will run throughout the year, keeping you informed on the top issues facing the profession. In the past, we have held these free webinars ad hoc, as major issues cropped up for the profession. With a structured program, driven by our state councils, you will soon have access to more frequent and regular free webinars.

Members are also encouraged to reach out to us regarding volunteering as a speaker at events. This is an excellent opportunity to grow your professional profile as an expert in your specialty. Where we can help you to raise your profile and share your ideas, we want to do so.

Our renewals window is now open, and you will soon be receiving communications from us regarding renewing your membership. I encourage you to pay attention – not just for the reminder to renew, but also for the reminder of the value that membership brings to your professional life and how to best tap into it.

I look forward to supporting you for another year and hearing your feedback as we continue to work towards better engagement between the Institute and the members who make it what it is.

Associate's Report

by Sumitha Krishnan, FTI

The OECD's Two-Pillar Solution

We reflect on and consider the potential impact of adopting the OECD's two-pillar approach on affected taxpayers.

To address complex tax challenges of the digital economy, the Organisation for Economic Cooperation and Development (OECD)/G20 Inclusive Framework on base erosion and profit shifting developed a comprehensive solution known as the Two-Pillar Solution, consisting of Pillar One and Pillar Two (the proposed OECD rules).

Pillar One

Pillar One aims to reallocate taxing rights for the largest and most profitable multinational enterprises (MNEs). It is centred around concepts including Amount A, Amount B, and measures to enhance tax certainty through effective dispute prevention and resolution mechanisms.

Amount A reallocates taxing rights for MNE groups with over €20b in global turnover and 10% profitability, broadly reallocating 25% of profits exceeding the threshold to be taxed where users and customers are located. This is proposed to be implemented through a multilateral convention and changes to domestic law.

Amount B introduces a simplified approach for applying the arm's length principle to marketing and distribution activities within a country. On 19 February 2024, the Inclusive Framework released its report on Amount B, which has been integrated into the OECD Transfer Pricing Guidelines.

Pillar Two

Pillar Two establishes a minimum global tax rate and includes the Global Anti-Base Erosion Rules (GloBE rules), which consist of the income inclusion rule, the undertaxed payment rule, and the switch-over rule, among other measures. These rules require companies with annual revenue over €750m to pay a minimum tax rate of 15% on corporate profits. If a company's effective tax rate is below 15% in a jurisdiction, they must pay a top-up tax to meet the minimum rate. Some countries are considering implementing a qualified domestic minimum top-up tax to collect top-up tax from an MNE's local branches and subsidiaries.

The subject to tax rule (STTR) is a treaty-based rule that allows source jurisdictions to tax specific intra-group payments such as interest, and royalties when the recipient's corporate income tax rate is below 9%. The STTR will be implemented through the STTR multilateral instrument, available for signature since October 2023.

Implementation status

On 21 March 2024, the Treasury released for consultation the primary and subordinate exposure draft legislation concerning the Pillar Two rules. The proposed effective start date of the Pillar Two rules is 1 January 2024, with a retrospective start date deemed appropriate to align with the OECD's Two-Pillar Solution and other jurisdictions implementing the GloBE rules. The progress of Pillar One remains uncertain, both globally and in Australia. However, the government and the MNEs should consider what changes these rules might bring and how they will interact with core accounting and taxation principles and domestic laws once implemented.

Interaction with Australian domestic law

The government has released for consultation a discussion paper inviting stakeholder feedback on the interaction of the Pillar Two rules with the hybrid mismatch rules, controlled foreign company rules and foreign income tax offsets. The potential impact of the Pillar One rules should also be considered as it advances. In addition, the following is a non-exhaustive list of other Australian domestic laws which, when combined in operation with the proposed OECD rules, may lead to unintended outcomes unless they are carefully considered: R&D tax offset; dividend imputation system; foreign branch income exemption; multinational anti-avoidance laws; diverted profits tax; Pt IVA of the *Income Tax Assessment Act 1936* (Cth); taxation of financial arrangements; petroleum resource rent tax regime; tax consolidation regime; and transfer pricing.

Additionally, the interaction between the proposed OECD rules with the updated ATO draft ruling on royalties (TR 2024/D1) and the intangibles measure that proposes to deny deductions for payments made to related parties for intangible assets in low or no-tax jurisdictions, should also be taken into consideration.

Conclusion

It goes without saying that the proposed OECD rules are complex. Affected MNEs should be preparing for the upcoming changes through updating their internal systems, accounting software, and upskilling employees. Effective implementation of these changes requires clear visibility over the legislation. Accordingly, we maintain our view that postponing the effective start date of the Pillar Two rules to a time after the legislation is enacted will allow affected stakeholders sufficient time to adjust to the tax, regulatory and compliance changes brought about by these rules. The government should also consider providing updates on the status of Pillar One to give taxpayers certainty.

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Tax News – the details

by TaxCounsel Pty Ltd

March – what happened in tax?

The following points highlight important federal tax developments that occurred during March 2024.

Government initiatives

1. Public country-by-country reporting

The government has released exposure draft legislation (and explanatory material) in relation to the proposal for multinational entities to prepare for public release certain tax information on a country-by-country (CBC) basis and a statement on their approach to taxation.

The exposure draft legislation reflects the government's previous announcement to refine the measure to more closely align with the European Union's public CBC regime, and includes deferring the start date by 12 months (to 1 July 2024) and policy changes on the reporting threshold and approach to disaggregated reporting.

Currently, large multinational enterprises are subject to confidential CBC reporting (in accordance with action 13 of the OECD's base erosion and profit shifting project). In addition, some companies voluntarily disclose some CBC information, but disclosures are fragmented leading to inconsistencies and difficulties in interpreting and comparing the information.

The proposed reporting obligation is to apply to CBC reporting parents that are certain types of constitutional corporations, partnerships or trusts, and that are members of a CBC reporting group. Further, the CBC reporting parent will only be subject to the reporting obligation if $10m or more of their aggregated turnover for the income year is Australian-sourced. The CBC reporting parent will be required to publish selected tax information on an Australian Government website by giving the information in the approved form to the Commissioner, with the Commissioner facilitating publication. Penalties are to apply for non-compliance.

Also released was an exposure draft determination[1] that it is proposed will be made under the amendments to specify the jurisdictions for which the CBC reporting parent must publish selected tax information on a CBC basis, if the CBC reporting group operates in those jurisdictions. The jurisdictions specified are those that are typically associated with tax incentives, tax secrecy and other matters likely to facilitate profit-shifting activities. Requiring selected tax information to be published on a CBC basis for these jurisdictions will provide greater transparency of how CBC reporting groups structure their tax affairs in these jurisdictions.

The Commissioner's perspective

2. Corporate limited partnership: "credit" an amount

The Commissioner has released a final ruling that sets out his view on when a corporate limited partnership (CLP) "credits" an amount to one of its partners within the meaning of s 94M of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) (TR 2024/2).

A CLP credits an amount to one of its partners within the meaning of s 94M (drawings etc deemed to be dividends paid out of profits) if, in substance, it applies or appropriates its resources to confer a benefit on the partner that:

- is not subject to a condition precedent and is legally enforceable by the partner; and
- is separate and distinct from the partner's existing interest in the CLP and its assets.

A mere credit entry in a CLP's accounts is not a crediting within the meaning of s 94M ITAA36 unless it records an underlying act or transaction that meets these requirements. However, a CLP does not need to make a distribution or pay an amount to a partner in order for it to credit an amount to that partner.

If the requirements set out are satisfied, a partner of the CLP is credited with that amount, even if a future event may occur which requires the benefit to be relinquished or returned to the partnership.

TR 2024/2 does not deal with whether an amount credited to a partner in a CLP is against the profits or anticipated profits of the CLP, or how the anti-overlap provisions apply to avoid double taxation where an amount credited is subsequently paid or distributed.

3. Self-education expenses

The Commissioner has released a final ruling that sets out the principles that are relevant to the deductibility of self-education expenses by an individual under the general deduction provision (s 8-1) of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) and also discusses the types of expenditure that can be deductible as a self-education expense, as well as those that cannot (TR 2024/3).

For the purposes of TR 2024/3, self-education includes:

- courses undertaken at an educational institution (whether leading to a formal qualification or not);
- courses provided by a professional or industry organisation;
- attendance at work-related conferences or seminars; and
- self-paced learning and study tours (whether within Australia or overseas).

To be deductible under s 8-1 ITAA97, expenditure must be able to be characterised as having been incurred in gaining or producing assessable income. It is well established that the words "in gaining or producing assessable income" are to be understood to mean "in the course of" gaining or producing assessable income and do not convey the meaning of outgoings incurred "in connection with" or "for the purpose" of deriving assessable income.

This means that there must be a relationship, or close connection, between the expenditure and what it is that the taxpayer does to produce their assessable income or, if none is produced, would be expected to produce their assessable income. It is not enough to simply show that there is some perceived connection, general link or causal connection between the expenditure and the production of the taxpayer's income. The expenditure must have a close connection to the performance of the duties and activities through which the taxpayer earns their income.

The question of what produces a taxpayer's assessable income should not be approached narrowly. It requires consideration of the tasks to be performed and the duties to be observed.

The reason or motive for undertaking the self-education is not determinative of whether the expense is incurred in gaining or producing the taxpayer's assessable income. In many, if not most, cases, the objective relationship between an expenditure and that which is productive of income will provide a sufficient answer to the inquiry posed by s 8-1 ITAA97.

Having the support or encouragement of the taxpayer's employer to undertake the self-education also is not, by itself, determinative of whether the expense is deductible. However, the fact that the taxpayer incurs an expense on a voluntary basis (that is, not at the direction of their employer) does not necessarily preclude a deduction.

A partial deduction may be appropriate where only part of the taxpayer's expense is for self-education connected with their income-earning activities or where only part of the self-education is relevant to the taxpayer's current income-earning activities.

Self-education expenses are incurred in gaining or producing the taxpayer's assessable income if either or both of the following principles apply:

- the taxpayer's income-earning activities are based on the exercise of a skill or some specific knowledge and the self-education enables them to maintain or improve that skill or knowledge; and/or
- the self-education objectively leads to, or is likely to lead to, an increase in the taxpayer's income from their current income-earning activities in the future.

Self-education expenses are not incurred in gaining or producing the taxpayer's assessable income (and so are excluded from being deductible) if either of the following apply:

- the self-education will enable the taxpayer to get employment, to obtain new employment or to open up a new income-earning activity (whether in business or in their current employment). This includes studies relating to a particular profession, occupation or field of employment in which the taxpayer is not yet engaged. These expenses would be incurred at a point too soon to be regarded as incurred in gaining or producing the taxpayer's assessable income; or
- the taxpayer is not undertaking income-earning activities to derive assessable income at the time they incurred the expenses.

The principles and exclusions outlined above are not mutually exclusive and should not be considered in isolation.

Furthermore, the many cases dealing with self-education expenses and s 8-1 ITAA97 are no more than examples of the application of these general principles and exclusions to the facts of those cases. These cases provide an indication of the facts that are relevant when determining the deductibility of self-education expenses. The expressions used in these cases should be taken to describe an attribute of an expenditure in a particular case rather than being an exhaustive test ascertaining the limits of the operation of the general deduction provision. It is, therefore, always necessary to read the words of s 8-1 ITAA97 and apply them to the facts.

TR 2024/3 gives a number of examples. It is stated, however, that the examples are for illustrative purposes only. It should not be assumed that a taxpayer's situation will have the same outcome as the example, even if the taxpayer has similar facts or undertakes the same study as shown in the example. Differences in occupation and industry requirements, the taxpayer's specific income-earning activities, and the relevance of the expense to the income-earning activities may produce different outcomes.

TR 2024/3 does not consider the substantiation and record-keeping requirements that may be relevant in relation to claiming deductions covered by the ruling.

4. Input tax and fuel tax credits: time limits

The Commissioner has released a draft ruling that sets out his preliminary view on the time limits that apply to the entitlement to claim an input tax credit under the GST legislation or a fuel tax credit under the *Fuel Tax Act 2006* (Cth) (FTA06) (MT 2024/D1).

More particularly, MT 2024/D1 explains:

- when and the extent to which a tax credit has been taken into account in an assessment;
- when the four-year entitlement period ends; and
- the exceptions to the limiting provisions.

MT 2024/D1 also explains:

- when an objection to an assessment may preserve an entitlement to a tax credit; and
- the interaction between the limiting provisions and private ruling and amendment requests.

"Taken into account"

A tax credit is "taken into account" in an assessment to the extent that the credit has formed part of the calculation of the amount that became the assessed net amount or assessed net fuel amount for the relevant tax period or fuel tax return period (referred to as the calculation that produced the assessed amount).

A tax credit will form part of the calculation that produced the assessed amount to the extent that the amount of the credit forms part of the amount of total tax credits that is used in calculating the assessed amount.

For GST, the amount of an input tax credit that is included in the calculation of total input tax credits is the amount which the taxpayer determined they were entitled to for the tax period under the GST law (worked out under s 11-25 of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GSTA99) for fully creditable acquisitions, or s 11-30 GSTA99 for partly creditable acquisitions).

For fuel tax credits, the amount of a fuel tax credit that is included in the calculation of total fuel tax credits is the amount which the taxpayer determined they were entitled to for the tax period or fuel tax return period under the fuel tax law, worked out under s 43-5 FTA06 (reflecting the taxpayer's entitlement under Subdiv 41-A or 42-A FTA06), before any reduction for the road user charge.

If the amount of the tax credit that formed part of the calculation that produced the assessed amount is less than the amount of the taxpayer's entitlement under the GST law or fuel tax law, the tax credit is only taken into account to the extent of the amount actually included in the calculation. The balance of the tax credit would not have been taken into account in the assessment.

If no amount of a tax credit is included as part of the total amount of the taxpayer's tax credits that formed part of the calculation of their assessed amount, the tax credit would not have been taken into account in the assessment.

During the four-year entitlement period

The four-year entitlement period is the period of four years commencing after the day on which the taxpayer was required to give the Commissioner a return for the tax period or fuel tax return period to which the credit would be attributable under s 29-10(1) or (2) GSTA99 or s 65-5(1), (2) or (3) FTA06.

The four-year entitlement period is only altered if, prior to the end of the four-year entitlement period, there is a formal extension granted by the Commissioner to the due date for the return for the tax period or fuel tax return period to which the tax credit would otherwise be attributable. An entitlement to tax credits ceases immediately on the expiry of the four-year entitlement period and actions after this time cannot revive an entitlement to a tax credit.

Recent case decisions

5. Default assessments upheld

The AAT has rejected an individual taxpayer's challenge to default assessments (and penalty assessments) made by the Commissioner for the 2014 to 2017 (inclusive) income years (*The Counsellor and FCT*[2]).

The Commissioner had determined the assessments on the basis that amounts paid during the relevant income years by a company (of which the taxpayer was the sole director and shareholder) to the taxpayer, or on his behalf, were his ordinary income or, alternatively, statutory income under Div 7A ITAA36.

The Commissioner's primary argument was that the taxpayer had not discharged his statutory onus of proving that the amounts paid by the company were not his assessable income. In particular, the Commissioner was of the view that the evidence relied on by the taxpayer was unreliable and contradictory. The Commissioner also assessed the taxpayer for administrative penalties on the basis that he had determined his tax-related liability without the assistance of tax returns and, therefore, imposed a penalty of 75% for the 2015, 2016 and 2017 income years. This base penalty amount was further uplifted by 20% in respect of the 2016 and 2017 income years. The Commissioner separately decided not to remit the administrative penalties.

The taxpayer submitted that all of the assessments were excessive. He maintained at the hearing that his taxable income for each of the relevant years was nil. During the tax objection stage, the taxpayer relied on signed income tax returns that had been subsequently prepared for him to support his position. The taxpayer also relied on further calculations prepared by his advisers (including his current tax agent) to support his position. The taxpayer argued that the company's payments to him, or on his behalf, were not assessable income but repayments of loans that he had made to the company. The taxpayer alternatively contended that the payments were a loan from the company to him, and that the company had no "distributable surplus" in the relevant income years for the payments to constitute deemed dividends under Div 7A ITAA36.

The AAT was not persuaded that the Commissioner's objection decision was incorrect and that the assessments issued to the taxpayer were excessive. This was because the taxpayer failed to prove what his actual taxable income was for each of the relevant income years. The key problems for the taxpayer were the shortcomings in the evidence, including the paucity of reliable records. This was highlighted by the mismatches and discrepancies in the multiple iterations of attempted reconciliations and calculations that were produced by the taxpayer.

Further, the AAT was not persuaded that the administrative penalties imposed by the Commissioner should be disturbed. The penalties were imposed at the correct percentages as set by the relevant legislation and remission was not appropriate.

6. Residence status: individual

The AAT has rejected an individual taxpayer's contention that he was not a resident for income tax purposes for the 2016 to 2020 income years and has held that he was a resident by virtue of the ordinary concepts test and also by virtue of the domicile test in s 6(1) ITAA36 (*Quy and FCT*[3]).

As is usual in cases of this kind, the ultimate decision turned on considering the relevant facts. The taxpayer, who was a mechanical engineer, was born in Vietnam and obtained Australian citizenship in 1978. In 1986, he commenced working with CBI Constructions Pty Ltd (C&BI) in Sydney. Since 1986, the taxpayer had worked both in Australia and on a number of international assignments.

In January 1998, the taxpayer accepted a posting to Dubai, United Arab Emirates. On that occasion, his wife and three young daughters moved to Dubai with the taxpayer.

In late 2009, as a result of the global financial crisis, work in Dubai reduced, and the taxpayer, his wife and daughters relocated to Perth where he continued to work for C&BI in a new position.

On 13 September 2015, the taxpayer accepted an internal assignment to Dubai and worked in this position during the relevant income years.

The AAT held that, for the income years in question, the taxpayer was a resident of Australia by virtue of the ordinary concepts test. The taxpayer, despite being absent from Australia for the majority of the income years in question, maintained an intention to return to Australia and an attitude that Australia remained his home during those income years. Such an intention, attitude and continued connection to Australia was evidenced by the taxpayer:

- leaving his wife and children in his family home while he worked in Dubai, continuing to fully support his family financially, and choosing to spend each of his leave periods back with his family in Australia (other than one occasion where the family holidayed outside of Australia), staying in the family home;
- maintaining his vehicle registrations and Australian drivers licence, allowing him to seamlessly use the vehicles on his return to Australia;
- intending to retire in Australia, specifically Sydney where his family was located. The taxpayer expressed the importance of family which was consistent with an intention to return to live close to family when his employment ceased;
- holding a visa and accommodation tied to the length of his employment assignment which did not allow him to establish a real connection with his residence in Dubai. This was particularly so where the taxpayer did not take furnishings from Australia to Dubai or take the furnishings he purchased in Dubai to his next assignment;
- failing to demonstrate any connection with Dubai outside of his employment; and
- maintaining his private health insurance despite, potentially, the option to cancel the cover with his insurer and seeking a refund of premiums paid but not used.

Based on the evidence before it, the AAT considered that the taxpayer's actions throughout the income years in question identified a long-term plan to keep returning to Australia for family purposes and did not demonstrate behaviour that was consistent with the formation of any definite plan in any of the income years in question to abandon Australia completely, either for a period of time or indefinitely.

The AAT also held that the taxpayer was a resident of Australia for tax purposes for the income years in question under the domicile test. The domicile test required, first, the consideration of whether, during the income years in question, the taxpayer was domiciled in Australia and then, if so, whether the tribunal was satisfied that his permanent place of abode was outside of Australia.

The AAT said that the evidence established that the taxpayer's domicile of choice was Australia. There was no evidence before the AAT to suggest otherwise. This meant that it was necessary to consider whether the taxpayer's permanent place of abode was outside of Australia for the income years in question.

The AAT said that, as established by the case law, to establish a permanent place of abode a person does not need to intend for it to be so indefinitely. However, what they needed to establish was that it was their permanent place of abode rather than their temporary place of abode. Consideration was to be given to the continuity or otherwise of the person's presence, the duration of their presence, and the durability of their association with the particular place. Further, a person's intention to make their home a place of abode outside of Australia was relevant, particularly to whether they can be said to have abandoned their residence in Australia and had commenced living in another country in a permanent way.

In objectively considering the evidence before it, the AAT considered that the taxpayer had not abandoned his residence in Australia during the income years in question, nor had he established a permanent place of abode in Dubai or anywhere else outside of Australia.

TaxCounsel Pty Ltd
ACN 117 651 420

References

1 *Taxation Administration (Country by Country Reporting Jurisdictions) Determination 2024.*

2 [2024] AATA 220.

3 [2024] AATA 245.

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Tax Tips

by TaxCounsel Pty Ltd

Main residence exemption: relationship roll-over

Special CGT main residence rules apply where an ownership interest in a dwelling was acquired under a transaction to which CGT relationship roll-over relief applied.

Background

The CGT main residence exemption provisions[1] are in practice frequently encountered. While, in many cases, the application of the provisions does not create any great difficulty, there are situations where difficulties can arise, for example, where the CGT main residence exemption provisions have an interface with other CGT provisions.

The Tax Tips column in the March 2024 issue of the journal[2] considered some aspects of the special CGT main residence exemption provision that applies where a dwelling is acquired by the trustee of a deceased estate under the deceased's will.

This article considers the special CGT main residence rules that can apply where there is a disposal of an ownership interest in a dwelling by an individual who had acquired the ownership interest in circumstances such that the CGT marriage or relationship breakdown roll-over relief[3] applied in relation to the acquisition. For convenience, this roll-over relief is referred to as the "CGT relationship breakdown roll-over relief". It should be noted that the discussion does not consider the CGT relationship roll-over relief more generally.

A point that needs to be kept in mind is that CGT relationship breakdown roll-over relief does not depend, for its operation, on a choice being made but automatically applies if the conditions for the roll-over relief to apply are met. This means that, if it were desired that CGT relationship breakdown roll-over relief not apply in relation to a particular asset or assets, it would be necessary to ensure that the transaction involving that asset or those assets did not come within the terms of the roll-over relief.

The Commissioner has published information in relation to how the CGT main residence exemption operates in the context of CGT relationship breakdown roll-over relief.[4]

When CGT relationship breakdown roll-over relief can apply

So far as is presently relevant, CGT relationship breakdown roll-over relief potentially applies where a CGT event (called the "trigger event") happens because of one or other of a number of specified kinds of court orders or agreements relating to a relationship breakdown.[5] For example, these orders and agreements include:

- a court order under the *Family Law Act 1975* (Cth) or under a state, territory or foreign law relating to breakdowns of relationships between spouses;
- a maintenance agreement approved by a court under s 87 of *the Family Law Act 1975* or a corresponding agreement approved by a court under a corresponding foreign law; and
- something done under a written agreement:
  - that is binding because of a state, territory or foreign law relating to breakdowns of relationships between spouses; and
  - that, because of such a law, prevents a court making an order about matters to which the agreement applies, or that is inconsistent with the terms of the agreement in relation to those matters, unless the agreement is varied or set aside.

CGT relationship breakdown roll-over relief can potentially apply where a CGT event that is relevant for the roll-over relief happens involving:

- spouses[6] or former spouses (referred to for convenience as a "GGT event involving spouses/former spouses"); and
- a company or trustee and a spouse or former spouse (referred to for convenience as a "GGT event involving a company or trustee").

There are specific CGT main residence exemption provisions (discussed below) that can apply in each of these situations.

Relevant CGT events

The only CGT events that are relevant for the purposes of CGT relationship breakdown roll-over relief are: CGT event A1 (disposal of a CGT asset); CGT event B1 (use and enjoyment before title passes); CGT event D1 (creating contractual or other rights); CGT event D2 (granting an option); CGT event D3 (granting a right to income from mining); and CGT event F1 (granting a lease).[7]

In the context of CGT relationship breakdown roll-over relief as it operates in relation to the CGT main residence exemption, CGT event A1 would be the CGT event that would usually be relevant and the discussion below assumes that this is the relevant CGT event.

Roll-over relief consequences

The consequences of CGT relationship breakdown roll-over relief applying are that:

- a capital gain or a capital loss that the transferor makes from the CGT event happening is disregarded;[8]

- if the asset was acquired by the transferor post-CGT, the first element of the transferee's cost base and reduced cost base is the transferor's cost base and reduced cost base at the time the transferee acquired it;[9] and
- if the asset was acquired by the transferor pre-CGT, the transferee is taken to have acquired it pre-CGT.[10]

As indicated, there are, in addition, potential consequences for the operation of the CGT main residence exemption. It is those consequences that are considered in this article.

The CGT main residence rules

CGT event involving spouses/former spouses

Where an ownership interest in a dwelling is acquired from a spouse or former spouse and CGT relationship breakdown roll-over relief applies, then, as noted above, the roll-over relief has the effect that, if the asset was a pre-CGT asset of the transferor spouse or former spouse, it retains that status in the hands of the transferee spouse or former spouse.[11]

If, however, an ownership interest in a dwelling is a post-CGT asset of the transferor spouse or former spouse, the roll-over relief provisions only provide for what the cost base and reduced cost base of the ownership interest are in the hands of the transferee spouse or former spouse. The time of the transferee's acquisition would be the time when CGT event A1 happened, which, in the absence of a contract, would be when the change of ownership to the transferee spouse or former spouse occurred.[12]

In addition, if the ownership interest in a dwelling is a post-CGT asset of the transferor spouse or former spouse, the way the CGT main residence exemption operates in relation to the transferee spouse or former spouse depends on whether the CGT event that triggered the CGT relationship roll-over relief happened after 12 December 2006.

Pre-13 December 2006 event

If the CGT event that triggered the CGT relationship roll-over relief happened on or before 12 December 2006, there are no special CGT main residence exemption provisions. Accordingly, in such a case, whether the CGT main residence exemption applies and how it applies are broadly determined by reference to the ordinary CGT main residence exemption rules as they apply having regard to the use (or deemed use) of the dwelling by the transferee spouse or former spouse after the time the CGT event happened.

Example

Albert acquired a dwelling on 12 April 1994 which he used as a rental investment (the rental investment). On 18 July 1996, Albert married Alice. Later that year, Albert and Alice jointly acquired a dwelling which they used as their main residence.

Example (cont)

Albert and Alice separated on 12 May 2003. Pursuant to a Family Court order, Albert transferred his interest in the rental investment to Alice on 4 November 2005. After the existing lease of the rental investment expired on 14 February 2007, Alice moved into the rental investment and used it as her main residence until she disposed of it on 28 April 2023.

On these facts, Alice would be entitled to a partial CGT main residence exemption calculated by reference to her period of ownership of the rental investment and the period that she used it as her main residence.[13]

Post-12 December 2006 event

If the CGT event that triggered the CGT relationship roll-over relief happened after 12 December 2006, the CGT main residence exemption rules in s 118-178 ITAA97 (previous roll-over under Subdiv 126-A) will potentially apply.

Under these rules, the CGT main residence exemption applies in relation to the transferee spouse or former spouse on the assumption that:

1. the ownership interest of the transferee spouse or former spouse had commenced when the transferor's ownership of the interest commenced (the acquisition time); and
2. from the acquisition time until the time the transferor's ownership interest ended:
   a. the transferee had used the dwelling in the same way that the transferor used it; and
   b. the dwelling had been the transferee's main residence for the same number of days as it was the transferor's main residence (s 118-178 ITAA 1997).

The way that (2) above operates is clear where the transferor spouse or former spouse in fact used the dwelling as their main residence for the whole period that they owned their ownership interests in the dwelling. Where, however, the transferor spouse or former spouse only actually used the dwelling as their main residence for part of this period, then (2)(a) would be relevant, for example, for the purposes of applying the CGT main residence rules that can apply where a dwelling is used for the purpose of producing assessable income, and (2)(b) would be relevant, for example, for the purpose of applying the CGT main residence rules that can operate to deem a dwelling to be a taxpayer's main residence (for example, the absence concession rule and the building, repairing or renovating a dwelling rule).

Example

Patricia and Raymond were married on 15 August 2001. On 5 March 2007, they entered into a contract to purchase a dwelling (the dwelling) as joint tenants. They moved into the dwelling on completion of the contract on 29 May 2007.

Example (cont)

Save for the period 20 June 2010 to 15 August 2012 when they travelled overseas, Patricia and Raymond used the dwelling as their main residence.

Patricia and Raymond separated on 18 April 2019, at which time Raymond moved out of the dwelling and commenced to rent a dwelling which he used as his main residence at all relevant times. Patricia continued to use the dwelling that was acquired in March 2007 as her main residence.

Patricia and Raymond were divorced on 5 July 2021. Pursuant to a Family Court order, Raymond transferred his interest in the dwelling to Patricia on 17 February 2022.

Patricia sells the dwelling under a contract entered into on 14 March 2024.

Assuming that these are the only relevant facts, CGT relationship breakdown roll-over relief would apply, with the consequence that:

- any capital gain or capital loss that Raymond would otherwise make on the disposal of his interest in the dwelling would be disregarded; and
- Patricia's cost base and reduced cost base of Raymond's interest in the dwelling will be Raymond's cost base and reduced cost base at the time of the CGT event (17 February 2022).

During the periods 20 June 2010 to 15 August 2012, and from 18 April 2019 to 17 February 2022, Raymond did not in fact use the dwelling as his main residence. He would, however, be able to make an absence choice in respect of each of the periods, which, if made, would have the consequence that the dwelling would continue to be treated as Raymond's main residence during each period.

From the perspective of the transferor spouse or former spouse (Raymond in the example), the operation of the CGT main residence exemption would not usually be an issue as any capital gain or capital loss that would otherwise arise to the transferor would be disregarded because of the operation of the CGT relationship breakdown roll-over relief.

Example

Barry owns a dwelling (the first dwelling) which he acquired on 8 October 2008 and which he immediately commenced to use as his main residence. He married Angela on 16 November 2018 and they jointly acquired a dwelling (the second dwelling) on 15 December 2018 which they used as their main residence until July 2021, when they separated. Barry continued to own the first dwelling, which he had rented out when the second dwelling was acquired. Under a consent order made by the Family Court that attracts CGT relationship breakdown roll-over relief,

Example (cont)

Barry transferred the ownership of the first dwelling to Angela on 4 February 2023.

Angela would be treated (by s 118-178 ITAA97) as having acquired her ownership interest in the first dwelling on 8 October 2008 and to have used the dwelling (1) in the same way Barry used it; and (2) as her main residence for the time Barry used it as his main residence. This period is from 8 October 2008 to 4 February 2023. If Barry were to make an absence choice, the first dwelling would be treated as having been his main residence for the whole period he owned it. The making of a choice could, however, have CGT main residence implications for Barry in relation to his interest in the second dwelling.

Practical point

A practical point is that, where the parties to a marriage breakdown are considering the terms of (say) a consent order in relation to their financial affairs, and the CGT main residence exemption may be in issue, all possibly relevant information relating to the prospective transferor's use of the property must be obtained and any main residence exemption choice(s) that may need to be made are in fact made. Of course, all relevant records relating to the determination of the cost base and the reduced cost base of the transferor's interest in the dwelling should be obtained.

In relation to the making of CGT main residence exemption choices, the relevant explanatory memorandum states that, for the practical reasons of negotiating a property settlement, any choices that the transferor spouse or former spouse decides to make would generally be expected to be made before they transfer their ownership interest to the transferee spouse or former spouse. A signed statement could be provided by the transferor spouse or former spouse to the transferee spouse or former spouse in these circumstances as evidence of the making of a choice.

Also, because the issue in any case of the operation of CGT relationship breakdown roll-over relief will, in most cases, in fact only become a live issue when the transferee spouse or former spouse disposes of the dwelling, it may be prudent in some cases to obtain from the Commissioner a binding private ruling.

CGT event involving a company or trust

As explained above, CGT relationship breakdown roll-over relief extends to the situation where a CGT event that is relevant for the roll-over relief involves a company (the transferor) or a trustee (also the transferor) and a spouse or former spouse (the transferee) because of one or other of the court orders or agreements that are relevant for CGT relationship roll-over relief to apply.[14]

In such a case, there is a special time of acquisition rule that applies for the purposes of the CGT main residence exemption. The individual who acquires the ownership interest is treated as having owned the ownership interest in the land or dwelling during the period the company or trust actually owned it.[15]

Further, the dwelling cannot be treated as the individual's main residence during the period the company or trust owned the ownership interest, despite any other CGT main residence provisions that would otherwise allow the individual to treat it as their main residence during that period.[16]

The practical effect of this is that the transferee spouse or former spouse can only ever be entitled to a partial CGT main residence exemption in respect of the land or dwelling. This is because the land or dwelling could not be (or be deemed to be) the main residence of the transferee spouse or former spouse throughout the whole of their deemed extended ownership period. The period the company or trust had an ownership interest in the land or dwelling would be taken to be non-main residence days for the purposes of the partial CGT main residence exemption formula. The fact that the transferee spouse or former spouse in fact used the dwelling as their main residence during the period it was owned by the company or trust would be irrelevant.

If land or a dwelling which is the subject of CGT relationship breakdown roll-over relief was acquired by the transferor company or trust pre-CGT, the land or dwelling will (by virtue of the CGT relationship breakdown roll-over provisions) be a pre-CGT asset of the transferee spouse or former spouse. The CGT main residence exemption will only become relevant if the transferee spouse or former spouse were to build a dwelling on the land post-CGT that is deemed to be a separate CGT asset.

Example

Real Estate Pty Ltd owns a block of residential land which it acquired on 10 August 2002 at a cost of $300,000. The shareholders of the company are Graham and Lucy (Graham's spouse). The marriage between Graham and Lucy fails and they divorce. Subsequently, on 19 February 2015, in pursuance of consent orders made by the Family Court, Real Estate Pty Ltd transfers the land to Lucy.

Some time later, Lucy builds a dwelling on the land and she commences to occupy the dwelling as her main residence on 9 May 2018 and continues to so occupy the dwelling until selling it on 21 June 2023.

Lucy's ownership period is treated (by s 118-180 ITAA97) as having commenced on 10 August 2002. Lucy should be able to make a choice under the building, repairing and renovation concession to treat the dwelling as having been her main residence from 19 February 2015 and, if this choice is made, the capital gain or capital loss that Lucy makes on her disposal of the dwelling will be calculated as follows:

Example (cont)

$$\text{Capital gain (or capital loss) calculated without regard to CGT main residence exemption} \times \frac{\text{Days in period from 19 February 2015 to 21 June 2023}}{\text{Days in period from 10 August 2002 to 21 June 2023}}$$

Observations

Where the circumstances are such that CGT relationship roll-over relief may potentially apply in relation to a later disposal of a dwelling, the special CGT main residence exemption provisions will need to be considered.

There will be circumstances in which a CGT main residence exemption choice (for example, an absence choice) available under the provisions may need to be made by one party to the relationship or former relationship. Such a choice should be made in writing as part of the resolution of the property aspects of the relationship breakdown. The deemed CGT choice-making rule provided for in s 103-25 ITAA97 should not be relied on.

TaxCounsel Pty Ltd

References

1 Subdiv 118-B of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).

2 Tax Counsel Pty Ltd, "CGT: dwelling acquired by deceased estate", (2024) 58(8) *Taxation in Australia* 418.

3 Subdiv 126-A ITAA97.

4 Australian Taxation Office, *Main residence exemption in relationship breakdown*, 30 June 2023. Available at www.ato.gov.au/individuals-and-families/investments-and-assets/capital-gains-tax/relationship-breakdown-and-capital-gains-tax/main-residence-exemption-in-relationship-breakdown.

5 Ss 126-5(1) and 126-15(1) ITAA97.

6 "Spouse" for this purpose takes the wide meaning that it is given in s 995-1(1) ITAA97.

7 S 126-5(2) ITAA97.

8 S 126-5(4) ITAA97.

9 S 126-5(5) ITAA97.

10 S 126-5(6) ITAA97.

11 S 126-5(6) ITAA97.

12 S 109-5(2) ITAA97.

13 It is assumed that the CGT main residence moving into a dwelling concession in s 118-135 ITAA97 would not apply in the circumstances.

14 S 126-15 ITAA97.

15 S 118-180 ITAA97.

16 S 118-180(2) ITAA97.

Higher Education

The joy of learning

The Dux of Tax for Trusts: from an SME perspective for Study Period 2, 2023 shares her joy of learning and how useful the subject has been for her work.

Marianne Dakhoul
Associate
Brown Wright Stein Lawyers, NSW

Tell us about your career in tax

I started my legal career working at the NSW Crown Solicitor's Office in various practice groups. During my time there, I worked on state revenue matters which exposed me, for the first time, to the tax world. From there, I developed an increased interest in tax and knew that I wanted to further pursue my knowledge and experience in this area.

In October 2019, I started working at Brown Wright Stein Lawyers where I have been provided with numerous opportunities to continue to grow and expand my knowledge in tax, including in state taxes, income tax, superannuation and trusts. I have had the privilege of working with amazing tax professionals and enjoy constantly learning from my colleagues and others in the industry, and applying this knowledge and expertise to assist clients.

What made you take the Tax for Trusts: from an SME perspective subject?

I am currently undertaking the Graduate Diploma of Applied Tax Law. I chose this subject as the majority of my clients use trusts in their structures, or trust issues arise on an almost daily basis. Understanding how trusts are taxed and the legal issues that can arise regarding the use of trusts is a very important aspect of my legal practice. The Tax for Trusts subject was tailored to my needs and I apply this knowledge in my work on an almost daily basis.

What's your experience studying at The Tax Institute Higher Education?

It has been great; the subjects are well planned and easy to follow online. The information I have learned is practical and can be readily applied to my practice. I also enjoy that I can learn at my own pace and organise my time so that studying fits into work and other commitments.

How did you manage study while working?

My tip for others would be to prioritise activities in your life. At various stages of our careers, we have different priorities but constant (and often competing) demands from clients, colleagues or other professionals. We cannot always meet these demands at once. Prioritising what is important to you at different stages in your career is important so you can grow as a professional, be a valued team member, and continue to service your clients to a high standard.

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Member Spotlight

From public practice to independent consulting

Max Hendriks
MAST Advisers

Max Hendriks, a seasoned tax professional and member of The Tax Institute for 30 years, has traversed the diverse landscape of both larger public practice and independent consulting throughout his career.

In a recent interview with us, he delved into his journey, shedding light on the pivotal transitions and challenges he has encountered along the way.

How it began ...

Max began his career in public practice with Greenwood Challoner, and then took a role at CCH. Max gained significant experience in this role, where he worked on updating CCH's publications in response to the tax law rewrites from the *Income Tax Assessment Act 1936* to the *Income Tax Assessment Act 1997* (Cth). This provided him with a deep understanding of the changes and updates to tax legislation, which would prove valuable throughout his career.

He then returned to large firms, including PKF and BDO. For a decade, he spearheaded the PKF Professional Practices Network, honing his expertise in navigating intricate tax structures and regulations. Max said, "... the part that shaped my career and ultimately led me to where I am today is just having those 10 years at PKF during 1999 to 2009".

But the 2009 global financial crisis marked a turning point for Max. Amid economic upheaval, corporate dynamics shifted, leading to restructuring within many firms, including PKF, where Max was working. Facing mounting pressures and unrealistic expectations, Max found himself at a crossroads, ultimately opting to explore independent consulting.

The transition to independent consulting

Transitioning to independent consultancy in 2009 offered Max newfound autonomy and flexibility, enabling him to tailor his approach to client-centric solutions. Freed from the constraints of corporate mandates and profit-driven agendas, he found his passion in focusing on the needs of his clientele. This newfound freedom also afforded Max the opportunity to find rhythm in his professional life, marked by less pressure and a better work–life balance.

The highlights of a busy career

One of Max's core areas of expertise in his consulting practice lies in small business CGT structuring and concessions. Through meticulous planning and strategic advice, he assists clients in navigating the complexities of the CGT regulations, aiming to secure favourable outcomes within stringent frameworks.

A career highlight that Max recalls fondly involved the successful representation of a client in a personal services income case in the early 2000s. Although he initially won the case, even up against highly respected tax counsel, the decision was later appealed to the Federal Court.

When asked what he is using to make sure he has the most up-to-date tax information for his clients, Max proudly states that he continues to frequent his old tax discussion group from The Tax Institute, "I think it's still called Tax Discussion Group #7". Now that's a blast from the past!

The complexity of our system

As a final word, Max shared his opinion on how our tax system could be improved. His main concerns were the need for less reliance on income tax as the main revenue raiser and the need for simplification of tax rules to make them more understandable for taxpayers.

He made note of the challenges faced by individuals, particularly business owners, in navigating the complexities of the tax system concerning issues like trust structures and property ownership – and how important it is for tax practitioners to understand this.

Max Hendriks' story embodies resilience, adaptability and unwavering dedication to client advocacy. It is members like Max who contribute to the collective diversity and experience of The Tax Institute membership.

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Trusts and distributions: avoiding disasters

by Greg Russo, Principal Lawyer, Greg Russo Law

Family trusts are the repository of enormous wealth in Australia, and for good reason – their ability to separate ownership of assets from their control can provide a suite of planning and asset protection opportunities. However, trust litigation is on the rise. The ageing population of many current trust controllers is one contributing factor, and it follows that trust controllers and their advisers need to be increasingly familiar with trust law and trust administration. This article undertakes a systematic review and analysis of recent trust case law and identifies key takeaway points to assist advisers working with trusts and their controllers, including: the necessity of having a sufficient understanding of trust complexity; the value in keeping up to date with developments in trust case law and legislation; an understanding of the impact of the death of a trust controller on the administration of a trust; and the likelihood of a trust dispute arising.

Introduction

Deficient trust management can contribute to disputes between beneficiaries and trustees and lead to contested litigation.

There are many lessons that clients and professional advisers can learn from recent cases on how to avoid traps and maximise the tax and other benefits that working with trusts can offer.

This article will identify some of the more important guiding practice principles through an analysis of recent cases.[1] In particular, this article will look at providing practical guidance on:

- what can go wrong with trust administration;
- the obligations of advisers; and
- entity record-keeping.

This article is aimed at practice management and risk minimisation and highlights practical steps that can be taken to avoid some of the issues that come before the courts.

Case studies relevant to some of the areas discussed in the article are included at the end.

Why are trusts so popular?

According to the *Australian Financial Review*, there are "about 928,000 family trusts managing assets worth nearly $2.2 trillion".[2]

There are many reasons why trusts are so popular, and why it is so important that legal, accounting and financial advisers (advisers) are comfortable providing advice in respect of them.

Separation of ownership and control

John D Rockefeller, the American businessman and philanthropist, is quoted as saying "... own nothing, but control everything ...".

That sentiment is at the heart of the structure of most trusts and one of the reasons that they are so widely used. Trusts create an opportunity to separate legal control and beneficial ownership so that, effectively, one entity or person can control an asset for the benefit of another entity, person or class.

Taxation benefits of using trusts

The flexibility of trusts may allow a trustee to allocate future income between a class of beneficiaries in a flexible and tax-effective manner.

Trusts are taxed pursuant to Div 6 of Pt III of the *Income Tax Assessment Act 1936* (Cth) (ITAA36).

As a general proposition and ignoring beneficiaries that may be under a legal disability, it is a basic premise of trust taxation that a beneficiary *presently entitled* to a share of trust income is responsible to pay tax on that income to the extent of that entitlement.[3]

In each financial year, tax will be payable by each of the beneficiaries presently entitled to a share of the trust income during that financial year, on those respective shares, at their relevant marginal tax rates. Any undistributed income will generally be taxed:

- in the hands of a trustee at ordinary progressive marginal tax rates after the tax-free threshold (for testamentary trusts, if the Commissioner's discretion is exercised)[4] pursuant to s 99 ITAA36; or
- at the highest marginal tax rates applicable to trustees generally.[5]

Accordingly, trusts provide an opportunity to split income between several beneficiaries.[6] This creates opportunities for advisers to add value for their clients in achieving beneficial tax outcomes but also imposes obligations to *get it right* for their clients.

Asset protection benefits of using trusts

Trusts can offer protection against the insolvency of a trustee, a beneficiary or an appointor:

- property held by a bankrupt as trustee of a trust is not property "divisible amongst creditors";[7]
- the power of an appointor of a trust to appoint or remove trustees has been held to not be property that vests in the trustee in bankruptcy, and it has been held that the power of appointment is not one contemplated under s 116 of the *Bankruptcy Act 1966* (Cth);[8] and
- the trustee in bankruptcy is in no different position than the bankrupt beneficiary insofar as trust entitlements are concerned and would not be able to require the trustee to distribute trust assets unless a beneficiary has a fixed entitlement to trust assets or income. This proposition is confirmed in case law:[9]

  "… the bankrupt's right as one of the general beneficiaries of the … trust did not vest in the applicant as property of the bankrupt … At best the applicant's position is a statutory equivalent of an assignee of an expectancy."

Trust disputes

Disputes between trustees and beneficiaries are common and are probably increasing because of:

- the ageing population of many current trust controllers;
- the complexity of trust control succession; and
- the wealth that is controlled by many trusts.

The broad financial, domestic and social reach of trusts also contributes to the number of court decisions handed down involving trusts.

Furthermore, the death or incapacity of trust controllers changes a family dynamic but will often not bring a trust to an end. The vacation of the office of the trust controller and disagreements as to how it should be filled are the source of many trust disputes. These disputes will often involve an assessment of recent adviser management.

Ideally, advisers need to be comfortable that the files they maintain for trust clients are capable of withstanding potential scrutiny by the court in the context of future contested proceedings.

What this means for advisers

Advisers need to proactively consider a variety of matters when providing advice to clients in respect of trusts, both to protect their clients' interest and to protect themselves professionally.

Who is the client?

Advisers may find themselves acting for:

- trustees;
- appointors, guardians or other "protectors"; or
- beneficiaries.

Advisers need to be clear about who they are acting for in a particular transaction.

Understanding complexity

Trusts are complicated. So are the families and other beneficiary groups that they involve. That's a lot of moving parts and a lot of things to consider. That complexity can create uncertainty. For example:

- notwithstanding the regularly articulated tax benefits of testamentary trusts, ultimately, aspects of their taxation are to a degree uncertain;[10] and
- the existence of trusts in a financial structure generally requires a more complex estate plan, and more complex tax advice to be formulated and provided to clients.

The existence of trusts in a financial structure creates both opportunities and obligations to "think strategically" for clients. For example:

- to promote particular taxation outcomes;
- to promote control over assets, including post-death control;
- to promote asset protection; and
- to achieve charitable objectives.

It is the separation of control and beneficial ownership that therefore is the strength of trusts and that creates:

- opportunities for advisers; and
- challenges for advisers.

Record-keeping and drafting

Advisers are often asked to advise about their clients' trust record-keeping obligations. Generally, records must be kept for five years after they were prepared or obtained, or five years after the completion of the transactions to which they relate, whichever is the later.[11] For legal practitioners, the files must be retained for seven years. Cautious advisers may choose to retain some records forever, such as file notes and important memorandums, as they may be important evidence at some future time.

Trustee record-keeping obligations are different to adviser obligations. The types of records that a trustee must keep are extensive (some of which can never be destroyed) and include:

- a copy of the relevant trust deed;
- copies of all trustee resolutions;
- detailed statements of assets and liabilities;
- a record of the name and contact details of the trustee at year end;
- records of all trust losses;
- records in respect of gains or capital loss made when a CGT event happens; and
- records of important declarations and elections, such as family trust elections, settlor wishes etc.

Trustees should be extremely selective in what they destroy and when. Indeed, some records should never be destroyed, including the trust deed, resolutions and declarations, and elections.

Advisers are also often called on to assist trustees to prepare and draft trust resolutions. As will be seen below, recent case law has had a big impact on the way resolutions should be drafted.

Read the deed …

The trust administrative provisions contained in a trust deed govern the operation of a trust and its day-to-day running, and may include:

- trust control succession provisions, addressing trustee succession, and the succession of an appointor, a principal or a guardian;
- the nomination of an appointor and/or guardian and appointor and/or guardian succession;
- a process by which the trust provisions may be varied;
- trustee powers;
- a definition of "income"; and
- provisions in relation to trustees self-dealing, trustee remuneration and indemnity.

Trust deeds are usually drafted by solicitors or specialised trust deed providers. There are numerous providers and each produces deeds which create a unique environment of legal rights. It is essential that an adviser be familiar with the terms of each trust that they are providing advice in respect of. Hence, the well-known mantra, "read the deed".

Trust deeds can be difficult to understand, and rules of interpretation have been developed by the courts over time. For example:

- the rules that apply to the construction and interpretation of deeds and contracts equally apply to trusts;[12]
- when interpreting a clause in the trust deed, the trust deed as a whole must be considered;[13]
- the intentions of the parties to the trust deed must be assessed objectively;[14] and
- unless specifically defined, words and phrases within the trust deed will carry their natural and ordinary meaning.[15]

Advisers should avail themselves of competent legal advice if they are unsure of the meaning of any of the trust deed provisions. In that regard, the above mantra possibly should be understood as "read and *understand* the deed" and, as will be seen, insofar as advisers are concerned in particular, "read and understand the deed, and *organise yourself professionally* accordingly".

Read the deed …

Background

Many recent cases reinforce the necessity of adopting the "read the deed" mantra when providing advice in relation to trusts.

A trust is created by a settlor.[16] In "reading a deed", an adviser may need to have regard to the settlor's intention as a guide to its interpretation.

The current position is that the settlor's intention should be determined by an objective test, with reference to the trust deed read as a whole.[17] However, recent case law demonstrates that the court will have regard to a variety of sources of information when determining a settlor's intention.

Cardaci

The facts

In *Cardaci v Filippo Primo Cardaci as executor of the estate of Marco Antonio Cardaci [No. 5]* (*Cardaci*),[18] the deceased was, before his death, the trustee, appointor, guardian and a primary beneficiary of a trust (the relevant trust). The deceased was survived by:

- a brother who became trustee and guardian of the relevant trust after his death; and
- his partner.

The guardian's role in the relevant trust was designed to protect the interests of the beneficiaries by giving the guardian a reserve "blocking" power in relation to the exercise, by the trustee, of certain trustee powers, including:

- paying, applying or setting aside trust income for a general beneficiary on a first occasion; and
- advancing capital.

This meant that the trustee needed the consent of the guardian in order to exercise those powers. The trust deed did not, however, confer any power of appointment or other dispositive discretions on the guardian.

The issues

The deceased's partner did not want the deceased's brother to have any control over the relevant trust. She sought and was successful in having him removed as trustee. She then sought his removal as guardian of the relevant trust. She did so on two bases:

- by challenging the validity of the deed appointing him as guardian (the appointment deed); and
- by seeking to control his use of the guardian power through the appointment of a receiver, which would have secured his "effective" removal.

The outcome

The court looked to the terms of the trust deed, and their interpretation, to resolve the issues.

The deceased's partner argued that the relevant deed did not authorise the variation of the identity of the guardian, and consequently that the appointment deed could not effectively appoint the brother-in-law as guardian. When assessing the validity of the appointment deed, the court held that the rules for the construction of contracts apply also to trusts.

The relevant deed authorised the variation of "the trusts provisions terms and conditions contained in this Deed", and the court concluded that the appointment deed was a valid exercise of this power and so the appointment of the guardian was also valid.

The court also held that the guardian powers did not amount to an interest of ownership of trust assets but were only "veto powers" and would therefore not be capable of being bound by of the restrictions imposed by a potential receivership.

Importantly, when determining this matter, the court also had regard to the deceased's wishes contained in a written memorandum regarding the administration of the trust. It did so notwithstanding that the memorandum was not part of the trust deed of the relevant trust and set out the wishes of the deceased, and not the settlor – although, in this case, the deceased was effectively regarded by the court as the "economic settlor".

The court held that:

> "327 … The trustee is not legally bound to give effect to the wishes set out in the memorandum, but the trustee is bound to give consideration to the memorandum."

Takeaways

While the court's determination regarding the status of the memorandum was specific to the circumstances of this matter, *Cardaci* highlights that, sometimes, extrinsic material will be relevant to the interpretation of a trust deed, and that, consequently, a prudent adviser should ask their clients for access to, and be familiar with, all relevant material in relation to the creation of their trusts, including evidence of the settlor's (and "effective" settlor's) intention.

Advanced Holdings

The facts

In *Advanced Holdings Pty Ltd as Trustee for The Demian Trust v FCT*,[19] Charbel Demian was the "principal"[20] named in the trust deed of a discretionary trust (the trust).

Under the trust deed, the principal had the power to appoint a new trustee, but that power could not be exercised without first removing the existing trustee.

Charbel executed a deed which purported to appoint a new trustee as the trustee of the trust.

The issues

The main issue was whether the power to appoint the new trustee had been validly exercised by Charbel in the circumstances and, in particular, whether the existing trustee had been removed first. The determination of that issue had significant tax consequences.

The outcome

When determining that the new trustee had not, in fact, been validly appointed, the court had regard to the following matters:

- there was no evidence that the current trustee had resigned;
- the court considered a "notice of removal of trustee" document, noting that:
  - it was signed by a director of the trustee company – but it was signed in the director's personal capacity and not as a director, and it was therefore held to be invalid; and
  - it was drafted on the assumption that the trustee had in fact already resigned;
- the court considered a "deed of retirement and appointment of trustee" document which referred to the minutes of the previous trustee company being tabled at the meeting of the directors of the purported new trustee. No such minutes could be produced to the court;
- accountants for the trust produced and backdated documents (leaving an email trail confirming their conduct) in an attempt to create the impression that the change of trustee had in fact occurred many years earlier; and
- there were allegations that the backdated documents had been further doctored from the actual documents in an attempt to create the desired tax outcome.

Takeaways

When determining the scope of trustee powers in a trust deed, the court will look to the relevant trust deed to determine both *what* can be done and *how* it must be done. It is essential that, in addition to reading the deed, advisers:

- ensure that the terms of the specific trust deed, and any necessary protocols under that specific deed, are complied with exactly;
- prepare detailed company minutes and trust resolutions which set out clearly the intention of the underlying documents and ensure that the documents are internally consistent, genuine and not in any way artificial; and
- maintain detailed records, including the decision-making process behind those records.

A "strategy" of backdating or in any way doctoring documents will always be inappropriate and advisers will often face professional disciplinary actions as a result.

Missing links in trust deed chains

Background

Often, the suite of administrative provisions relevant to a trust will be partly contained in an original trust deed and partly contained in a series of deeds of variation. This may occur for a variety of reasons, including:

- to respond to changes in taxation laws and other legislation; and
- to provide the trustee with the necessary powers (missing from the original trust deed) to transact trust business, such as the power to enter into mortgages or to provide guarantees.

In the case of SMSF trust deeds, it is common for the entirety of the existing trust provisions to be revoked and replaced from time to time in response to legislative changes, and for the effective trust deed to be the latest deed by date, with a "chain" of earlier deeds sitting behind that deed.

Trusts are administered over decades in some cases, and it is common for trust controllers to change their advisers during that time. Deeds can accordingly sometimes be lost, resulting in missing links in the deed chain.

In those circumstances, it can be challenging for a trustee to be confident regarding the validity of their trust deed and the extent of the suite of powers that they are able to rely on because an earlier invalid link in the deed chain may "break the chain" of validity and invalidate subsequent trust deeds.

Given the importance of the "read the deed" mantra, what should a trustee in those circumstances do? One solution is for a trustee to seek directions from the court as to how a trust should be administered. Order 54 of the *Supreme Court (General Civil Procedure) Rules 2015* in Victoria (for example) relevantly provides that a trustee can seek directions from the court in relation to:[21]

> "… the determination of any question … including any question … arising in the administration of an estate or in the execution of a trust …"

Similar provisions exist in all other Australian jurisdictions, eg s 63 of the *Trustee Act 1925* (NSW), s 91 of the *Trustee Act 1936* (SA), and s 69 of the *Administration and Probate Act 1919* (SA).

Ellasil

The facts

In *Application by Ellasil Pty Ltd* (*Ellasil*),[22] the deceased was survived by three children, John, Lynette and Janet. In her will:

- Lynette and her solicitor were appointed as executors of the deceased's estate;
- Lynette was gifted any superannuation death benefits paid to the deceased's estate;
- Janet was gifted the residue of the estate; and
- no provision was made for John.

In her SMSF:

- the deceased was the sole director of the corporate trustee and sole member at the date of her death; and
- the deceased had executed a binding death benefit nomination (BDBN) in favour of Lynette.

In relation to the SMSF deed chain:

- there was an original executed deed; and
- there was a subsequent deed of variation:
  - that had not been properly executed;
  - that referred to intermediate deeds that could not be located; and
  - that referred to a power of amendment that was not consistent with the power of amendment in the original deed.

The issues

The original executed SMSF trust deed did not allow binding nominations. The deed of variation did, but the validity of that document was uncertain given the missing links in the deed chain.

Proceedings were issued by the executors of the estate who had assumed control of the SMSF pursuant to the provisions of the will, seeking directions from the court in relation to:

- the status of the various trust deeds;
- the status of the BDBN; and
- liability for the executors'/trustees' costs.

These issues were critical to the administration of the estate, and to the identification of any conflicts that Lynette may have had in acting both as estate executor and director of the corporate trustee of the SMSF (if she had to exercise a discretion in the latter capacity to the best interests of anyone other than the deceased's estate).

The matter commenced initially as an unopposed application, seeking answers to a series of cascading questions. The court subsequently appointed a contradictor to make submissions.

The outcome

Cost liability on an application for directions. The court confirmed that a trustee is entitled to an indemnity from the trust in respect of costs incurred in making an application for directions to the court. The court required the applicant to identify with particularity those costs directly relevant to the application for directions, and only those costs were allowed.

Trust deed. In a long judgment and after significant costs had been incurred, the court ultimately determined that the original SMSF deed had been varied properly and that the trustee could rely on the terms of the later deed which authorised the BDBN. The judgment provides good guidance about what evidence a court will accept when there are missing links in a trust deed chain. It should not be assumed that the court will always find a way to regularise trustee decisions or trust operations; it was certainly not a fait accompli for this applicant.

The judgment is also useful in identifying when a court will accept that a variation power has been validly exercised. In particular, the court held that a trust deed can be varied less formally than by executing a new deed[23] if consideration is provided:

> "89 … at equity, an agreement for consideration can be effective in varying a deed."

The court also stated that member contributions to a superannuation fund may be able to be regarded as consideration in that regard.[24]

Takeaways

Advisers should ensure that trustees are aware of the availability of guidance from the court. Of course, the availability of court directions, from a commercial perspective, will depend on the circumstances of the matter and, in particular:

- a client's preparedness to delay the administration of the estate or the trust for the period of time it takes the court to make a determination; and
- the value of the issue in dispute.

While seeking court directions is one possible remedy to a certainty problem, this can be avoided by careful retention of documents and faithfully following the terms of the deed.

Often it may also be possible to achieve a satisfactory outcome for the trustee and beneficiaries by entering into a deed of arrangement with all beneficiaries.

Insofar as the costs of the application for directions are concerned, it may be sensible for a solicitor trustee to outsource all legal work associated with the application in order to create a clear distinction between legal work conducted in respect of the application for directions and other legal work.

When providing advice in relation to drafting a BDBN, advisers should:

- advise their clients on the importance of establishing the validity of each link of the relevant trust deed chain;
- highlight any gaps in the chain;
- ensure that they have reviewed all deeds in the chain or limit their advice and their retainer to a consideration to only the trust deeds actually available; and
- only advise on matters within their professional expertise and insurance.

Lost deeds

Background

Sometimes entire trust deeds are misplaced or lost. In view of the importance of "reading the deed", what happens when this occurs? It's a problem for trustees because:

- trustees have a duty to know the terms of any trust that they manage. A failure to produce the trust deed may breach that duty;
- pragmatically, a lost trust deed may make it difficult or impossible for a trustee to exercise their obligations; and
- in extreme cases, the trust may cease to exist.

Recent cases have highlighted the problems that a lost deed can create and some of the solutions that are available to advisers and their clients in these circumstances.

Know your customer

Problems associated with lost trust deeds have, arguably, been exacerbated by the uptake of the Know Your Customer (KYC) protocols in the banking and other sectors[25] since 2015.

The three components or pillars of KYC are:

- customer identification program;
- customer due diligence; and
- ongoing monitoring.

The KYC regime has arguably resulted in:

- trustees and their advisers being more aware of the important trustee duty of knowing the terms of the trust deed and keeping the original trust instrument safe and secure; and
- beneficiaries and their advisers being increasingly aware of their rights against trustees and trustee advisers.

Mantovani

The facts

In *Mantovani v Vanta Pty Ltd (No. 2)* (*Mantovani*),[26] Teresa Mantovani settled (created) a family trust in 1976 and transferred several properties to the trust. Over time, and up until her death, over $120,000 had been distributed to her four children pursuant to the trust.

After Teresa died, two of the four children secured control of the trust. A dispute arose between the siblings, during which it was discovered that the original trust deed had been lost. A copy was unable to be located.

The issues

The Supreme Court in each state and territory has power to provide advice and directions in relation to questions arising from the administration of trusts (as occurred in the *Ellasil* case above). The court also has power to authorise dealings with trust property and to vary the terms of a trust where the terms of a trust may be uncertain, for example, because a trust deed is lost.[27]

In *Mantovani*, the court had to decide whether the trust still existed in the absence of any direct evidence regarding the terms of the trust deed and, if so, what the provisions of the trust were.

The outcome

First instance. Even though the new controllers of the trust presented the court with a copy of the schedule to the trust deed and trust financial statements as evidence of the terms of the trust deed, the court at first instance held that the trust failed completely because the contents of the original trust deed could not be ascertained with sufficient certainty. The court stated:

- to satisfy a court that a trust deed is "lost", reasonable searches must have been undertaken;
- secondary evidence may then be relied on to prove the existence of the trust and the contents of the lost trust deed in limited circumstances, and only when it is clear and convincing, such as:
  - a letter written by an accountant setting out in full the details of a trust;
  - the author of a missing deed attesting that its terms were identical to an existing precedent; and
  - a photocopy of an original trust deed;
- the presumption of regularity[28] can only be relied on in relation to trusts in respect of questions of formalities, not substantive issues; and

- where the contents of a trust deed cannot be ascertained, the trust will fail for uncertainty. If that happens but it is clear that the settlor intended to create a trust, equity may impose a resulting trust, preventing the trustee from receiving the benefit of the trust property personally. In such cases (as was the case here), the resulting trust arises in favour of the settlor (or their estate).[29]

In this case:

- Vincenzo Mantovani was the settlor, but Teresa had contributed most of the trust property, and the court held that she should be regarded as the settlor for the purposes of the resulting trust;
- all of the property held in the trust formed part of Teresa's deceased estate; and
- the trustee was ordered to pay the deceased estate an amount equal to all distributions made from the trust to beneficiaries during the previous six years.

On appeal. The appeal[30] was successful and the court held that the copy of the trust deed schedule, together with the trust financial statements and tax returns, established "on the balance of probabilities" the essential terms of the trust. The deed schedule contained the following information:

- the date that the trust deed was executed;
- the name of the trust;
- the identity of the settlor;
- the identity of the trustee;
- the settled sum;
- the identity of the appointor and the successor appointor; and
- the identity of the primary beneficiaries and the general class of beneficiaries.

The trust property therefore continued to be owned by the trust and did not form part of Teresa's estate. However, the Court of Appeal was critical of the conduct of the trustee, noting that a responsible trustee would have had a copy of the trust deed in its possession, and would have been proactive in making a court application[31] regarding the trust.

In view of the lack of evidence regarding the powers of the trustee and its vesting date, the Court of Appeal requested (and received) an undertaking from the trustee that it would, within two months, seek guidance from the Supreme Court of Victoria as to how it should manage the trust moving forward.

Accordingly, while this was ultimately a positive outcome for the trustee, the court was critical of the trustee's conduct. Furthermore, the cost, delay and stress of contested litigation could have been avoided if the original trust deed had been properly stored by any of the many advisers or controllers of the trust over the years.

Also, the matter was ultimately decided with reference to the particular circumstances of this matter. Had the trust schedule been less informative, for instance, there may have been a different outcome.

Nyasa

While the *Mantovani* cases are authority for the proposition that a trust can subsist even if all of the original terms cannot be located, the terms on which the trust should be administered into the future may still need to be determined.

In the Application of Nyasa No. 19 Pty Ltd,[32] a recent decision of the NSW Supreme Court, provides guidance on that issue.

In that case, the trustee obtained judicial advice that they were justified in administering a trust on the same terms as another family trust which had been executed around the same time as the lost trust deed.

Takeaways

A number of takeaway points arise from these cases for advisers:

- always know the location of the original, signed trust deed of each client;
- ensure that you have sighted the original or a certified copy of the original trust deed before advising on distributions from the trust, or other trust transactions;
- advisers should recommend in writing to their clients that they keep their original trust deeds in a safe place;
- advisers should never assume that the terms of a trust deed are "standard"; and
- if a client has lost the original trust deed, an adviser should seek advice from a solicitor as soon as possible and consider the requirement to make an application to the court to seek directions. To avoid court criticism, and the necessity for a beneficiary having to seek judicial recourse at a later date, trustee clients should be advised to approach the court promptly.

Trustee discretion

Background

The manner in which a trustee exercises its discretion to nominate income and capital beneficiaries, and the checks and balances that can be brought to bear on the nature of trustee discretion, have been the subject of considerable case law recently.

Two recent cases dealing with trustee discretion are considered in this article. It is useful to discuss a historical case first. Each of the cases considered below deals with a variety of issues that are relevant to trust law and each involves complex fact scenarios. The analysis that follows is intentionally brief and focused on the issues relating to trustee discretion only.

Karger v Paul

The facts

In *Karger v Paul*,[33] the deceased died and left assets in her will to her husband for life, effectively granting him a life interest. The couple had no children. The plaintiff was a niece of the deceased and the remainder beneficiary of the life interest trust. The defendant and the husband were trustees of the life interest trust.

The husband was also a potential capital beneficiary of the life interest trust subject to the absolute discretion of the trustees, and the trustees had the specific power to transfer all of the trust property to the husband on his request.

The husband made such a request shortly after he had entered into a new relationship, and the trustees exercised their discretion to transfer all assets to him. He subsequently passed away shortly thereafter, and the capital of the life interest trust passed to his new partner.

The issues

The niece argued that the discretion had been improperly exercised and sought to impugn it.

The outcome

The court held that the trustees had not exercised their discretion improperly in authorising the transfer of capital to the husband. In particular, the court found that:

- it was open to it to examine the evidence to decide whether there had been a failure by the trustees to exercise their discretion in good faith, on a real and genuine consideration and in accordance with the purposes for which the discretion was conferred;
- solely for the purpose of ascertaining whether there has been any such failure, it was also relevant to look at evidence of the inquiries which were made by the trustees, the information they had and the reasons for, and manner of, the exercise of their discretion; but
- it was not open to the court to look into those matters:
  - for the independent purpose of impugning the exercise of a trustee's discretion on the grounds that their inquiries or the manner of exercise of the discretion fell short of what was appropriate and sufficient; or
  - for the purpose of impugning the exercise of the discretion on the grounds that the trustees were wrong in their appreciation of the facts or made an unwise or unjustified exercise of discretion in the circumstances.

The issues able to be examined by the court were held to be limited to whether there has been a failure to exercise the discretion, that is, the court examines *whether* the discretion was exercised but does not examine *how* it was exercised.

The court also held that it is an established principle that, unless trustees choose to give reasons for the exercise of their discretion, that exercise cannot be examined or reviewed by a court as long as they act in good faith and without an ulterior purpose and on real and genuine consideration.

The plaintiff argued during the case that she should have been given a fair opportunity to make representations to the trustees "before they exercised their discretion". The court disagreed, noting that there was no necessity to import the rules of natural justice into the exercise of a discretion by trustees.

Twigg

The recent New South Wales decision of *Twigg v Twigg*[34] is also relevant to the issue of trustee discretion. The facts and judgment are complex. A very brief summary is provided below.

The facts

William Twigg and his wife Diane had three children, Max, Elizabeth and Frances.

William established a waste disposal and landfill business that was operated through a number of discretionary trusts established for his benefit and for the benefit of his family (the Twigg Trusts).

On William's death, Max took over the running of the business interests and became a director of the corporate trustees. Diane was the other director, sole shareholder and chairperson for each trustee. It was unclear, however, how active her decision-making was.

On 2 April 2007, the business interests of the Twigg Trusts were sold for $155m:

- Max distributed $5m each to Diane, Frances and Elizabeth;
- over $100m, after taxes and debts, was paid to the Twigg Trusts (the Twigg Trusts amount); and
- the Twigg Trusts amount was then distributed to entities controlled by Max alone based on trust resolutions executed solely by Max (on behalf of the corporate trustee, notwithstanding that Diane was a co-director). In that regard, Max asserted:
  - in 2001, Diane had delegated her decision-making functions as co-director to him;
  - in 2001, Diane had otherwise agreed to him taking full control of the corporate trustee and took no interest in the business operations or management for many years; and
  - his actions were authorised by virtue of an enduring power of attorney signed by Diane.

Max told Diane that the business was under financial pressure and had a large amount of debt. He had not told her, or his sisters, that the net sale proceeds were in the order of $113m or that he intended to distribute nearly $100m for his own benefit.

Diane, Frances and Elizabeth invested and lost the $5m they each received from the Twigg sale (this was during the global financial crisis).

A number of issues associated with the ongoing administration of the Twigg Trusts then ensued, resulting in Diane, Frances and Elizabeth learning the magnitude of the proceeds of sale and that Max had in fact secured the bulk of the proceeds of sale for himself.

The issues

A number of claims and cross-claims were made by the parties and a number of issues raised. For the purposes of this article, the only issue that will be considered is the court's assessment of Max's conduct in making the payments without the proper authority of the corporate trustees of the Twigg Trusts.

The outcome

The primary judge held that Max breached his fiduciary duties as a director of the trustee companies by causing them to distribute trust property in breach of the respective trust provisions, company provisions, and without Diane's authority.

Max appealed. The Court of Appeal:

- dismissed Max's appeal;
- held that the primary judge had made no error which altered the conclusion that Max was liable for causing the proceeds of the sale of the family businesses to be distributed for his own benefit; and
- upheld the primary judge's conclusions that the resolutions purportedly made by Max on behalf of the trustee authorising the distribution of the trust assets:
  - had not been made by 30 June in conformity with the requirements of the trust deeds;
  - had not been made pursuant to the corporate trustee's constitution; and
  - had not been made pursuant to the delegated authority of Diane.

The court was also critical of the preparation of an affidavit by a financial adviser that was clearly tailored to support their client's case, that also contained information for which he had no actual recollection.

Takeaway points

If relevant to an issue before it, the court will scrutinise trust and company documents and the conduct of directors of corporate trustees when examining the exercise of trustee discretion. This is particularly the case where the financial consequences of the exercise of discretion are significant, as they were in this case.

This case is a reminder to advisers:

- to advise their trustee clients to ensure that they maintain a thorough paper trail of all trust transactions in a manner that is capable of withstanding third-party scrutiny;
- to advise their trustee clients that they have fiduciary duties which include acting for a proper purpose on a real and genuine consideration and in good faith at all times (unless the deed specifies otherwise);
- to ensure that their director clients fully comply with all corporate trustee requirements;[35] and
- that the quality and veracity of the evidence that they provide on behalf of their clients will be tested by the courts and that documents should be prepared on clear instructions and be objectively accurate and real.

Owies

The facts

Re Owies Family Trust (*Owies*)[36] involved a dispute between siblings over the control of a trust which had assets with an estimated value in excess of $23m.

Paul Andrew Owies and Deborah Owies were the plaintiffs, and their brother, Michael Benjamin Owies, was the second defendant in the proceeding. The first defendant was the corporate trustee of the trust. The assets of the trust had been cultivated over time by the parents of the children, John and Eva Owies.

The trust had been settled by a trust deed which named the three children as primary beneficiaries and their parents as general beneficiaries. Unusually, at the time of the trial, only five individuals satisfied the definition of trust beneficiary, despite being a discretionary trust.

The trust gave the trustee absolute discretion in relation to the appointment of capital and income beneficiaries.

The issues

Paul and Deborah brought a number of claims in respect of the trust, on various bases, including the validity of trust variations (and the consequent changes in the identity of the trust guardian and appointor).

The court was asked to investigate the trustee's exercise of discretion to distribute income in the 2011 to 2019 financial years. In each of those years, the entirety of the very significant income was distributed to Michael and the parents. In particular, in none of those years had any distributions been made in favour of Paul or Deborah, other than in 2019 when Deborah received a capital distribution of a residential unit (as an appeasement in the course of litigation and which took an inordinate length of time to effect).

During the course of the proceedings, Paul and Deborah asserted that the trustee's decisions to distribute income were made in breach of trust because they were made without the trustee giving any genuine consideration as to whether, in the exercise of its discretion, a distribution should have been made to Paul and Deborah. As a consequence, Paul and Deborah sought various orders, including the removal of the trustee (controlled by Michael and the parents, and later by Michael and the parents' long-time solicitor).

The outcome

On the issue regarding the distribution of income, the court found in favour of Paul and Deborah to a limited extent. In particular, the court found that:

- there was no evidence that the trustee had received any information about the plaintiffs' financial circumstances for the 2015 and 2016 years, and in relation to Deborah for the 2018 year. This was very relevant because Deborah was in parlous financial circumstances and had significant health issues, and Paul was in modest financial circumstances and getting divorced. Michael and the parents, on the other hand, were very wealthy individuals in their own right. In particular, in the last couple of years of distributions, the parents were in high-care aged care and their needs were extremely limited, which cast significant doubt on whether the distribution of income in the order of half a million dollars to them was in good faith and on real and genuine consideration;
- the trustee did not take an informed view of whether or not to exercise its discretion in relation to any income

distributions to Deborah or Paul in 2015 and 2016, and in 2018 in relation to Deborah; and

- the claims against the trustee in relation to earlier income years were deemed barred under the *Limitation of Actions Act 1958* (Vic).

Notwithstanding those findings, it was determined that the directors of the trustee should not be removed because the court was confident that the trustee would act appropriately.

The court's decision at first instance confirmed that the focus in such claims is the protection of the beneficiaries and of the trust assets, not the punishment of the trustee.

Owies appeal

The plaintiffs appealed.[37] They argued that:

- there were additional years in which the trustee's discretion had miscarried, and they succeeded on this ground;
- the distribution of 100% of the income to John was "grotesque" and demonstrated bad faith – this ground was not determined;
- the income distributions in the relevant years were void – they did not succeed and the distributions were held to be voidable rather than void; and
- the trustee should be removed – they succeeded on the last ground and the court ordered that an independent trustee be appointed.

The court said:

> "158. We are well satisfied that it is necessary to remove the trustee. In our view, the trustee has, over a number of years, failed to act impartially, failed to give real and genuine consideration to the interests of two of the primary beneficiaries …"

When assessing the trustee's exercise of discretion, the court had regard to a number of considerations and authorities when determining that, even though the discretion was described as absolute and uncontrolled, it was not without bounds:

> "Trustees must act in good faith, responsibly and reasonably. They must inform themselves … of matters which are relevant …"[38]

> "Where a trustee exercises a discretion, it may be impugned on a number of different bases such as that it was exercised in bad faith, arbitrarily, capriciously, wantonly, irresponsibly, mischievously or irrelevantly to any sensible expectation of the settlor, or without giving a real or genuine consideration to the exercise of the discretion. The exercise of a discretion by trustees cannot of course be impugned upon the basis that their decision was unfair or unreasonable or unwise."[39]

When assessing a discretion, the court will consider:

- what the relevant matters are that must be considered;
- what standard of review the court should adopt when assessing whether there has been non-compliance; and
- what is the consequence of the failure by the trustee to give real and genuine consideration.[40]

The tests for impugning a trustee's discretion must be applied with reference to the nature, scope and purpose of the specific discretion in issue.

Matters that are relevant when assessing a trustee's discretion include:

- whether a trustee informed itself of all relevant considerations;
- the size and scale of the trust;
- the nature of the relationship that exists between the trustee and the beneficiaries; and
- the purpose of the discretion.[41]

In the *Owies* appeal, the court held that, when analysing the exercise of discretion:

> "110. … the starting point must be the nature and purpose of the trust having regard to the terms of the trust deed. The trust deed is by settlement, and as the preamble records, the settlor settled the sum 'being desirous of making provision for the Primary Beneficiaries and the General Beneficiaries'."

and:

> "111. … It is not to be supposed that, when those familial bonds become strained or broken, the purpose of the trust to provide for the family as a whole would change or that the trustee would be relieved of the obligation to properly inform itself."

and:

> "116. … The purpose of the trust was to provide for the primary beneficiaries in an even handed, impartial way, in a fashion that is more constrained than the whims, passions and strong feelings, both favourable and adverse, that can underpin a parent/child relationship."

In impugning the trustee's discretion, the Full Court determined that the trustee had not had proper regard to the financial position of two of the primary beneficiaries, which was inconsistent with the purpose of the trust. In doing so, the court had regard to both the failure of the trustee to inform itself properly, and also to the outcome of the decisions that were actually made.

The *Owies* appeal has been referred to subsequent cases, for example, with respect to:

- a named beneficiary's control on a trustee through a threatened removal application;[42] and
- the positive obligation placed on trustees to consider the exercise of discretion.[43]

Takeaway points

Paragraphs 113 and 158 of the judgment are of particular importance:

> "113. … The intention that the primary beneficiaries take any non-applied or accumulated income in the same manner as will occur with respect to the whole fund on vesting, reinforces the general default structure of the

> trust deed as one providing for the benefit of the children in equal shares. That does not mean that the trust deed does not contemplate unequal distributions across the beneficiaries, an outcome made possible by the width of the discretionary powers. However, the exercise of all of the powers has to take into account the purpose of the trust and the default position just described …
>
> 158. … relations between the beneficiaries and those involved in managing the trustee are, at least from this vantage point, irreconcilably damaged, such that it is not in the best interests of the beneficiaries for the trustee to continue in office."

It is possible to interpret the court's reasoning as creating degrees of "proximity" that beneficiaries in the trust have to the exercise of a trustee's discretion – with primary beneficiaries, default income and capital beneficiaries, and those specifically referred to in the trust deed as aligned with the settlor's intention and the trust's purpose as being "closer" to the exercise of that discretion. If that is the case, it follows that the exercise of a discretion in apparent disregard to the financial position of the needs of those beneficiaries may be able to be more readily set aside.

When providing advice to trustees of existing trusts, advisers should:

- review the terms of their clients' trusts to ensure that they are fit for purpose, eg capital retention, protection of beneficiaries etc;
- advise their clients to fully inform themselves of the financial position and needs of each primary beneficiary named in a trust deed when exercising a trust discretion, even if that means writing to the primary beneficiaries each year to inquire about their respective situations, giving genuine consideration to the responses received and retaining the responses as important trust documentation;
- remind their trustee clients to make dispassionate decisions when exercising discretions and to ensure that they are acting in good faith and with real and genuine consideration;
- ensure that distributions and the enquiries made by trustees are fully documented;
- recommend that their clients avoid formulaic resolutions (ie each resolution is to be genuine and contemporaneous of the decision-making process, not artificial and backdated or created as an afterthought); and
- review the qualifications of their trustee clients to ensure that they have the necessary skills to meet the required standards for dispassionate decision-making.

When estate planning with trusts, advisers could advise their trust-controlling clients of the entitlements that primary beneficiaries may have, in the future, to query the exercise of trustee discretions and devise estate planning strategies accordingly.

It is possible that George Orwell's *Animal Farm* quote:

> "All animals are equal – but some are more equal than others …"

may now have some application to beneficiaries of discretionary trusts:

> "All beneficiaries are equal – but some are more equal than others …"

Notable mentions

A number of recent trust cases dealing with discrete issues that may be of relevance to advisers are discussed below.

Greensill

The facts

In *Peter Greensill Family Co Pty Ltd (Trustee) v FCT*,[44] an Australian resident non-fixed trust derived capital gains from the sale of shares (non-taxable Australian property) over three financial years. The gains were distributed to a non-resident individual beneficiary.

The beneficiary argued that the capital gains were not subject to tax due to the operation of ss 855-10 and 855-40 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) which provides that a capital gain can be disregarded if:

- the taxpayer was a foreign resident for CGT purposes at the relevant time; and
- the CGT event happens in relation to a CGT asset that is not taxable Australian property.

The outcome

The Full Federal Court determined that the capital gains were assessable because:

- a capital gain can only be disregarded pursuant to s 855-40 if the trust is a fixed trust; and
- ss 855-10 and 855-40 have no application to a non-fixed trust.

Following the decision, the Commissioner issued TD 2022/12 and TD 2022/13 which provide as follows:

- Subdiv 115-C ITAA97 attributes capital gains to non-resident beneficiaries regardless of source; and
- s 855-40 ITAA97 only disregards a non-taxable Australian property capital gain attributed to a foreign resident if the trust is a fixed trust.

Takeaways

Advisers should review all trust deeds where non-resident beneficiaries have derived or may derive capital gains, consider the above decision and determinations when providing planning advice in such cases, and in each case, advise their clients of their relevant tax liability.

Hill v Zuda

The facts

The *Hill v Zuda Pty Ltd*[45] decision concerned an SMSF, the trust deed of which allowed for the creation of a BDBN. The deceased member had executed a BDBN in favour of his de facto partner. After his death, his daughter (from an earlier relationship) asserted that the BDBN was not valid because it did not comply with the BDBN requirements outlined in:

- the *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA), s 59(1A) of which allows the member of a superannuation fund to direct the trustee as to how to pay their benefit on the death; and
- the *Superannuation Industry (Supervision) Regulations 1994* (Cth) (SISR), reg 6.17A(6) and (7) of which prescribe the form that a BDBN must be for it to be effective.

The daughter sought orders that the superannuation death benefits instead be paid to the estate, of which she was a beneficiary, because the BDBN for the deceased did not comply with reg 6.17 SISR.

The question to be determined was whether the BDBN was valid.

The outcome

The court at first instance found in favour of the de facto and held that:

- s 59(1A) SISA does not apply to SMSFs and therefore reg 6.17A SISR also does not apply to SMSFs; and
- if a fund's governing rules allow, an SMSF member can have a tailored BDBN that allows for more flexibility than that envisaged in the SISA and SISR.

An appeal to the Western Australian Supreme Court of Appeal was dismissed. The daughter was then granted leave to appeal to the High Court of Australia

The Full Court of the High Court unanimously dismissed the appeal and confirmed that an SMSF is not bound to follow the prescribed form of a BDBN as determined by the SISR, including the three-year expiration requirement, if the fund's governing rules allow.

Takeaways

Advisers should remember that SMSFs are trusts — albeit trusts that attract special tax treatment. The vast body of trust case law applies to them, in addition to superannuation-specific case law and legislation, such as the SISA and the SISR.

Advisers should ensure that their SMSF clients' BDBNs fully comply with the provisions of their relevant SMSF trust deeds.

Also, even where BDBNs are non-lapsing, it is prudent to review them at least every three years, and probably a good course of action to review them annually as part of the fund's reporting requirements.

Walters v Perton

The facts

In *Walters v Perton*,[46] the deceased was survived by his de facto partner and an adult child from an earlier relationship. The partner brought a family provision claim seeking greater provision from his estate.

In the context of that claim, one of the issues in dispute was whether a property, which had been paid for by the deceased and was owned by the daughter as trustee of a discretionary trust at the date of the deceased's death, was actually held on constructive trust for the de facto partner (or for the de facto and the estate).

The outcome

The court held (at para 208) that, although the deceased advanced funds for the purchase of the property, his decision to ultimately place ownership of it within a discretionary trust meant that it was to be administered in accordance with the terms and the discretions of the relevant trust deed.

There were many deficiencies in the trust and financial paperwork, and each one was analysed at length by the court in its long judgment. Legal costs ran into hundreds of thousands of dollars, with one party having to sell her only asset to pay the legal costs. There is a separate judgment about the legal costs.[47]

Takeaways

This decision again focuses on the importance of the intention of the "effective trust settlor" when determining trust disputes and good record-keeping to demonstrate what decisions are made by individuals in their own right and those made by them in their capacity as trustee of the trust. The mixing of funds between the key people in the trust and the trust itself will inevitably lead to problems.

McGowan & Valentini Trusts

The facts

Re McGowan & Valentini Trusts[48] dealt with a number of trust issues.

By trust deeds dated 14 February 1977, Guiseppe and Iris Valentini created two trusts, one for the benefit of each of their children, Anna and Peter, respectively. There were irregularities in:

- the dates of the trust deeds;
- the date of incorporation of the trustee company; and
- the date of purchase of trust assets.

It was all a bit of a mess!

The two trust deeds provided that all trust property would vest absolutely in the two children respectively when they each turned 30 years old, that is, 7 January 1988 and 14 February 1991.

On 23 June 1991, after both trusts had vested, the two children executed further trust deeds purporting to amend the original trust deeds to inter alia*:*

- widen the class of beneficiaries; and
- extend the vesting date to effectively resurrect the trusts.

The ATO's position on trust vesting

TR 2018/6 sets out the ATO's position on the CGT and other taxation consequences of a trust vesting:

> "… once the vesting date has passed, the trust has vested and it is no longer possible for a trustee to change the vesting date. Specifically, once the trust has vested, the interests in the trust property become fixed at law."

What the court said

Notwithstanding the ATO's published position, the court held that:

- the vesting of the trust property in 1988 and 1991 respectively did not mean that the trusts were at an end at that time because the trusts were not wound up by the trustee; and
- the trust property continued to be held under the same terms of the trust deeds as continuing trusts until they were subsequently amended by the 1991 deeds.

In coming to this position, the court found that there was nothing in the language of the original trust deeds that would prevent a continuation of the trusts beyond the vesting dates pending their winding-up and the distribution of trust property.

It was important that the two children consented to the continuation of the trusts.

The court determined that the extent of the power to amend the original trust deeds after the vesting date was dependent on the construction of the provisions of the relevant trust deed, and placed particular importance on the fact that the wording of the power of amendment was to the effect that it could be exercised "at any time".

In relation to whether the extension of the vesting date of the trusts amounted to a resettlement of the trusts, the court held that:

- the scope of the amendment power in the original trust deeds was extremely broad and the extension of the vesting did not exceed the scope of the amendment power; and
- the amendment did not affect the substratum of the trusts (being the purpose or underlying nature of the trust) as the purposes of both the original trust deeds and later deeds were to benefit the Valentini family and to create tax effective mechanisms for spreading the income of the family enterprise in an advantageous way,

and so did not amount to a resettlement.

Takeaways

This (somewhat unexpected) decision is a reminder that trust case law continues to evolve and that advisers can always consider the availability of court intervention and assistance in appropriate circumstances, even if existing legislation and ATO guidance is potentially unfavourable.

Most importantly, had the clients and advisers been abreast of the vesting dates and been proactive in handling the upcoming issues, this application to the court could easily have been avoided.

Conclusion

It is important for advisers to:

- have proper regard to the complexity that dealing with trusts imports into any transaction that they undertake on behalf of their clients;
- ensure that they keep up to date with trust case law and legislation (specific to each state and territory) to ensure that they are able to deliver positive tax and other benefits to their clients and avoid corresponding problems;
- recognise that the death of a trust controller will often promote the likelihood of a trust dispute; and
- in each case, ensure that they provide advice on a trust, that they have read and understood the terms of a trust deed, and that they organise their professional processes accordingly.

Summary of takeaway points

Further to the above observations, the following list summarises some of the more important takeaway points for advisers:

- consider the relevance of the settlor's (and the "effective settlor's") expressed intention, whether within the trust deed or not;
- carefully follow any trust processes prescribed in the trust deed that are necessary to invoke the utilisation of any trust power;
- keep a paper trail of internally consistent minutes, resolutions and other trust documents;
- review all trust deeds, variations and appointments in a trust deed chain;
- where issues of uncertainty exist regarding the terms of a trust, consider the availability of court directions if necessary, having regard to cost, complexity and other options, such as deeds of family arrangements;
- when advising on the form of BDBNs, consider deed chain issues and scope the retainer accordingly;
- always know the location of the original signed trust deed of each client trust and recommend in writing to clients that they keep their original trust deeds in a safe place;
- sight the original or a certified copy of the original trust deed before advising on distributions from the trust, or advising on other trust transactions;
- never assume that the terms of a trust deed are "standard";
- if a client has lost the original trust deed, seek advice from a solicitor promptly about the necessity to make an application to the court to seek directions;
- advise director clients to ensure that they fully comply with all corporate trustee requirements;
- ensure that evidentiary documents that are prepared to support clients are based on clear instructions and objectively accurate;
- regularly review the terms of clients' trust deeds to ensure that they are, and remain, fit for purpose;
- advise trustee clients to fully inform themselves of the financial position and needs of each primary beneficiary named in a trust deed when exercising a trust discretion,

even if that means writing to the primary beneficiaries each year to inquire about their situation;

- remind trustee clients to make dispassionate discretionary decisions in good faith;
- ensure that all trust distributions and the associated enquiries made by trustees are fully documented;
- recommend that clients avoid formulaic resolutions when exercising discretions;
- review the qualifications of trustee clients to ensure that they have the necessary skills to meet the required standards for dispassionate decision-making;
- when estate planning with trusts, advise trust controlling clients of the entitlements that primary beneficiaries may have, in the future, to query the exercise of trustee discretions and devise estate planning strategies accordingly;
- advise trustee clients that they should notify income beneficiaries of proposed income distributions prior to 30 June each year;
- advise potential beneficiary clients who may desire to disclaim distributions that they should make enquiries regarding potential income distributions prior to 30 June each year;
- stay up to date with evolving trust laws;
- when incorporating trusts into existing financial structures, ensure conformity with trust laws;
- exercise caution and ensure that any involvement in structuring transactions is undertaken with reference to genuine commercial objectives – understanding the motivation for a transaction may be a relevant future court consideration;
- carefully document intra-family transactions, particularly regarding client intentions and with regard had to the possibility of resulting or other constructive trusts being created;
- assess and draft trust structures with regard to the potential impact of future family law issues and keep up to date with ongoing case law developments in that regard;
- regularly review trust deeds and distributions where non- resident beneficiaries have derived capital gains;
- review SMSF trust deeds to ensure BDBN compliance and review BDBNs annually; and
- consider the availability of court intervention and assistance in appropriate circumstances, even if existing legislation and ATO guidance is potentially unfavourable.

APPENDICES

Advisers need to be familiar with a large number of trust administration issues in order to be able to properly advise their clients.

Some discrete issues – additional to those dealt with above – that may be of assistance to advisers are dealt with in the appendices that follow.

Appendix 1. Trust disclaimers

Background

A beneficiary may wish to disclaim their entitlement to a distribution of trust income for a number of reasons, for example, where the entitlement creates an unwanted tax liability.

Historically, the ATO has accepted that a valid disclaimer would be sufficient to negate a present entitlement on the part of the disclaiming beneficiary to a share of the income of the trust estate for the purposes of s 97(1)(a) ITAA36.

That has changed with the decision in the *Carter* case.[49]

Carter

The facts

In *FCT v Carter*,[50] the plaintiffs were the default income beneficiaries named in the trust deed of a trust.

At the end of each of the 2011 to 2014 financial years, undistributed income was allocated to them under the deed.

The Commissioner assessed them as liable for tax on their respective distributions.

The plaintiffs executed disclaimers in respect of their respective distributions. The Commissioner did not accept that the disclaimers were effective in altering the assessment of present entitlement.

The outcome

The High Court determined that a disclaimer by a beneficiary of their entitlement to income made after the end of an income year is not effective in altering the share of the trust net income that they are assessed on.

Takeaways

The decision in *Carter* has the potential to create an unfair outcome for beneficiaries who, for reasons of ignorance or otherwise, do not disclaim prior to the end of the financial year in which an income distribution is made.

In circumstances where the net income and trust income are not equivalent, a financially disastrous outcome could potentially result.

Furthermore, and particularly in view of the *Owies* case, a beneficiary who was made presently entitled to income pursuant to a resolution that was later successfully challenged:[51]

- would be liable to tax on the distribution as a valid but voidable distribution at 30 June; but
- would not be entitled to receipt of the distribution if it were later determined to be void.

Advisers should ensure that:

- where they act for trustees, their clients notify income beneficiaries of proposed income distributions prior to 30 June each year;
- where they act for beneficiaries of trusts, who may desire to disclaim, they make certain that their clients are

proactive in making enquiries regarding potential income distributions prior to 30 June each year; and

- timely resolutions and disclaimers are accurately prepared in compliance with the governing trust deeds and stored appropriately.

Appendix 2. Reimbursement agreements

Section 100A ITAA36 was originally introduced as an integrity provision. Its intent is to monitor "reimbursement agreements" by deeming, in particular circumstances, a beneficiary who may otherwise be presently entitled to the trust income, to not be presently entitled to that income. The result is that the trustee is then assessed on that income at the top marginal tax rate.[52]

Background

A reimbursement agreement arises where a beneficiary becomes presently entitled to trust income and is therefore taxed on that income at their applicable tax rate, but the trust income is effectively transferred or paid to someone else, by agreement, with the result that less tax is paid on the trust income.

The legislative framework deals with:

- an agreement involving trust income, where someone other than the presently entitled beneficiary actually …
- benefits from that income and at least one party enters into the agreement for purposes that include getting a …
- tax benefit.

Each of the three critical elements – agreements, tax benefits and other benefits – are widely defined.

Agreements

Examples of possible "agreements" include arrangements or understandings that may be informal, express or implied. An agreement can comprise a series of steps or transactions and need not be enforceable or even intended to be enforceable.

Tax benefits

A "tax benefit" arises where a person would be liable to pay less income tax for an income year, or where a person's tax liability would be deferred to a later income year.

Other benefits

Other (non-tax) benefits can include the payment or a loan of money, the transfer of property, the provision of services or other benefits, a release, an abandonment, a failure to demand payment, or the postponement of the payment of a debt.

Guardian

The operation of s 100A ITAA36 has not been referred to the court on many occasions since its inception. The recent decision of *Guardian AIT Pty Ltd ATF Australian Investment Trust v FCT*[53] demonstrates the importance of keeping detailed records of any arrangement that could possibly be interpreted by the ATO as a reimbursement agreement.

The facts

Over two financial years, the trustee of a discretionary trust made one of the beneficiaries of the trust – a company that it owned the shares in (the beneficiary) – presently entitled to a share of the income of the trust (the relevant distribution).

The relevant distribution was not paid but left as an unpaid present entitlement (UPE) in favour of the beneficiary.

After drawing on the UPE to pay its tax liability for the year, the beneficiary then declared a fully franked dividend to the trustee to discharge the remainder of the UPE.

The declaration of the dividend meant that the beneficiary owed a debt to the trustee. That debt was offset against the UPE owing from the trust to the beneficiary.

The trustee set aside the fully franked dividend for the benefit of Mr S, a non-resident individual beneficiary, who was not liable for any further tax on the dividend due to his non-resident status. Had the relevant distribution been distributed directly to Mr S, it would have borne tax at the marginal rates for non-resident taxpayers.[54]

The issues

The ATO argued that the arrangement was a reimbursement agreement for the purposes of s 100A and that the trust should pay tax on the distributions made.

The outcome

The court found in favour of Mr S for reasons that included:

- a reimbursement agreement must exist at the time or prior to a beneficiary becoming presently entitled to income. Mr S was able to produce sufficient written and oral evidence to demonstrate that the decision to pay the dividend and create a loan in respect of the UPE occurred after present entitlement arose; and
- the court accepted that the arrangement in place was motivated by Mr S's desire to decrease risk associated with distributing to trading entities and to shield accumulated wealth from creditors.

The decision was appealed to the Full Court.[55]

Guardian appeal

Reimbursement agreement

The Full Court upheld the decision of the trial judge, and made the following observations:

- a reimbursement agreement must exist at or prior to the time that the present entitlement to income is created; and
- the court will adopt a robust approach to determining whether an agreement exists and will require evidence of:
  - common intention; and
  - adoption of the terms of the agreement.

The court's determination in this case that no agreement (at all) existed between the parties at law meant that no reimbursement agreement could exist either.

Part IVA

Part IVA ITAA36 is the general anti-avoidance rule for income tax.

The court held that the taxpayer had breached Pt IVA in one of the two income years and remitted the matter back to the ATO for reassessment.

Current ATO guidance

The ATO has historically provided the following guidance on s 100A ITAA36 and reimbursement agreements for trustees and beneficiaries of a trust where the present entitlement of a beneficiary (who is not under a legal disability) to a share of trust income arises out of a reimbursement agreement:

- in July 2014, the ATO published its July 2014 web guidance setting out the ATO's administrative position at that time;
- in 2022, the Commissioner published:
  - TR 2022/4 which included the meaning of key terms and how the provision applies to some taxpayers' circumstances;
  - PCG 2022/2 which highlights the compliance approach that the ATO will take when considering s 100A; and
  - TA 2022/1 which specifically targets arrangements involving families seeking to use income allocated to adult children to offset expenses paid by the parents for usual parental responsibilities,

  and updated the relevant ATO webpage; and
- the ATO has created three zones, white, green and red, to categorise "arrangements" with respect to a "reimbursement agreement risk assessment".

BBlood

Section 100A was again considered recently in the appeal from the Federal Court in *BBlood Enterprises Pty Ltd v FCT*[56] to the Full Federal Court.[57]

The facts

BBlood considered the treatment of proceeds from a buy-back of shares arising from a complex series of transactions (the arrangement). The ultimate result of the arrangement was that the retained profits of a company (the company) were able to be distributed to, and then accrued by, the trustee of a trust without tax being payable.

The issues

The Full Federal Court had to consider whether s 100A applied to the arrangement.[58]

The outcome

The court found that s 100A did apply to the arrangement because the trustee received a benefit of a deemed dividend instead of the company.

When considering the second requirement of s 100A of whether the parties entered into the agreement for the purpose of reducing tax, the court gave consideration to material produced by the trust's accountant and found that:

- the trustee's accounting company could be regarded as a party to the arrangement; and
- the accountant's understanding of the intended effect of the arrangement – that being that the trustee would be paying less tax – was relevant to a conclusion as to the trustee's purpose of entering into the arrangement.

Takeaways

Timing. For an arrangement to be regarded as a reimbursement agreement to which s 100A applies, it needs to be in existence at, or prior to the time, the relevant beneficiary is made presently entitled, and evidence of consensus and adoption by the relevant parties will be required.

Part IVA. Even if s 100A does not apply to an arrangement, Pt IVA may apply and may be easier to satisfy due to:

- the broad definition of "scheme" under Pt IVA; and
- "dominant purpose" being an objective test based on factors set out in the legislation so there is no need to find evidence of a subjective intention.

ATO scrutiny. Since 2014, a dedicated Tax Avoidance Taskforce has been actively targeting taxpayers engaged in trust-based tax avoidance or evasion schemes.

Given the significant developments in this area, it is imperative for advisers to stay up to date with evolving trust laws, and when incorporating trusts into existing financial structures, it is important to ensure conformity with trust law.

Professional advisers. The *BBlood* case demonstrates the importance placed by the courts on the intent (or purpose) of the architects of any relevant trust arrangement. Advisers should exercise caution and ensure that their involvement in structuring transactions is undertaken with reference to genuine commercial objectives.

Ultimately, whether s 100A or Pt IVA (or neither) applies will depend on the facts and circumstances surrounding the arrangement. Accordingly, it is important that the parties and their advisers make detailed file notes and keep contemporaneous records of the decisions that are made and the sequence of, and motivation for, transactions that have occurred.

It is also important for advisers to actively consider whether s 100A or Pt IVA applies to any settlement arrangement, for example, when drafting a deed of family arrangement to settle a matter.

Appendix 3. Advancements and resulting trusts

Background

Sometimes there is no trust deed to "read" because there is no express trust. Instead, a trust is implied or construed by

the law. Advisers need to understand when these trusts may arise, and when and how to avoid them or when to invoke such trusts for the benefit of their clients. A discussion of some recent cases dealing with resulting trusts follows.

Resulting trusts

A resulting trust arises when two or more people contribute towards the purchase price of an asset, but the title does not reflect the contributions made.

As a starting point, equity assumes that people do not usually intend to make gifts of property.

If two people contribute to property but the property is put in one person's name only, the recipient may be said to hold the property on trust for the other, unless the presumption can be rebutted on the facts.

Advancements

Sometimes property is transferred from one person to another, but no trust arises because the property is presumed to be "advanced".

Where the presumption of advancement applies, the property is treated as being handed over to the recipient and the recipient assumes full legal title and does not hold the property on trust for the other.

This situation often arises when a parent transfers property to a child, or one spouse transfers it to another, with the clear intention that the beneficial and legal interest in the property is being disposed of as a gift.

Resulting trusts v advancements

When assessing whether the above presumptions apply in particular cases, the courts have typically looked for:

- evidence of any obligation to advance the interests of the recipient;
- evidence of intention; and
- evidence of the nature of the relationships between the parties

The application of the presumptions has changed with the recent decision in *Bosanac v FCT*.[59]

Bosanac

The facts

The Bosanacs married in 1998. They separated in about 2013.

They had purchased their former matrimonial home "Dalkeith" in 2006:

- in Ms Bosanac's name only;
- Ms Bosanac had paid the deposit of $250,000 with funds from a joint loan account;
- Mr and Ms Bosanac had jointly borrowed $4.5m to pay the remainder of the purchase price; and
- Mr Bosanac moved out of Dalkeith in 2015.

During the marriage, the Bosanac's accrued and held substantial assets in separate names.

In 2015, the ATO audited Mr Bosanac's financial affairs. Mr Bosanac was found to owe $9m in unpaid tax and declared bankruptcy.

The ATO, as creditor, sought possession of his assets, including Dalkeith.

The issues

As a starting point, Mr Bosanac was not (and never had been) a registered proprietor of Dalkeith, and accordingly no creditors could directly enforce their interests against the property.

The ATO sought a declaration that half of the equity in Dalkeith belonged to Mr Bosanac under a resulting trust.

Ms Bosanac asserted that the presumption of a resulting trust was rebutted by the presumption of advancement.

The ATO argued that the presumption of advancement is no longer part of Australian property law.[60]

The outcome: Federal Court

At first instance, the court dismissed the Commissioner's application. The decision was overturned in the Full Court which held:

- the presumption of advancement was still good law in Australia; but
- it could be displaced by evidence of a contrary intention; and
- the presumption was rebutted for a number of reasons, including:
  - Mr Bosanac assumed liability through the mortgage; and
  - Mr and Ms Bosanac jointly used the property.

The Full Court declared that Ms Bosanac held 50% of Dalkeith on trust for Mr Bosanac.

Ms Bosanac appealed. At the appeal, the ATO invited the High Court to abolish the presumption of advancement on the basis that it was anachronistic.

The outcome: the High Court

The High Court held that:

- there was no resulting trust;
- the intention of the parties in each case must be determined by assessing the facts objectively and not by applying the presumptions of a resulting trust or advancement; and
- the doctrines of resulting trusts and advancements are weakly applied today and are only of significance in cases where all of the evidence is incapable of supporting an inference about what the purchaser intended. Here, the intention was clear. The key facts relied on were:
  - Mr Bosanac was a sophisticated businessman and understood the importance of property ownership;
  - the Bosanacs had historically held assets in their own names, separate to each other (not jointly);

- the Bosanacs had an established pattern to take out mortgages in both names and use each other's properties as security; and
- Ms Bosanac was the sole contracting party for the purchase of Dalkeith and had conducted all negotiations.

The High Court also refused to abolish the presumption of advancement, stating that legislative intervention would be required for that to occur.

Koprivnjak

Koprivnjak v Koprivnjak[61] followed the reasoning in the *Bosanac* case.

The facts

Natalie Koprivnjak purchased a property for $300,000. Her father, John Koprivnjak, paid the $75,000 deposit secured by a mortgage. John continued to contribute to the property by paying for renovations, repairs, maintenance and monthly deposits of $1,400 (from a company controlled by him) to Natalie's personal bank account to assist her in making mortgage payments. The property was sold as part of Family Court proceedings between John and Natalie's mother.

The issues

The court was asked to determine John and Natalie's respective beneficial interests in the property.

The outcome

At first instance, the court determined that the moneys advanced by John were a loan to Natalie and did not give rise to a resulting trust in his favour, notwithstanding text message evidence relied on by John.

John appealed, arguing that the presumption of advancement had been rebutted (such presumption applies when a parent puts assets in their child's name), and that there was a demonstrated common intention for the property to be held on trust by Natalie for him.

The Court of Appeal dismissed the appeal, finding that the documentary evidence relied on by John was not determinative because it had come into existence after the purchase of the property, and that it was also ambiguous.

The court confirmed that, when determining the objective intention of the parties, the principles set out in *Bosanac* should be followed, and the court must first examine the objective facts and assess the parties' words or conduct at or about the time of the transaction to determine the parties' objective intention regarding the beneficial ownership of the property.

The court noted that the parties' intention may be inferred from documents created contemporaneously with the purchase, for example, a "settlement sheet". Accordingly, Natalie owed funds to John secured against the property.

Takeaways

The *Koprivnjak* decision is particularly relevant for advisers practising in the areas of family law, estate planning and insolvency.

The presumption of advancement in modern Australia is now weak and would only arise in the absence of any evidence of the parties' intentions.

In all circumstances where intra-family transactions are effected, it is important that the parties' intentions are documented properly and contemporaneously. Those intentions will not override the Family Court's ability to alter property interests. However, they are matters that the court will take into account when assessing entitlements.

Where a bankrupt has contributed to the purchase of a property held by their spouse or child but is not named as a registered proprietor, the relevant paper trail will be critical to determine whether the bankrupt holds any interest in the asset and whether it is available to the trustee in bankruptcy. This is because the court will examine the objective facts, contemporaneous documents, and the parties' words or conduct.

Consideration could be given to documenting the parties' intentions by way of a deed to promote certainty, with such a deed to be done before the asset is acquired or as soon as after as possible.

Appendix 4: Trusts and family law

Background

The *Family Law Act 1975* (Cth) (FLA) permits the court to make orders with respect to the property of the parties to the relationship or either of them, and to alter the interests of the parties in that property.[62]

"Property" is defined as any interest in which a party to the relationship is entitled, whether in possession or reversion.[63]

A "financial resource" has a wider meaning than "property" under the FLA.[64] A financial resource is effectively the benefit of financial support that a party can reasonably expect to have or become available to them.[65]

Family law and trusts

Assets in a trust may be regarded by the Family Court in family law proceedings as property of the relationship, as a financial resource, or as neither.

The court's power under the FLA is not unfettered. The court's characterisation of trust assets will be determined on a case-by-case basis.[66]

Property

Assets that are held within a trust structure may, depending on the circumstances, be determined by the court to be "property", notwithstanding the existence of that trust structure, because:[67]

> "... the property of the parties to the marriage or either of them was to be identified as including the right of the wife to due administration of the Trust, accompanied by the fiduciary duty of the husband, as trustee, to consider whether and in what way the power should be exercised. And because, during the marriage, the husband could have appointed the whole of the Trust fund to the wife, the potential enjoyment of the *whole* of that fund

was 'property of the parties to the marriage or either of them'."

Even where a party does not have legal ownership or control over a trust, where a court finds that the legal control vests in someone who is the "alter ego" of a party to the relationship, then the court may deal with the assets in accordance with the apparent, rather than the legal, realities.[68]

Financial resources

Where a party does not have "control and benefit" of a trust or its assets, a court may regard trust assets as potential "financial resources" when considering a party's future financial circumstances. This assessment involves a variety of factors, including an examination of the historical benefits received.

Generally, where control of a trust is shared with third parties, the "effective control" element requirement will not be met.

Woodcock & Woodcock[69] may change the Family Court's approach to the characterisation of trust assets.

Woodcock

The facts

In *Woodcock & Woodcock*, during matrimonial property proceedings, the husband disputed that three trusts (the relevant trusts) were matrimonial property. Features of the relevant trusts included:

- the relevant trusts were established by the husband's grandparents and continued to be operated for the benefit of his family;
- the husband and the four daughters of the husband's grandparents were the directors of the corporate trustees of the relevant trusts;
- the husband was one of the primary beneficiaries of the relevant trusts; and
- the husband had received over $15m by way of distributions from the relevant trusts in the previous five years.

The husband did not have sole control of the relevant trusts. The wife issued subpoenas seeking the production of relevant trust documents, including financial statements, trust deeds, and documents evidencing distributions. The trustees objected on various grounds, including:

- relevance;
- confidentiality; and
- abuse of process,

and asserted that the subpoenas were a "fishing expedition". In the first instance, the Registrar set aside the subpoenas. The wife sought a review of that decision.

The issues

It is established law that a discretionary beneficiary in a trust does not have a proprietary legal or equitable interest in the trust, but instead has the right to insist on the "proper administration of the trust", as well as "due consideration" as a potential beneficiary[70] (discretionary rights).

In an insolvency context, it has been held that the trustee in bankruptcy of a discretionary trust beneficiary would not be able to require the trustee to distribute trust assets:[71]

> "… the bankrupt's right as one of the general beneficiaries of the [trust] did not vest in the applicant as property of the bankrupt … At best, the applicant's position is a statutory equivalent of an assignee of an expectancy."

As noted above, in a family law context, the High Court of Australia has held that discretionary rights, coupled with the power to direct the appointment of the property of the trust, can amount to "property" and that the value of that "property" can be assessed as equal to the value of the assets of the relevant trust.[72]

One of the issues that the court was asked to determine in *Woodcock*, in connection with the subpoenas, was whether discretionary rights, without more, were:

- "property" for the purposes of a property settlement pursuant to s 79 FLA; and
- capable of valuation, therefore being included in the asset pool available for division between parties.[73]

Counsel for the wife submitted that the discretionary rights were property within the meaning of s 79 and took effect as an equitable chose in action which was capable of valuation.

The outcome

Wilson J was not willing to determine, at an interlocutory application, whether the husband's discretionary rights in the trusts were property and should be valued. However, in the second *Woodcock* case, his Honour said:

> "73 … it seems to me that according to existing statements of principle of the High Court, the equitable choses in action of due consideration and due administration under a discretionary trust … are in fact and in law 'property' within the meaning of s 4 and s 79 of the [FLA]. I say that for several reasons …The husband enjoys a position of considerable influence … and historically the husband has received distributions of approximately $15 million. He also has the ability to block. To my way of thinking the husband enjoys a legally endorsed concentration of power over things or resources …"

and in the first *Woodcock* case:

> "80 … For present purposes I take the view that the wife's proposition about the husband's interests under the trusts being property is arguable. I also take the view that the valuation of that interests is also arguable."

and in the second *Woodcock* case:

> "112 … in my view, not only should the debate in this litigation about whether the husband's rights are property be fully ventilated at trial but the value of those rights should also be fully ventilated at trial."

Subject to the above qualifications, his Honour determined that the husband's interests under the relevant trusts were property as defined in the FLA and were capable of valuation.

A finding that that the discretionary rights were property, notwithstanding that the husband did not control the relevant trusts, is something of a departure from earlier cases.

It will be interesting to see what the ultimate outcome of the matter is.

Takeaways

Trust structures that previously considered "family law proof" may, in the future, come within the reach of a former spouse in the context of a family law property settlement.

This issue is not currently resolved. It would be prudent for clients and advisers to consider, and take into account, the potential impact of this decision when providing structuring advice to their trust beneficiary clients.

Failing to recognise, and factor in, the realistic risk presented to trust structures by future relationship breakdown may result in the creation and perpetuation of trusts that are less able to deal with those risks.

Appendix 5. Case studies

Deed chains

Nina is the sole remaining director of an SMSF, her second husband, Simon, having recently passed away.

Simon appointed Nina and his sole daughter Amy as executors of his estate.

Nina is appointed beneficiary of Simon's death benefits in the SMSF under a BDBN. Amy is his sole estate beneficiary.

As a result of missing links in the deed chain, Nina and Amy are in disagreement in respect of the status of the BDBN (the SMSF issue).

Nina and Amy each engage solicitors in their personal capacities to provide advice to them in respect of the SMSF issue.

Additionally, Nina engages a solicitor to act on behalf of the trustee of the SMSF. That solicitor recommends that an application for directions be made by Nina on notice to Amy in respect of the SMSF issue.

Ahead of preparing and issuing that application, Nina and Amy, with their solicitors and the SMSF solicitor, engage in informal mediation and resolve all estate and SMSF issues by way of a deed of family arrangement:

- executed by all beneficiaries and potential beneficiaries of both the SMSF and Simon's estate; and
- providing the trustee of the SMSF and the executors of Simon's estate with full releases.

Tax and stamp duty advice is sought in respect of the deed of family arrangement before it is finalised.

Further questions

If Simon was instead survived by two children, one of whom he had not provided for in his will or SMSF:

- Should Nina act as his executor or should she renounce?
- Could settlement on the same terms as above have been achieved?

Reimbursement agreements

Billie is an 18-year-old beneficiary of a discretionary trust. He is presently entitled to income from that trust. Joel is Billie's father.

Prior to funds being paid to Billie, Billie's accountant, Amy, suggests, as a tax-saving measure, that agreement be entered into by:

- the relevant trustee;
- Billie; and
- Joel,

to the effect that Joel be made presently entitled to those funds by way of reimbursement for expenses previously incurred by him connection with caring for Billie.

> "Trusts are complicated. So are … families. That's a lot of moving parts and a lot of things to consider."

This arrangement is likely to be regarded by the ATO as a reimbursement agreement. Amy's intention/purpose will be relevant to that assessment and Amy will probably be regarded as a party to the reimbursement agreement.

Advancements and resulting trusts

Bob is a widower with two children. He acquires a business property with his daughter, Marley, to assist her in expanding her business. The purchase price is funded equally by Bob and Marley, but the property is placed into Marley's sole name for reasons associated with the ongoing running of the business.

Bob also acquires a residential property for his son, Ziggy, in consideration of the support that Ziggy has provided to him over an extended period of time. The purchase price is funded equally by Bob and Ziggy, but the property is placed into Ziggy's sole name with the intention that it be a gift to her.

Bob's will includes an adjustment clause, in order to achieve parity between his children, directing his executor – an independent trustee company – to adjust the division of his estate between Ziggy and Marley, with reference to:

- pre-death assets that he has acquired for each of them; but
- excluding outright gifts.

Specifically, it is Bob's intention that:

- his contribution to the business property to Marley, and similar contributions to Marley in the future, be adjusted against her share of his future inheritance; but
- Ziggy's residential property, and future gifts provided to each of her children, not be adjusted.

Bob includes a specific reference to each of the properties in his will. He also keeps detailed notes of the circumstances of each transaction, and the reasons that they were affected, to assist his executor in characterising them and any future transactions arising from them in the event of any dispute between his children after his death.

He is also advised by his solicitors to ensure that any future transactions are accompanied by similarly detailed explanations.

Disclaimers

Bob dies on 10 July 2020. His will creates a testamentary trust which commences to operate on 1 July 2021. Roger and David are discretionary income beneficiaries of the trust. Simon is the default income beneficiary of the trust.

On 15 June 2022, the trustee of the trust resolves to distribute 100% of the $100,000 trust income in the 2021–22 financial year to David and Roger equally.

If you were acting for the trustee, what information would you recommend your client provide to David and Roger about the income distribution, and when would you recommend that information should be provided?

Roger and David both learn of the proposed distribution of income on 25 June 2022.

Roger executes a valid disclaimer on 28 June 2022. David makes an appointment to see his solicitor about his options on 12 July 2022.

Is Roger's disclaimer effective for tax purposes? Who is assessed on his share of net income? Would a disclaimer executed by David now be effective for tax purposes?

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This article is an edited and updated version of "Trusts and distributions – traps and avoiding disasters" presented at The Tax Institute's Death and Taxes Conference held in Brisbane on 11 to 12 October 2023.

Disclaimer

The material and opinions in this article should not be used or treated as professional advice and readers should rely on their own enquiries in making any decisions concerning their own interests. Liability limited by a scheme approved under professional standards legislation.

References

1 It is not possible to address all recent cases or trust issues in this article. What follows is a "grab bag" of some of the more important issues and cases.

2 D Hughes, "ATO turns screws on bogus payments by family trusts", *Australian Financial Review*, 9 December 2022. Available at www.afr.com/wealth/personal-finance/ato-turns-screws-on-bogus-payments-by-family-trusts-20221208-p5c4vh.

3 S 97(1) ITAA36.

4 Pt 1 of Sch 10 of the *Income Tax Rates Act 1986* (Cth).

5 Subject to the Commissioner's discretion (s 99A(2)(a) ITAA36).

6 Additionally, testamentary trusts provide an opportunity to distribute income to minors on favourable terms because income allocated to minors generated from assets owned at a deceased's death are taxed at progressive marginal tax rates (with the tax-free threshold included) as excepted assessable income (s 102AG(2)(a) ITAA36).

7 S 116(2) of the *Bankruptcy Act 1966* (Cth).

8 *Re Burton; Wily v Burton* [1994] FCA 1146.

9 *Fordyce v Ryan* [2016] QSC 307.

10 Practitioners place reliance on the ATO's preparedness to address the administration of testamentary trusts in accordance with the practices set out in PS LA 2003/12. Ultimately, however, that practice statement does not have the force of legislation but is an administrative statement to provide guidance to ATO staff.

11 TR 2005/9.

12 *Royal Botanic Gardens and Domain Trust v South Sydney City Council* [2002] HCA 5.

13 *Australian Broadcasting Commission v Australasian Performing Right Association Ltd* [1973] HCA 36.

14 *Byrnes v Kendle* [2011] HCA 26.

15 *Hill (Viscount) v Hill (Dowager Viscountess)* [1897] 1 QB 483.

16 Or by a testator in the case of testamentary trusts.

17 *Byrnes v Kendle* [2011] HCA 26.

18 [2021] WASC 331.

19 [2021] FCAFC 135.

20 A role analogous to that of guardian.

21 Additionally, the court has the power to authorise dealings with trust property under s 63 of the *Trustee Act 1958* (Vic).

22 [2023] VSC 69.

23 If the variation power is interpreted as not being required to be exercised by deed.

24 On one view, the deceased may have provided consideration in the form of her contributions.

25 Know Your Customer was founded in Hong Kong in 2015 to revolutionise the world of KYC compliance. The founders' mission was to fully digitise and streamline the onboarding process for both corporate and individual customers, improving efficiency and strengthening compliance.

26 [2021] VSC 771.

27 For example, in NSW, ss 63, 81 and 86A of the *Trustee Act 1925* (NSW), and in Victoria, ss 63 and 63A of the *Trustee Act 1958* (Vic) and r 54.02 of the *Supreme Court (General Civil Procedure) Rules 2015* (Vic).

28 The presumption of regularity means that, where an act is done in accordance with usual procedure, it is presumed to have been done as it normally would be, unless evidence to the contrary exists.

29 Most modern trust deeds expressly prevent distributions to a settlor. What if an independent person (such as a solicitor or an accountant) settled the trust?

30 *Vanta Pty Ltd v Mantovani* [2023] VSCA 53.

31 At [6].

32 [2023] NSWSC 578.

33 [1984] VR 161.

34 [2022] NSWCA 68.

35 The court will be reluctant to make an order to rectify any irregularities under s 1322(4) of the *Corporations Act 2001* (Cth) where a purported passing of a resolution involved something more than a procedural issue.

36 [2020] VSC 716.

37 *Owies v JJE Nominees Pty Ltd* [2022] VSCA 142.

38 *Scott v National Trust for Places of Historic Interest or Natural Beauty* [1998] 2 All ER 705.

39 *Owies v JJE Nominees Pty Ltd* [2022] VSCA 142 at [87], quoting from *Attorney-General (Cth) v Breckler* [1999] HCA 28 at [7], quoting in turn from *Wilkinson v Clerical Administrative and Related Employees Superannuation Pty Ltd* (1998) 79 FCR 469 at 480.

40 *Wareham v Marsella* [2020] VSCA 92.

41 *Finch v Telstra Super Pty Ltd* [2010] HCA 36.

42 *Kornwasser v Spigelman* [2022] VSC 759.

43 *Tambakeras v UniSuper Ltd* [2022] NSWSC 1162.

44 [2021] FCAFC 99.

45 [2022] HCA 21.

46 [2023] VSC 37.

47 *Walters v Perton (Costs)* [2023] VSC 380.

48 [2021] VSC 154.

49 ATO ID 2010/85 provided that a beneficiary having disclaimed income was not presently entitled for the purposes of s 97 ITAA36. It is now withdrawn. Taxpayers who relied on ATO ID 2010/85 have administrative protection against penalties and interest but not against tax if the ATO amends an assessment relying on *Carter*.

50 [2022] HCA 10.

51 After 30 June in the year it was paid.

52 And without the CGT discount.

53 [2021] FCA 1619.

54 Up to 45% in the relevant years.

55 *FCT v Guardian AIT Pty Ltd ATF Australian Investment Trust* [2023] FCAFC 3.

56 [2022] FCA 1112.

57 *B&F Investments Pty Ltd as trustee for the Illuka Park Trust v FCT* [2023] FCAFC 89.

58 And, in the alternative, whether s 207-150 ITAA97 (the dividend stripping provisions) applied to the arrangement.

59 [2022] HCA 34.

60 As a result of the decision of the High Court in *Trustees of the Property of John Daniel Cummins v Cummins* [2006] HCA 6.

61 [2023] NSWCA 2.

62 S 79(1) FLA.

63 S 4 FLA.

64 *In the Marriage of Crapp and Crapp (No. 2)* (1979) 5 Fam LR 47 at 67.

65 *In the Marriage of Kelly and Kelly (No. 2)* (1981) 7 Fam LR 762 at 773.

66 Accordingly, a trust controlled by a major beneficiary may not be effective alone to segregate assets from the court jurisdiction. Important considerations include whether income distributions are being made to the beneficiary affected by family law proceedings, whether the beneficiary in question has the right to receive capital from the trust and in fact whether any capital has been distributed to them, whether the trust has been administered recently (or historically) for the sole benefit of that beneficiary (notwithstanding its form), the origin of the trust asset structures, the history of distributions, what evidence of patterns of distributions exist, and where the control of the trust really lies.

67 *Kennon v Spry* [2008] HCA 56 at [137] per Gummow and Hayden JJ.

68 *Ascot Investments v Harper* [1981] HCA 1.

69 [2021] FedCFamC1F 88, and *Woodcock & Woodcock (No. 2)* [2022] FedCFamC1F 173.

70 *Fay v Moramba Services Pty Ltd* [2009] NSWSC 1428 at [32]–[33].

71 *Fordyce v Ryan* [2016] QSC 307.

72 *Kennon v Spry* [2008] HCA 56 at [137] per Gummow and Hayen JJ.

73 *Lygon Nominees Pty Ltd v Commissioner of State Revenue* [2005] VSC 247.

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Tax accounting and livestock in Australia

by Lex Fullarton, CTA, Adjunct Professor, and Dale Pinto, CTA (Life), John Curtin Distinguished Professor of Taxation Law, Curtin Law School, Curtin University

This article provides a comprehensive examination of the tax accounting treatment of livestock in Australian primary production businesses. Contrary to the established practice of categorising all livestock as trading stock, the authors propose an alternative approach, advocating for the recognition of stud or breeding livestock as capital assets. Through a thorough investigation of historical legal cases, particularly *FCT v Wade*, and legislative changes such as the repeal of s 17 of the *Income Tax Assessment Act 1922*, the authors challenge the current viewpoint upheld by the ATO since 1951. They suggest practical measures for tax preparers to capitalise breeding animals, enabling them to benefit from CGT concessions. Despite potential challenges in record-keeping and expense deduction, the study emphasises the financial advantages and fairness in aligning tax treatment with the true nature of livestock in primary production businesses.

Introduction

This article is a brief synopsis of more extensive research conducted by the authors as to the tax accounting treatment of livestock in primary production businesses in Australia. The complete research findings have been published in peer-reviewed journals in New Zealand and Australia, and the papers are available on the Social Science Research Network.[1]

In this article, the authors point to an alternative treatment for accounting for livestock in Australia. Since 1936, all livestock held in a business of primary production have been accounted for as trading stock, regardless of the function they perform in that business. Therefore, even though animals might be held for their produce – milk, wool, progeny, and such like – they are included in the business' livestock trading account as though they are held for sale.

Following years of research into the tax accounting treatment of animals held in primary businesses, the authors have concluded that stud or breeding livestock can be considered as capital assets and treated accordingly in the accounts of farmers, graziers and pastoralists. Of significance to taxpayers is that this allows tax concessions provided for under the CGT provisions to be applied to individual taxpayers on the sale of their stud or breeding livestock rather than paying ordinary income tax rates on the revenue from the sale of those animals.

The authors' conclusion is that the general view held by tax practitioners and the ATO – that all animals held as part of a primary production business are trading stock regardless of the function that those animals perform in the business – is not correct. The authors found that this view, which applies only to farmers, graziers and pastoralists, deprives them of a raft of tax concessions which are granted to other business owners on the sale of their businesses and, in particular, CGT concessions granted to individual taxpayers. The authors consider this situation to be particularly unfair to primary producers who may be obliged to sell their breeding stock as a result of natural disasters or on the sale of their business as they retire from the industry.

FCT v Wade

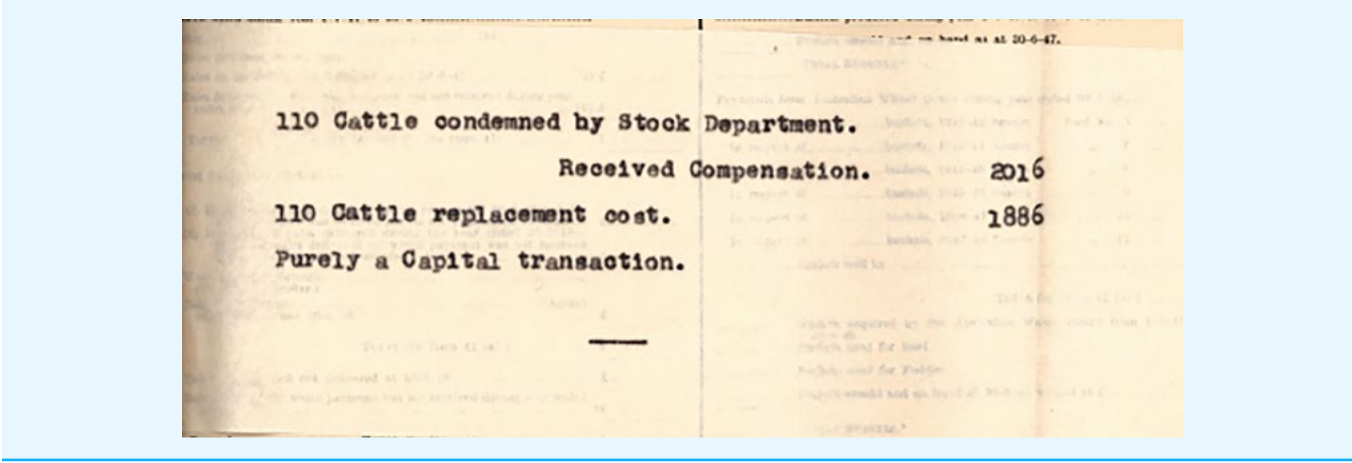
The authors' research looked at how the ATO's view was established and why it came into being. It looked at the basis on which the ATO formed its view and examined the litigation which the ATO used to support its opinion, that is, *FCT v Wade* (*Wade*).[2] They examined the background of the *Wade* case in detail, including the court documents presented in the preceding trial and administrative reviews, as well as Wade's original 1948 income tax return, and found that the accepted ATO opinion has not been challenged since it was established in 1951.

However, it appears from evidence provided to the High Court that, at least between 1936 and 1948, some tax preparers were under the honest, but mistaken, belief that, if livestock were not intended to be bred or purchased for resale, they were simply not accounted for in taxpayers' income tax returns. Evidence of that belief is demonstrated by a note pinned to Michael Wade's 1948 income tax return that came to the attention of the ATO and began a series of events that culminated in the 1951 *Wade* case (see Figure 1).

Therefore, it is fair to assume that Wade's accountant was of the belief that the dairy herd was capital. Despite that, he felt obliged to disclose the transaction to the ATO.

This article suggests that, in 1933, Wade's accountant might have been correct but he was not correct in 1948. That is beginning of this story and the research that followed to establish what happened and why it led to the ATO's view that persists to the present day. The authors suggest that, since 1985 and the introduction of CGT, given proper recording and registration systems, stud or breeding stock (or any animal held for its produce rather than for trade) may be considered as capital assets and accounted for accordingly.

Figure 1. Note pinned to Michael Wade's 1948 income tax return


110 Cattle condemned by Stock Department.
Received Compensation. 2016
110 Cattle replacement cost. 1886
Purely a Capital transaction.

To support that opinion, the authors referred to earlier litigation, specifically to the very similar case of *Robinson v FCT* (*Robinson*).[3] They found that the 1927 *Robinson* case was almost identical the 1951 *Wade* case, save that *Robinson* involved sheep and *Wade* centred on dairy cattle, but the decision in *Robinson* was exactly the opposite to that handed down in *Wade*. The authors then investigated beyond the court reports of the *Wade* case to ascertain why the outcomes between the 1927 *Robinson* case and the 1951 *Wade* case might be different.

The authors found that, in *Wade*, their Honours accepted the concept put to them by the ATO that the dairy cattle were trading stock, although Kitto J confessed that he had:[4]

> "some difficulty in accepting the view that the fact that dairy cattle, which are not trading stock according to ordinary concepts, are required by force of a definition to be taken into account under ss. 28 and 32 of the Income Tax Assessment Act 1936–1947 (Cth.) as trading stock …"

> "… the authors have concluded that stud or breeding livestock can be considered as capital assets …"

However, the *Wade* case focused on the excess of compensation over the cost of replacement of Michael Wade's herd of dairy cattle, and it was decided that the excess (£110) was assessable income according to ordinary concepts. The classification of the assets being trading stock or capital is not central to the decision. It is sufficient that the insurance recovery was greater than the cost of replacement of the herd and, for that reason, was assessable income. Therefore, it is not a basis of support for the ATO's current view.

Section 17 of the Income Tax Assessment Act 1922

The authors discovered that it was s 17 of the *Income Tax Assessment Act 1922* (Cth) that existed in 1927 which provided for an election to be made by taxpayers as to whether animals in a business of primary production were to be treated as capital assets or as revenue assets, and that s 17 had been repealed from the succeeding *Income Tax Assessment Act 1936* (Cth) (ITAA36). In 1951, it was that amendment that compelled taxpayers, and the court, to regard all animals held in a business of primary production to be revenue assets, regardless of the role they played in the business.

The authors then investigated why s 17 was repealed, and concluded that the repeal of s 17 was based on a mistake. Parliament had amended the legislation based on an incorrect interpretation of the recommendations made in the 1934 Ferguson *Royal commission on taxation*.[5]

The Royal Commission report pointed to a difficulty in separating the value of the fleece of a sheep (a revenue asset for sale) and the value of the sheep carrying it (a capital asset). It recommended that, for simplicity (to separate the two assets), s 17 be repealed. The explanatory memorandum that accompanied the Bill[6] did not explain why the section should be repealed but simply stated "for simplicity". An alternative might have been to add the words "for this section to apply, sheep must be sold off-shears (shorn)". However, that alternative was not given to parliament and s 17 was deleted from the ITAA36.

It appears that none of those involved in the matter of the *Wade* case were aware of the repeal of s 17 and the consequences thereof. It can be assumed that the intervening impact of the Great Depression and World War II led to that misunderstanding. Perhaps Wade's accountant had returned from military service, as many had done (including Sir Charles Court who returned to the accounting practice Hendry Rae and Court after service in the Dutch East Indies (Indonesia)). Nonetheless, unaware of the legislative amendment, Wade's accountant wrote the note attached to Wade's tax return to disclose the loss

of the cattle and their replacement. He assumed that the transaction was of a capital nature and, but for the note, did not include it in the 1948 income tax return.

Likewise, the assessing officer in the ATO was apparently unaware of the change in legislation as he might have pointed to that when amending the income tax return and thus the *Wade* case would never have happened. The many events that ultimately concluded at the Full Bench of the High Court might never have taken place. The modern ATO might simply point to the repeal of s 17 instead of the *Wade* case to support its view.

That might be the end of the matter – *all* livestock held in a business of primary production are intended to be considered as trading stock and the repeal of s 17, which enabled breeding stock to be considered as capital, clarifies that view. Therefore, the status quo, as generally understood by the ATO, accountants and tax preparers, remains valid.

However, the authors note that, despite the omission of the provisions of s 17, several factors have changed since 1951. Namely:

- the 1975 Asprey review[7] indicated that livestock could be considered as capital assets, rather than trading stock;
- CGT was introduced in 1985. While CGT prevents the tax avoidance activity of classifying revenue assets as capital assets, it also provides for concessions to individuals to reduce their CGT liabilities. Those concessions are the focus of the authors' research;
- self-assessment for the lodgment of income tax returns was introduced in 1986, which provides details of compliance requirements for the keeping of records to support returns lodged with the ATO. A key element of self-assessment is that, subject to those record-keeping compliance requirements, tax declarations and liabilities are assessed by the taxpayer and not the ATO. The classification of breeding stock as capital assets by the taxpayer requires detailed asset registers and transactions to be kept by the taxpayer to clearly distinguish animals held for their product from those held for the purposes of sale;
- in 2000, GST was introduced in Australia. It has implications for primary producers as exemptions exist for some food items such as meat or milk, but not on the sale of living animals;
- IAS 41[8] was originally issued in December 2000 and first applied to annual periods beginning on or after 1 January 2003. IAS 41 sets out "the accounting for agricultural activity – the transformation of biological assets (living plants and animals) into agricultural produce (harvested product of the entity's biological assets). The standard generally requires biological assets to be measured at fair value less costs to sell". This was adopted as AASB 141, effective as of 1 January 2016, but can be applied after 1 January 2014;[9]
- IAS 16[10] was reissued in December 2003 and applies to annual periods beginning on or after 1 January 2005. IAS 16 outlines the accounting treatment for most types of property, plant and equipment. Property, plant and equipment are initially measured at their cost, subsequently measured either using a cost or revaluation model, and depreciated so that the depreciable amount is allocated on a systematic basis over the useful life of the property, plant or equipment. This was adopted as AASB 116[11] on 1 January 2019, but it can be applied after 1 January 2014; and, most significantly,
- the United States IRS publication, *Farmer's tax guide*,[12] that was issued in October 2023 states that livestock "held primarily for sale must be included in inventory. Livestock held for draft, breeding, or dairy purposes can either be depreciated or included in inventory … If you are in the business of breeding and raising chinchillas, mink, foxes, or other fur-bearing animals, these animals are livestock for inventory purposes".

Conclusion

In light of the above discussion, the authors propose that, in order to benefit from the CGT tax concessions available to individual taxpayers, tax preparers in Australia should:

- adopt a depreciation schedule and rate of 25% of cost as a flat rate, or 37.5% diminishing value, for animals held for breeding or produce purposes, such as milk, wool, progeny, and such like;
- keep animal husbandry methods and detailed records to support the capital depreciation method adopted; and
- give taxpayers the option to capitalise their breeding animals should they choose to do so.

It is recognised that some primary producers may find the record-keeping and physical segregation of stock too difficult to maintain and adhere to. They may also wish for an instant expense deduction on the purchase of animals, rather than spreading the expense over four years. However, they should be aware that any revenue expense may be countered by the value of closing stock, in which case, there will be no net benefit until the animals are actually disposed of.

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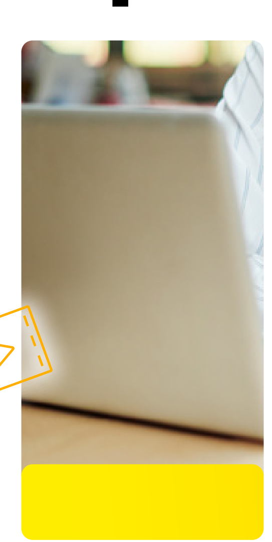
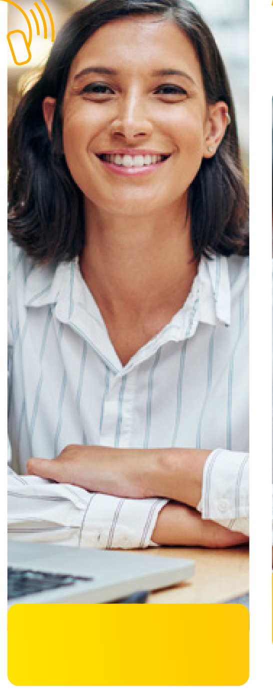
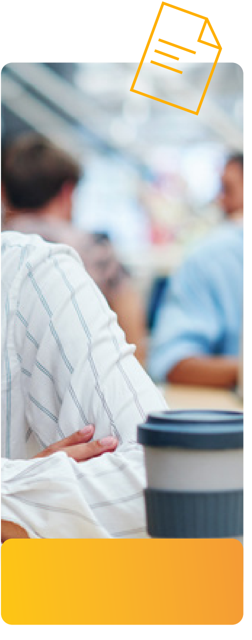

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A Matter of Trusts

by Edward Hennebry, Sladen Legal

Bare trusts, resulting trusts and dealings in land

A failure to document a trust relationship at the time of acquisition may not always be fatal.

Introduction

Typically, but not always, land is legally and beneficially owned by the person registered on the title. However, sometimes the legal owner owns the land as trustee, the terms of which are supported by a written trust deed.

In the absence of a written trust deed, your client may maintain that the land is owned pursuant to a "bare trust" and the person registered on the title is the trustee (the legal owner) holding the land on trust for a beneficiary (the beneficial owner, or owners if there is more than one beneficiary).

Where the bare trust relationship is undocumented, the client might be concerned as to whether expected dealings in respect of the land trigger undesired tax outcomes.

In particular, issues can arise when:

- the parties wish to vary the land title deed to record the beneficiary on the title (ie remove the trustee from the title);
- a party has passed away and there is uncertainty about whether the land forms part of their estate; or
- a party asserts that they qualify for the CGT main residence exemption in respect of the disposal of the land (and dwelling).

Is the absence of a written trust deed or declaration of trust at the time of purchase fatal? As discussed below, not necessarily, as objective facts can be persuasive in supporting the intentions of the parties.

What are the undesired tax outcomes?

From an income tax perspective, there may be unintended CGT exposure if a trust relationship cannot be supported, or is poorly documented, at the time the land was acquired:

- CGT event A1 may occur when the parties vary the land title deed to record the beneficiary on the title (or remove the trustee from the title). This is because there has been a change of beneficial (not merely legal) ownership;
- CGT event E5 may occur because the conduct of the parties post-acquisition has resulted in a beneficiary becoming "absolutely entitled" to the asset as against a trustee (this would not arise if a beneficiary were absolutely entitled at the time of acquisition);[1] or
- a party may incorrectly self-assess that the capital gain happens to an absolutely entitled beneficiary.

From a duty perspective, and subject to the particulars of each state and territory, complications can arise in respect of qualifying for a duty concession or exemption. For instance, the apparent purchaser/real purchaser exemption under s 34(1)(b) of the *Duties Act 2000* (Vic) has been interpreted strictly.[2]

Express and implied trusts

There are generally two recognised forms of trust in Australia: express trusts and implied trusts.

For an express trust to exist, one of the core requirements is "certainty of intention," which is typically manifested in the form of a trust deed or written declaration. This is particularly important when the trust property is land (as, for the purposes of property law, the enforceability (but not validity) of a trust over land must be in writing)).

A bare trust is a type of express trust that is generally a trust under which a trustee holds the legal title to the property and has no active duties other than to transfer the legal title of the property to a beneficiary on demand. However, sometimes clients might confuse a bare trust with a resulting trust (which have been recognised judicially as having very similar characteristics).[3]

A resulting trust is a type of implied trust that is substantially based on the intention and conduct of the parties at the time the land is purchased. It arises where a person (A) has acquired the legal title to the property, but another person (B) has contributed to the cost of acquisition of the land. In such circumstances, A is treated as holding an interest in the land on a resulting trust for B, based on B's contribution to the purchase price.

Traditionally, the existence of a resulting trust can be rebutted in two ways:

1. evidence of an actual intention to pass beneficial interest (for example, a gift); or
2. a presumption of advancement, which operates on the hypothesis that, because a certain relationship exists between two parties, a benefit provided by one party to the other at the cost of the first was intended (such as a husband purchasing a property by putting the title to the property exclusively in the wife's name).

However, the High Court in *Bosanac v FCT*[4] amplified the weaknesses in these traditional concepts and stressed that

the correct analysis should be based on objective facts.[5] Specifically:

- the presumption of advancement and the presumption of a resulting trust can always be rebutted by evidence of the actual intention of the purchaser at the time of the purchase;
- a resulting trust is an inference drawn in the absence of evidence and requires a factual inquiry on the objective facts; and
- when assessing if a resulting trust arises, the key question to ask is: "What were the parties' words or conduct *at the time of the transaction* or *immediately thereafter* as to constitute part of the transaction – the objective facts?"[6]

Using objective evidence to support a trust relationship

Based on *Bosanac*, and in the absence of an express written trust deed at the time the land was purchased, evidence concerning the intentions of the parties on, or immediately after the time of, acquisition can be used to substantiate the existence of an implied trust in respect of the land (ie that the legal and beneficial owners of the land are not the same).

The evidence could include:

- receipts and/or bank statements outlining who contributed to the purchase price, legal fees, and associated costs of acquisition (for example, stamp duty);
- correspondence between the parties and/or their solicitors; and
- correspondence between the parties and the bank in respect of mortgages.

This evidence could be collated and documented in a deed of confirmation and executed by the parties.

What about the conduct of the parties post-acquisition?

The conduct of the parties post-acquisition may also assist in supporting an argument that the legal and beneficial owners of the land are different. However, post-acquisition conduct may have limited persuasive force.

For instance, the High Court in *Calverley v Green*[7] stressed that contributions to mortgage instalment repayments post-acquisition do not inform a person's beneficial interest in the land. That is, the assessment of a person's beneficial interest in the land must be determined at the time the property was purchased, or immediately thereafter. The payment of instalments under a mortgage is not a payment of the purchase price.

Despite this, some private rulings suggest that, in certain circumstances, the ATO may take a more lenient approach to substantiating where beneficial ownership lies.

Bare trusts and absolute entitlement

It is often maintained that a beneficiary of a bare trust is "absolutely entitled" as against the trustee to the trust property.

The concept of "absolute entitlement" is not legislatively defined but is generally understood to exist when a beneficiary has an interest in a trust asset that cannot be challenged, that is, the beneficiary can demand an immediate transfer of the asset from the trustee without question.[8] However, judicial decisions have highlighted that it will only be in extremely limited circumstances that a beneficiary is absolutely entitled. This is because a beneficiary's interest could be defeated by a trustee's right of indemnity or statutory power of sale.[9]

Despite these judicial decisions, it appears that the ATO continues to rely on TR 2004/D25 (at least based on the private ruling register) to maintain that beneficiaries may be absolutely entitled in both a narrower and wider range of circumstances. With respect to a non-fungible asset such as land, the ATO view is that, if there are multiple beneficiaries, they cannot be absolutely entitled to the land even if there is a bare trust relationship.

Accordingly, given the ATO's view of absolute entitlement, caution may be needed with regard to certain trust scenarios. For instance, consider a situation where Mum and Dad agree to take out a mortgage over land and remain on the title while their child lives on the land and pays all expenses associated with the land (including the mortgage repayments on behalf of Mum and Dad).

Does CGT event E5 happen when the child has fully repaid the mortgage taken out by Mum and Dad and there is nothing left to do other than for Mum and Dad to transfer the title of the land to the child?

Can a deed of bare trust be prepared today?

In the absence of an express declaration or document recording the trust relationship at the time of acquisition, should a document be prepared today and backdated to the acquisition date? The answer is no, as this is likely to constitute a sham and be fraudulent.

The proper course of action is to execute a deed of confirmation reciting the intentions of the parties in respect of the ownership of the land. This deed should annex material that helps to objectively substantiate those intentions from that effective date (such as contemporaneous documents on or around the time the land was acquired.)

Although a deed of confirmation may only be binding between the signatories (that is, it does not bind third parties, like the Commissioner of Taxation), if the objective facts are consistent with the intentions of the parties, the deed may be persuasive.

Conclusion

Taxpayers bear the onus of proof under Australian tax law, and the CGT rules require taxpayers to retain records in order to calculate and substantiate the quantum of their capital gains and losses.

Where beneficial ownership and legal ownership of land are not the same, the absence of evidence to support a trust relationship may cause undesired tax outcomes. But this does not mean it is "game over".

Ideally, if parties intend to establish a trust relationship in respect of the ownership of land, that relationship should be documented at the time of acquisition. If it is not documented, the *Bosanac* decision highlights the importance of objective facts. If the objective facts support the contention that land is held on trust for a particular beneficiary, this will be persuasive.

If you have an impending transaction involving land and consider that the legal and beneficial ownership of the land are different, collating supporting documents to show a trust relationship is recommended if it was not documented at the time of acquisition.

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Superannuation

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

SMSF staff discount policy: do you have one?

This article examines the non-arm's length income and non-arm's length expenditure issues that can arise from the provision of staff discounts to an SMSF related to a staff member.

Advisers, including accountants, financial planners, lawyers and other service providers, should have an SMSF staff discount policy where they offer discounted services to an SMSF related to a staff member. If a discount is provided due to the staff relationship, the SMSF can be exposed to significant tax consequences. This would not bode well for the staff relationship and it is best to ensure that the risks are communicated to staff members so that they are more comfortable having to pay for any services or supplies. Indeed, it is invariably less costly for the SMSF to pay than it is to suffer non-arm's length income or non-arm's length expenditure (NALI/E).

This article provides an outline on how to manage NALI/E risks and the best method to minimise those risks by ensuring that appropriate guidelines and documentation are implemented.

Non-arm's length expenditure (NALE) can give rise to a substantial tax liability under the NALI/E provisions in s 295-550 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97). Under current law, an SMSF incurring a lower general fund expense (eg for accounting or audit services) is taxed at 45% on all of its ordinary and statutory income. Amending legislation still needs to be finalised to reduce this extremely harsh tax impact.

Relevant background to non-arm's length dealings

Broadly, if an SMSF derives more income than an arm's length transaction, the income is likely to be taxed as non-arm's length income (NALI) under s 295-550 ITAA97.

Conversely, and again, broadly speaking, if an SMSF incurs an expense that is lower than arm's length or there is no expense charged, this is likely to give rise to NALE. If an expense is NALE, the SMSF's income is taxed as NALI.

This article focuses on NALE and the tax treatment of NALI and NALE is discussed in more detail below. One point to raise now is that there is general NALE and specific NALE. This article focuses on general NALE rather than specific NALE.

Specific NALE is where an expense relates to a particular asset or income stream. Specific NALE can taint an asset for life, eg a lower expense such as in example 9 of LCR 2021/2, where Trang the plumber worked on her SMSF's rental property for free. Specific NALE in relation to the investment property in this example resulted in all of Trang's SMSF ordinary and statutory income (including a net capital gain on future disposal, even if 30 years later) less attributable expenses in relation to the second rental property being taxed as NALI at a 45% tax rate.

Why should a firm have an SMSF staff discount policy?

If an advisory firm does not have a staff discount policy that is line with the ATO's position in LCR 2021/2, this is likely to result in a NALE for any staff member's SMSF that obtains discounted services.

NALE can give rise to a substantial tax liability under the NALI/E provisions in s 295-550 ITAA97. Under current law, an SMSF incurring a general fund expense (eg for accounting or audit services) that is NALE, or a nil expense where an expense should have been incurred if the parties were dealing at arm's length, can result in a 45% tax liability, applying to the following:

- all of the fund's ordinary income;
- all of the fund's statutory income (including net capital gains and franking credits); and
- assessable contributions received by the fund.

A 45% NALI tax rate also applies even if an SMSF is in pension or retirement phase, that is, generally, there is no pension exemption to the extent that there is NALI/E. This outcome is based on the ATO's view that a lower or nil general fund expense has a sufficient nexus to all of a fund's income (including both ordinary and statutory income). Thus, it appears that a general expense has a nexus to a fund's entire activities, which may surprise many tax advisers. In contrast, as noted above, specific expenses only taint the particular asset for the entire period it is held by an SMSF.

Also, when the ATO refers to a "staff discount policy", it appears that this can relate to employees, partners, shareholders or office holders, rather than being limited to employees (as noted in para 51 of LCR 2021/2). It also appears that the discount can be limited to a particular class of these stakeholders. Thus, the drafting of the staff discount policy can be limited to, say, partners or directors if needed.

Although PCG 2020/5 previously provided some relief (ie the ATO was not applying its compliance resources to general NALE in respect of the 2018–19 to 2022–23 financial years), this transitional compliance approach

ceased on 1 July 2023. Accordingly, from 1 July 2023, it is critical that discount arrangements are revised to minimise NALI/E risks. The best form of protection is to implement an appropriate staff discount policy for each firm, which is appropriately communicated and appropriate training is provided to relevant stakeholders.

Proposed NALE changes

On 13 September 2023, the Treasury Laws Amendment (Support for Small Business and Charities and Other Measures) Bill was introduced. The Bill proposes a cap on the amount of income that will constitute NALI from a non-arm's length scheme involving a lower or nil general fund expense. This cap is in the form of a maximum cap of two times (2 x) multiple of the amount of the lower general expense for an SMSF or a small APRA fund unless the fund's actual taxable income is lower.

While this proposed change will reduce the severe impact of NALE for general SMSF expenses, these changes are still to be finalised as law. Accordingly, it is strongly recommended that firms act now to finalise their staff discount arrangements due to the substantial downside risks.

Further requirements

In accordance with the ATO guidance in para 51 of LCR 2021/2, firms seeking to implement a staff discount policy should ensure that the discount is consistent with normal commercial practice and that the same discount is applied to each eligible staff category (eg employee, director, shareholder). Additionally, as there is no express ATO guidance in LCR 2021/2 regarding staff discounts being offered in relation to non-SMSF services (eg unit trusts or companies that a staff member's SMSF may be invested in), staff discount policies should be limited to SMSF services only.

Conclusion

Firms offering discounts without a properly documented staff discount policy are exposing themselves and their staff to significant risks. We therefore recommend that an appropriately documented policy be implemented as soon as possible.

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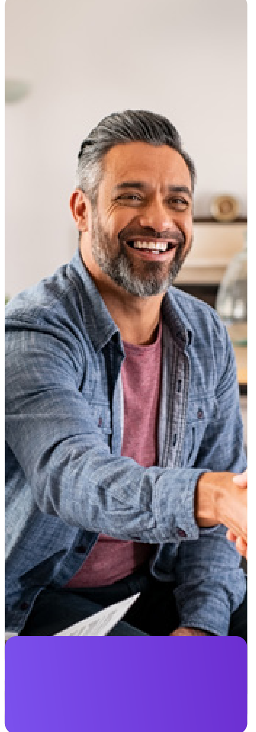

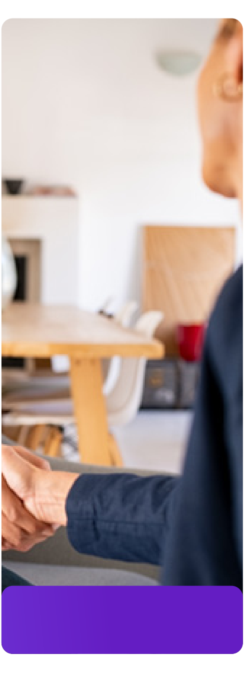

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Cumulative Index

The following cumulative index is for volume 58, issues (1) to (9). Listed below are the pages for each issue:

Vol 58(1): pages 1 to 56
Vol 58(2): pages 57 to 118
Vol 58(3): pages 119 to 168
Vol 58(4): pages 169 to 220
Vol 58(5): pages 221 to 300
Vol 58(6): pages 301 to 362
Vol 58(7): pages 363 to 406
Vol 58(8): pages 407 to 468
Vol 58(9): pages 469 to 531

15-year exemption
small business CGT concessions, impact of death ... 288–290
50% CGT discount
consolidated groups, discretionary trusts within ... 347
contracts, timing issues ... 180, 181
family home becomes investment property ... 76
sale of shares in family trust ... 22
100-point innovation test ... 238
183-day test ... 10, 192

A
Absence rule
main residence CGT exemption ... 76, 255, 261, 262, 267
Absentee owner surcharge ... 102–104
Absolute entitlement
bare trusts ... 514
Accounting
foreign trusts ... 196
labour costs, construction or creation of capital assets ... 9, 10
livestock in Australia ... 509–511
loans and gifts ... 339, 340
sale and purchase agreements ... 39, 41, 43, 44
Accounting standards
general insurance contracts ... 174
Active assets
sale, small business CGT concessions ... 21
Adjacent land
main residence CGT exemption ... 255, 256
Administrative penalties
default assessments ... 476
Advancements
resulting trusts and ... 502–504, 506
Affordable housing — see **Housing affordability**
Aggregated turnover
connected entities
– Commissioner's discretion, control ... 174, 175
– concept ... 70
Agreement
acquisition of CGT asset, timing ... 180–183
Allocation of profits
professional practices ... 33
Amended assessments
property development profits ... 178, 179
Amnesty
payroll tax, medical practices ... 304
small business lodgment penalty ... 11, 33, 34
And for no other purpose
definition ... 176, 177
Announced but unenacted measures ... 32, 302, 366
Annual property tax ... 6
Anti-avoidance rule
intangible assets ... 26–30
Archer Brothers principle ... 194
Arm's length concept
proposed OECD Two-Pillar Solution ... 472
superannuation fund ... 129–133
Army reserve transfer
early retirement scheme payment ... 373
Asprey report ... 189, 197, 511
Assessments — see also **Default assessments**
asset betterment ... 12, 13
Asset betterment assessments ... 12, 13
Asset protection
discretionary trusts ... 340, 341, 487, 488
– consolidated groups ... 345–348
– testamentary trusts ... 148, 149, 152
Assets — see also **Depreciating assets**
instant asset write-off ... 33, 174, 304
small business CGT concessions, asset sale versus share sale ... 21, 22
Associated transactions
landholder duty ... 210, 211
Associates
payments to
– low corporate tax jurisdictions ... 82, 84, 85
– R&D claims ... 438, 439
Audits
Project Wickenby ... 65
AusIndustry
R&D claims ... 435–438
Australian beneficiaries of foreign trusts
conduit foreign income ... 195
foreign income tax offset ... 200
foreign source income ... 189–201
tax rates ... 191, 192
Australian Capital Territory
non-foreign discretionary trust amendments ... 104
property taxes ... 6
Australian residents
foreign companies, central management and control ... 122
foreign source income ... 156, 157, 189–201
throwback interest ... 156, 189, 200
working overseas, residence status ... 477
Australian tax system
complexity and cost ... 60
statutory interpretation ... 172
taxation of gifts ... 443, 444
Australian Taxation Office
central management and control ... 122
digital services ... 176
dispute resolution ... 175
fraud prevention ... 175, 226
individuals, ATO focus on claims ... 37
information-gathering powers ... 125
intangible assets ... 10
interest charges, deductions denied ... 368
main residence exemption in relationship breakdown ... 479
non-arm's length capital gains ... 158–160
objections, communication protocols ... 227, 228
R&D claims ... 435–440
reimbursement agreements ... 34, 35
risk framework, worker classification ... 371
Small Business Litigation Funding Program ... 119
SMSFs, voluntary disclosure service ... 106, 107
superannuation, non-arm's length expenses ... 96, 98
superannuation death benefits ... 342
trust vesting ... 498
Australian Treasury
2023 Intergenerational Report ... 224
Modernising individual tax residency ... 125
tax adviser misconduct ... 124, 125

B
Backpacker tax ... 102
Bad debt deduction
non-receipt rule, deferred consideration ... 334
Balance sheets
sale and purchase agreements ... 40–42
Banking industry
Know Your Customer ... 492
Bankruptcy
testamentary discretionary trusts ... 152, 153
trustees ... 488, 504
Bare trusts
absolute entitlement ... 514
CGT exposure ... 513
confused with resulting trusts ... 513
undocumented ... 513
whether deed can be prepared later ... 514
BAS agents — see **Tax practitioners**
Base erosion and profit shifting
anti-abuse tax (US) ... 85
country-by-country reporting ... 474
Global Anti-Base Erosion Rules ... 472
Benchmark interest rate
Div 7A ... 57
Beneficial enjoyment of trust property ... 199
Binding death benefit nominations ... 47–49, 141–143, 148, 491, 497, 506
Bitcoin ... 61
Board of Taxation
individual tax residency rules ... 125
Review of corporate tax residency ... 122
tax consolidated groups, CGT roll-overs ... 137
Bonus deduction
SME energy incentive ... 174
Books of accounts
loans and gifts ... 339, 340
Breed stock
record-keeping ... 511
"Bright line" test ... 125
Build-to-rent projects
foreign investment application fees ... 368
Building expenditure
income characterisation ... 37
Burden of proof
default assessments ... 307, 308
foreign trusts, financial accounting ... 196
lost trust deeds ... 14–19
payment, advance or deposit ... 68, 69
trust beneficiaries, amounts received by ... 372
Burnout
self-coaching strategies ... 204–206
Business activity statements
small business lodgment amnesty ... 33, 34
Business practice case
international tax evasion ... 65, 66

C
Capacity
loss of, gifts made by attorney ... 109–111
Capital account or revenue account
labour costs, construction or creation of capital assets ... 9, 10
Capital assets
breeding stock ... 511
labour costs, creation or construction ... 8–10
Capital expense/capital nature
non-arm's length expenses ... 50
Capital gains
foreign trusts
– Australian beneficiaries of ... 156, 157, 190, 194–197
– transferor trust rules ... 192, 195–197
Capital gains tax
CGT improvement threshold ... 1
contracts, timing issues ... 180, 181
deferred consideration ... 327
– buyers ... 332
– market value substitution rule ... 332
– non-receipt rule ... 333–335
– sellers ... 331, 332
dwelling acquired by deceased estate ... 418–420
fairness fund payment, taxi industry ... 177, 178, 306
family law settlements ... 317, 318
main residence CGT exemption ... 76–79
non-arm's length income interaction ... 158–160
retiring partner ... 125, 126
vacant land ... 231
Capital gains withholding
foreign residents ... 368
Capital raisings
funded by franked distributions ... 35
Car museum
luxury car tax, quotable purpose ... 176, 177
Carrying on a business
vacant land deduction exclusion ... 232
versus working from home ... 77, 78
Cars — see **Motor vehicles**
Central management and control
ATO guidance ... 122
Centrelink pensions
default assessments ... 307, 308
CGT assets
asset sale compared with share sale ... 21, 22
owned by deceased individual ... 288, 289
CGT events
event A1 ... 43, 180, 199, 254, 265, 267, 271, 272, 332, 336, 419, 420, 479, 480, 513
event B1 ... 254, 265, 419, 479
event C1 ... 254, 262, 265, 419
event C2 ... 22, 199, 252–254, 265, 334, 419
event D1 ... 180, 479
event D2 ... 479
event D3 ... 479
event E1 ... 254, 265, 347, 419, 513
event E2 ... 254, 265, 419
event E4 ... 157
event E4 to E8 ... 199
event E5 ... 265, 419, 514
event E5 to E7 ... 252
event E6 ... 252, 253
event E7 ... 265
event F1 ... 479
event F2 ... 254, 265, 419
event H1 ... 419
event H2 ... 177, 178, 199, 306
event I1 ... 254, 265, 268, 270, 273
event I2 ... 254, 265, 268, 273
event K3 ... 250, 253, 254, 265, 419
event K4 ... 254, 265, 419
event K6 ... 195, 265, 419
event L3 ... 136, 137
CGT improvement threshold ... 1
CGT main residence exemption — see **Main residence CGT exemption**

CGT roll-overs
family law settlements ... 318
family law superannuation splits ... 349, 350
relationship breakdown
– main residence CGT exemption ... 263, 264, 267, 268, 479–482
– sale of jointly owned property ... 78
sale and purchase agreements ... 44, 45
SMEs, tax consolidation ... 135–137

"Change-of-use" duty
commercial and industrial property (Vic) ... 454

Charities
community, deductible gift recipients ... 174

Children
death benefits ... 144
definition of "child" ... 142, 145
superannuation dependants ... 142, 144
testamentary discretionary trusts ... 150, 151, 153

Clean energy
electric vehicle customs and excise duty (Vic) ... 322

Clear and convincing proof – see **Evidence**

Clothing
work-related expenses ... 37

Code of Professional Conduct ... 127, 128, 310, 368, 427–431
breach reporting measures ... 430
disqualified entities providing tax agent services ... 427–431
Minister to amend ... 431
new notification obligations ... 375–378

Commercial and industrial property
tax reform (Vic) ... 453, 454

Commercial transactions
residential property, losses on purchase and sale ... 314

Commissioner of Taxation
compliance, vacant land deductions ... 235, 236
corporate limited partnerships, "crediting" an amount ... 474
default assessments ... 383–386, 476
depreciating assets, composite items ... 227, 414, 415
discretion, connected entities ... 174, 175
electric vehicles, home charging rate ... 414
fairness fund payment, taxi industry ... 306
input tax and fuel credits, time limits ... 475, 476
international tax evasion ... 65, 66
new appointment ... 363
Project Wickenby ... 65
risk assessment, foreign incorporated companies ... 122
royalties, software and intellectual property rights ... 412–414
self-education expenses ... 474, 475
Tax Summit address ... 175, 176

Commonwealth income support payments
superannuation conditions of release ... 94

Commonwealth penalty units ... 368

Community charities
deductible gift recipients ... 174

Companies
acquisition of dwelling from, CGT relationship breakdown roll-over relief ... 481, 482
family trust elections ... 422, 423
interposed entity elections ... 423, 424

Company directors
retirement, superannuation conditions of release ... 89

Compassionate grounds
superannuation conditions of release ... 93, 94

Compliance
intangible assets ... 10
professional practices ... 33
reimbursement agreements ... 34, 35

Composite assets
depreciating assets ... 227, 414, 415

Conditions of release
superannuation
– compassionate grounds ... 93, 94
– first home super saver ... 94
– health-related ... 91–93
– preservation components ... 87
– retirement ... 88–91
– severe financial hardship ... 94
– spouse contribution splitting ... 95
– transition to retirement pension ... 93

Conduit financer arrangements
third party debt test ... 280

Conduit foreign income
received by Australian beneficiaries ... 195

Conflict transactions
gifts made by attorney ... 109–111

Connected entity
aggregated turnover ... 70
– Commissioner's discretion, control ... 174, 175
– concept of control ... 71–74
definition ... 70, 71

Consolidated entity disclosure statement ... 63

Consolidated groups
discretionary trusts ... 345–348
– CGT discount ... 347
– flexible distributions ... 346
– head company status ... 347
– income accumulation ... 346
– losses ... 347
– recommendations ... 347, 348
– subsidiary members ... 347
SMEs, CGT roll-overs ... 135–137

Constitutional validity
electric vehicle customs and excise duty (Vic) ... 320–323

Consultation
integrity provisions, design ... 410

Contractors
employee or independent contractor ... 1, 370, 371, 450–452

Contracts
timing issues ... 180–183

Contribution splitting
spouse, superannuation conditions of release ... 95

Control – see also **Central management and control**
connected entities ... 71–74

Controlled foreign company regime
intangible integrity measure ... 84
third party debt test ... 280

Copyright
software and intellectual property rights ... 413

Corporate collective investment vehicles
tax treatment ... 306, 307

Corporate limited partnerships
"crediting" an amount ... 474

Corporate tax entities
loss carry back rules ... 33, 185, 186

Corporate tax rates
low corporate tax jurisdictions ... 27, 28, 84, 85

Corporate tax residency
foreign incorporated companies ... 122
proposed amendments ... 35

Corpus of the trust estate ... 194

Cost of living tax cuts ... 412

Country-by-country reporting
public release ... 474

COVID-19 impacts
Australian musicians ... 381
maintainable earnings of businesses ... 39, 40
residential property, losses on purchase and sale ... 314

Cross-border arrangements
intangible assets ... 10
intangible integrity measure ... 82–86
software arrangements ... 412–414

Customs and excise duty
electric vehicle charge (Vic) ... 304, 320–323
zero or low emissions vehicles (Vic) ... 409

D

Death – see also **Deceased estates**
before administration ... 250, 251
foreign residents, life events test ... 267
of transferor, foreign trusts ... 196
small business CGT concessions, impact on ... 288–290

Death benefits
BDBNs ... 47–49, 141–143, 148
"fast death tax" ... 341–343
SMSFs
– beneficiaries ... 142, 143
– payments ... 141–145
– taxation ... 145
– timing of payments ... 143
– type of payment ... 143, 144
superannuation conditions of release ... 91

Death tax ... 244, 341–343

Debt
sale and purchase agreements ... 40, 41

Debt creation rules
thin capitalisation ... 274, 277, 282, 283

Debt deductions
limitation ... 282, 283

Debt forgiveness
foreign trusts ... 198, 199
non-receipt rule, deferred consideration ... 334

Deceased estates – see also **Death**
dwelling acquired by, CGT ... 418–420
foreign resident beneficiaries ... 247–249
foreign trusts ... 197
legacies ... 250, 251
life and remainder interests ... 251, 252
main residence CGT exemption ... 249, 250, 264–266
present entitlement ... 243–247
residency ... 247–249
taxation ... 243–252
testamentary discretionary trusts ... 147
trusts
– guardianship ... 489, 490
– lost deeds ... 492, 493
– SMSF trust deed ... 491

Deductibility of expenditure
ATO interest charges ... 368
car expenses, work-related ... 415
deferred consideration ... 328, 329
depreciating assets ... 227
intangible assets ... 26–30, 84, 85
litigation settlement ... 11, 12
overtime meal allowances ... 63
rental properties ... 67, 68
residential property, losses on purchase and sale ... 312–315
self-education ... 226, 474, 475
temporary full expensing ... 32
throwback interest, Australian beneficiaries ... 156, 200
travel expenses ... 64, 65
vacant land ... 231–236

Deductible gift recipient provisions
community charities ... 174
meaning of "school" ... 8

Deemed market value cost base ... 79

Default assessments
Centrelink pensions ... 307, 308
discharging onus of proof ... 383–386, 476
gambling/taxable income ... 308, 309

Deferred consideration
CGT consequences ... 327
– buyers ... 332, 335
– market value substitution rule ... 332
– non-receipt rule ... 333–335
– sellers ... 331–335
deductions ... 328, 329
earnouts distinguished ... 325–327
non-arm's length dealing ... 332, 333
ordinary income
– annuity ... 327, 328
– or employment income ... 329–331
share sales ... 325–335
TOFA rules ... 331–333
– balancing adjustment ... 332, 334
usage ... 325

Demolition
established house, vacant land deductions ... 233

main residence CGT exemption ... 262, 263

Department of Industry, Science and Resources ... 435

Dependant
definition ... 148

Depreciating assets
composite assets ... 227, 414, 415
technology investment boost ... 33
temporary full expensing ... 32

Deregistration
tax agents ... 127, 128, 310

Digital currency ... 61

Digital games tax offset ... 35, 36

Disability pensions ... 152

Disclaimers
trusts ... 500, 501, 507

Disclosure of information
consolidated entity disclosure statement ... 63
country-by-country reporting ... 474

Discount capital gain – see **50% CGT discount**

Discretionary trusts
amounts received by beneficiaries, penalties ... 372
appointment of new trustee ... 490
asset protection ... 340, 341
– consolidated groups ... 345–348
consolidated groups
– CGT discount ... 347
– flexible distributions ... 346
– head company status ... 347
– income accumulation ... 346
– losses ... 347
– recommendations ... 347, 348
– subsidiary members ... 347
deceased individuals, CGT assets owned by ... 289, 290
distributions ... 487–507
Div 7A loan issues ... 228, 229
family provision claims ... 498
family trust distribution tax ... 177
family trust elections ... 422–424
foreign surcharge provisions ... 102–104
lost trust deeds ... 14–19, 207, 208, 491–493
tax consolidated groups ... 345–348
testamentary trusts ... 147–154
trustee duties ... 388–390

Dishonesty
Code of Professional Conduct ... 376

Dispute resolution
ATO ... 175

Disputes
trusts ... 488, 492, 495, 498

Disqualified entities
Code of Professional Conduct ... 427–431
reporting obligations ... 428–430

Distribution resolutions
trust income ... 446–449

Dividend traps
consolidated groups, discretionary trusts within ... 345

Dividends
family law settlements ... 317

Division 7A
benchmark interest rate ... 57
family law settlements ... 318
loan issues ... 228, 229
loan repayments ... 34
trust reforms ... 34
unpaid present entitlements ... 34

Divorce – see also **Relationship breakdown**
foreign residents, life events test ... 267
sale of jointly owned property ... 78
testamentary discretionary trusts ... 153

Documentation
books of accounts ... 339, 340
family law superannuation splits ... 349, 350
lost trust deeds ... 14–19, 207, 208, 337–339, 492, 493
production ... 301
roll-overs, sale and purchase agreements ... 44, 45

superannuation conditions of release ... 87
– retirement ... 90, 91
– temporary incapacity ... 93
– termination of employment ... 89–91
trust beneficiaries, rights to ... 390
trust relationship, ownership of land ... 513–515

Domestic travel expenses ... 63

Domicile test
individual taxpayers ... 477

Double tax agreements
Australia–Finland ... 102
Australia–Germany ... 102
Australia–NZ ... 102
Australia–South Africa ... 102
dual tax residents ... 192
royalties, software and intellectual property rights ... 412–414
state surcharges, validity ... 102–104

Double taxation
intangible assets anti-avoidance provision ... 29

Dual tax residents
trust distributions ... 192

Due diligence
sale and purchase agreements ... 39–46

Dwellings — see also **Main residence CGT exemption; Residential property**
foreign investments, fees for established dwellings ... 368

E

Early access
superannuation benefits ... 87

Early retirement scheme payment
army reserve transfer ... 373

Early-stage innovation companies
incurred expenses ... 369, 370
investor benefits ... 238

Earnings
sale and purchase agreements ... 39, 40

Earnouts
deferred consideration distinguished ... 325–327, 329, 330
sale and purchase agreements ... 42, 43

Education — see also **Tax education**
self-education expense deductions ... 226

Electric vehicles
customs and excise duty (Vic) ... 304, 320–323, 409
electric car discount ... 36
home charging rate ... 414

Employee
definition ... 88
or independent contractor ... 1, 370, 371, 450–452

Employee bonus
assessable income ... 169

Employee declarations
FBT ... 307

Employers
FBT, electric car discount ... 36
SG contributions ... 36, 37

Employment
receipt of gain or reward ... 89
volunteering ... 88

Employment income
deferred consideration ... 329–331

Enduring power of attorney
gifts made by attorney ... 109–111

Energy incentive
SME bonus deduction ... 174
SME business boost ... 33, 63, 304

Engineering, procurement and construction contracts ... 64, 65

Enterprise value
sale and purchase agreements ... 39

Equitable life and remainder interests
deceased estates ... 251, 252

Equity value adjustments
sale and purchase agreements ... 40

Errors
GST, correcting by taxpayer ... 125

Estate planning — see **Succession and estate planning**

Ethics
increased regulation of tax profession ... 304

Evidence
car expenses, work-related ... 415
discretionary trusts ... 341
intangible assets ... 10
international tax evasion ... 65, 66
lost trust deeds ... 14–19, 207, 208, 337–339
tax agent, judicial review proceedings ... 126, 127
trust beneficiaries, amounts received by ... 372
trust relationship ... 514

Excepted trust income
minor beneficiaries ... 150, 151

Excise
definition ... 320

Executors
testamentary discretionary trusts ... 147

Expenses incurred
early-stage innovation companies ... 369, 370

Exploit
definition ... 27, 84

Express trusts ... 513, 514

F

Fairness
taxation of gifts ... 443

Fairness fund payment
taxi industry ... 177, 178, 306

Fame of an individual
use of for a fee ... 63
use of images ... 63

Family home
main residence CGT exemption ... 76

Family law
asset protection ... 340, 341
settlements, unrealised tax liabilities ... 317, 318
superannuation splits ... 349, 350
testamentary discretionary trusts ... 153, 154
trust assets ... 504–506

Family living expenses
superannuation conditions of release ... 94

Family provision claims
discretionary trusts ... 498

Family trust distribution tax ... 177, 422–424

Family trust elections ... 177, 201, 422–424

Family trusts — see **Discretionary trusts**

Farming
tax accounting, livestock ... 509–511
vacant land deduction exclusion ... 232

"Fast death tax"
superannuation ... 341–343

Federal Budget 2016–17 ... 79

Federal Budget 2017–18 ... 266

Federal Budget 2018–19 ... 231

Federal Budget 2022–23
SME business boosts ... 33

Federal Budget 2023–24
announced but unenacted measures ... 32, 302
business measures ... 32–36
Medicare amendments ... 8
non-arm's length expenses ... 50, 51
retrospectivity ... 366
superannuation ... 36, 37, 225

Federal–state taxation
vertical fiscal imbalance ... 322

Fiduciary trustee duties
lost trust deeds ... 337–339

Fifty per cent CGT discount
consolidated groups, discretionary trusts within ... 347
contracts, timing issues ... 180, 181
family home becomes investment property ... 76
sale of shares in family trust ... 22

Financial accounting
foreign trusts ... 196
labour costs, construction or creation of capital assets ... 9, 10

sale and purchase agreements ... 39, 41, 43, 44

Financial hardship
superannuation conditions of release ... 94

"Financial resource"
tax losses ... 317

Finland
Australia–Finland DTA ... 102

First home super saver scheme
superannuation conditions of release ... 94

Fixed ratio test
earnings-based method ... 274
thin capitalisation ... 274–278

Fixed trusts
superannuation funds, non-arm's length expenses ... 97, 100, 101

Fly in fly out employees
FBT, employee declarations ... 307
travel expenses ... 64, 65, 119

Food
GST
– combination of foods ... 469
– prepared meals ... 228

Foreign currency ... 61
foreign trusts ... 192

Foreign hybrid mismatch rules
intangible integrity measure ... 84

Foreign income tax
intangible integrity measure ... 84

Foreign income tax offset
Australian beneficiaries ... 200
mismatches ... 201

Foreign investments
fees
– application fee increases ... 412
– build-to-rent projects ... 368
– established dwellings ... 368

Foreign pension funds
foreign trusts ... 197

Foreign resident companies
central management and control ... 122

Foreign residents
capital gains withholding ... 368
deceased estates, beneficiaries ... 247–249
main residence CGT exemption ... 78, 79, 266–272
– disposal of dwelling acquired from deceased person ... 268
– individuals ... 267
– inheritance of dwelling from deceased Australian resident ... 272
– inheritance of dwelling from deceased foreign resident ... 271
– life events exemption ... 267, 268
– relationship breakdown ... 268, 269

Foreign source income
Australian beneficiaries, foreign trusts ... 156, 157, 189–201
employee bonus ... 169
temporary residents ... 192
voluntary disclosure ... 193

Foreign surcharge purchaser duty
NSW, validity ... 102–104

Foreign tax elections
sale and purchase agreements ... 45

Foreign trusts
Australian resident beneficiaries ... 156, 157, 189–201
– conduit foreign income ... 195
– death of transferor ... 196
– debt forgiveness ... 198, 199
– deceased estates ... 197
– family trust elections ... 201
– financial accounting, burden of proof ... 196
– foreign currency ... 192
– foreign pension funds ... 197
– in specie distributions ... 199, 200
– loans ... 199
– migration to Australia ... 196
– non-resident family trusts ... 196
– post-marital and family relief trusts ... 196
– testamentary trusts ... 197
– transferor trust rules ... 192, 195–197
– unpaid present entitlements ... 198, 199

Franked distributions
funded by capital raisings ... 35
in specie ... 368, 369

Fraud
ATO prevention ... 175, 226
international tax evasion ... 65, 66
Project Wickenby ... 65

Fraud and Criminal Behaviours Group ... 175

Freezing orders
family trust distribution tax ... 177

Fringe benefits tax
electric car discount ... 36
electric vehicles, home charging rate ... 414
employee declarations ... 307
otherwise deductible rule ... 64, 65, 119
PAYG instalments ... 307
small business lodgment amnesty ... 33

Frozen food
GST, prepared meals ... 228

Fuel tax credits
time limits ... 475, 476

Funding resolution
SMSF loan agreement ... 131

Future earnings
sale and purchase agreements ... 42, 43

G

Gainfully employed
definition ... 88

Gambling income
default assessments ... 308, 309

General class investors
thin capitalisation ... 275

General insurance
accounting standards ... 174

General interest charge ... 177

Genuine redundancy payment
army reserve transfer ... 373

Germany
Australia–Germany DTA ... 102
royalty barrier rule ... 85

Gifts
books of account ... 339, 340
classification ... 442
deductible gift recipients ... 174
– meaning of "school" ... 8
made by attorney ... 109–111
taxation ... 442–444

Global Anti-Base Erosion Rules ... 472

Global tax evasion ... 65, 66

Goods and services tax
adjustments ... 35
cars, quotable purpose ... 176, 177
errors, correcting by taxpayer ... 125
food
– combination of foods, supplies of ... 469
– prepared meals ... 228
input tax and fuel credits, time limits ... 475, 476
instalments ... 35
payment, advance or deposit ... 68, 69
sale of land, taxable supply ... 415, 416
small business entity status ... 70
technical amendments ... 125

Goodwill
CGT, retiring partner ... 126
consolidated groups ... 136

Graziers
tax accounting, livestock ... 509–511

Group ratio test
thin capitalisation ... 274, 278, 279

Guardianship
trusts ... 489, 490

H

Hardship
superannuation conditions of release ... 94

Harmonisation
property taxes ... 6

Health conditions
terminal, superannuation conditions of release ... 91, 92

Henry review ... 443

High Court of Australia
statutory interpretation by 172
High net wealth individuals
foreign trusts, Australian beneficiaries of....189–201
Holiday home
family member occupation 77
Home charging rate
electric vehicles 414
Housing affordability
foreign investment application fees.... 368
foreign residents, CGT main residence exemption.... 266
residential properties....6

I

Implied trusts.... 513, 514
In specie distributions
foreign trusts 199, 200
franking credits.... 368, 369
Incapacity
superannuation conditions of release....91–93
Income
definition in trust deeds.... 447, 448
fairness fund payment, taxi industry....177, 178, 306
fame of an individual....63
intangible assets, indirect derivation 28
Income accumulation
discretionary trusts 346
Income characterisation
building expenditure....37
Income-earning activities
self-education expenses....474, 475
Income equalisation clause
trust deeds.... 447, 448
Income inclusion rule....472
Income splitting
minors....150
Income streams
transfer balance cap
– defined benefit.... 306
– effect of 36
Income tax returns
small business lodgment amnesty 11, 33
unlodged, sale and purchase agreements....45
Incurred expenses
early-stage innovation companies....369, 370
Independent contractor
or employee....1, 370, 371, 450–452
Indictable offences
registered tax agents....376
Individuals
ATO focus 37
deceased, CGT assets owned by 288, 289
fame
– use of for a fee 63
– use of images....63
rates of tax.... 412
residency tests....10, 11, 35, 125
Industrial and commercial property
tax reform (Vic)....453, 454
Information disclosure
country-by-country reporting....474
SMSFs, voluntary disclosure.... 106, 107
Information-gathering
ATO powers....125
Information-sharing
tax practitioners.... 432
Inheritance
superannuation fund 88
Innovation
early-stage innovation company scheme....238–240
R&D claim improvement....434–**440**
Input tax credits
adjustments....35
technical amendments 125
time limits 475, 476
Insolvency
testamentary discretionary trusts....152, 153
trustees....487, 505
Inspector-General of Taxation
Small Business Litigation Funding Program 119
Instant asset write-off
small business entities 33, 174
small-to-medium businesses 304
Insurance
accounting standards 174
permanent incapacity, condition of release.... 91
Intangible assets
anti-avoidance rule.... 26–30, 82–86
associate payments, low corporate tax jurisdictions....82, 84, 85
cross-border arrangements....10
definition 27
denial of deductions....60, 84, 85
ordinary meaning 83
right to exploit.... 83, 84
"royalty" definition 83
royalty withholding tax....27, 84
Intangible-related payments
significant global entities 82–86
Integrity measures
design 410
intangible assets anti-avoidance rule....26–30, 82–86
multinational enterprises 304
reporting obligations imposed by.... 410
thin capitalisation.... 62, 63, 304
transparency....63
vacant land deductions 231–236
Intellectual property
anti-avoidance rule....27, 28
intangible integrity measure....82
"royalty" definition 83
royalty withholding tax....412–414
Interdependency relationship
definition 144, 145, 148
superannuation dependants....142, 144, 148
Interest charges
ATO deductions denied.... 368
Australian resident beneficiaries....156, 189, 200
Interest expenses
vacant land deductions 234
Intergenerational Report.... 224
International tax evasion 65, 66
International tax treaties
state surcharges, validity 102–104
Interposed entity elections
family trust elections 422–424
Investments
foreign investment application fees....368, 412
landholder duty....210, 211
SME business boosts....33
Investors
early-stage innovation company scheme....238, 240

J

James review 427, 432
JobKeeper
Australian musicians 381
expenditure on salaries 438
overpayment....309, 310
Judicial review proceedings
tax agent....126, 127

K

Know Your Customer 492

L

Labour costs
construction or creation of capital assets....8–10
Land
commercial and industrial property (Vic) 453, 454
owned by trustee....513–515
sale of land
– contracts, timing issues.... 183
– taxable supply 415, 416
vacant land deductions 231–236
Land tax surcharge
commercial and industrial property (Vic) 454
foreign discretionary trusts....102–104
Landholder duty
associated transactions 210, 211
Leases
vacant land deductions 231–236
Legacies
deceased estates....250, 251
Legal personal representative
definition 145
superannuation dependants.... 142
Legal practice
CGT, retiring partner 125, 126
Legal professional privilege
tax adviser misconduct 124
Legislation
retrospectivity 366
technical amendments 125
Letter of wishes.... 341
Life and remainder interests
deceased estates....251, 252
Life events test
foreign residents....267
Life insurance
foreign trusts 197
Limited recourse borrowing arrangements
SMSFs, nil cashing....90
Liquidation
sale of business....22
Litigation
settlement amount, deductibility 11, 12
Small Business Litigation Funding Program 119
Livestock
tax accounting....509–511
Living-away-from-home allowance
FBT, employee declarations....307
Loan agreements
SMSFs, non-arm's length income....129–133
Loan repayments
Div 7A....34
Loan scheme
upfront duty payments (Vic) 454
Loans
books of account 339, 340
definition of "loan".... 221
Div 7A issues 228, 229
foreign trusts 199, 200
Lodgment penalty amnesty
small business 11, 33, 34
Look-through earnout rights.... 41, 42
Loss carry back rules
claiming tax offset....185, 186
temporary measures....33
Loss of capacity
gifts made by attorney 109–111
Loss or outgoing
holding land.... 234
residential property, purchase and sale 312–315
Lost trust deeds 14–19, 207, 208, 337–339, 492, 493
Low corporate tax jurisdiction
definition 27, 28, 84
intangible assets.... 26–30, 82, 84, 85
Low-income threshold
Medicare amendments....8
Lump sum death benefits
payments.... 143
taxation 144
Luxury car tax
car museum, quotable purpose.... 176, 177

M

Main residence CGT exemption
absence rule.... 76, 255, 261, 262, 267
adjacent land....255, 256
building separate to the land 257
deceased estates....249, 250, 264–266, 418–420
demolition 262, 263
family home becomes investment property....76
family law settlements.... 318
foreign residents.... 78, 79, 266–272
– disposal of dwelling acquired from deceased person.... 268
– individuals....267
– inheritance of dwelling from deceased Australian resident 272
– inheritance of dwelling from deceased foreign resident 271
– life events exemption 267, 268
– relationship breakdown....268, 269
owning two or more dwellings.... 257, 258
relationship breakdown
– CGT roll-overs 263, 264, 267, 268, 479–482
– foreign residents 268, 269
– sale of jointly owned property.... 78
requirements....254, 255
special disability trusts.... 266
tax concessions.... 76–79
two buildings on the land 256, 257
using dwelling to derive income....258–262
– deceased estates 264, 265
working from home versus carrying on a business.... 77, 78
Maintainable earnings
sale and purchase agreements....39, 40
Market value
SMEs, CGT roll-overs.... 135, 136
Market value substitution rule....129, 137
CGT, deferred consideration.... 332
Marriage breakdown — see **Relationship breakdown**
Maximum net asset value test 21, 22
Meal allowances
expenses, reasonable amounts 63
Medical conditions
terminal, superannuation conditions of release....91, 92
Medical practices
payroll tax changes....304, 409
Medicare levy.... 8, 412
Member Spotlight
Kylie Thompson.... 381
Max Hendriks 485
Mental incapacity
gifts made by attorney 109–111
Mergers
superannuation funds 306
Mergers and acquisitions
sale and purchase agreements....39–46
Mid-year economic and fiscal outlook, 2023–24.... 368
Mindfulness
self-coaching....204–206
Minors
testamentary discretionary trusts....150–152
Mirror taxes....320, 322, 323
Misconduct
tax advisers 124, 125
tax agents 368
tax practitioners.... 428
Motor vehicles
car expenses, ATO focus on claims 37
cents per kilometre rate, work-related expenses 37
electric vehicles
– customs and excise duty (Vic).... 304, 320–323
– electric car discount.... 36
– home charging rate 414
quotable purpose.... 176, 177
work-related expenses
– deductibility 415
Multinational enterprises
country-by-country reporting, public release....474
OECD Two-Pillar Solution....472
reallocation of taxing rights for MNE groups....472
tax integrity measures.... 304
thin capitalisation rules 274–283, 304
Multinational Tax Integrity Package 366
Museums
cars, quotable purpose.... 176, 177
Musicians
JobKeeper payments.... 381

N

Net cash/debt adjustment
sale and purchase agreements.... 40, 41
Net income
definition 447

Netherlands
royalty withholding tax........................85
New South Wales
annual property tax..................................6
non-foreign discretionary trust amendments..104
surcharge purchaser duty, validity..102–104
New Zealand
Australia–NZ DTA................................102
Non-arm's length arrangements
deferred consideration............332, 333
SMSF property development profits..64, 101
Non-arm's length expenses
SMSFs
– amendments................................304
– pending changes...............392–394
– staff discount policies.........516, 517
superannuation funds
– amendments............................96, 97
– fixed trusts......................97, 100, 101
– general fund expenses..........98, 99
– in specie contribution value........98
– non-fixed trusts..............................97
– private companies.........97, 100, 101
– proposed changes............50, 51, 60
– services provided in capacity of trustee.................................99, 100
– specific assets..........................97, 98
Non-arm's length income provisions
CGT interaction............................158–160
staff discount policies, SMSFs...516, 517
superannuation......... 37, 50, 51, 96–101, 129–133, 224
Non-receipt rule
CGT, deferred consideration....333–335
Non-resident companies
central management and control....122
Non-resident trusts — see **Foreign trusts**
Non-residents — see **Foreign residents**

O
Objections
ATO communication protocols..................................... 227, 228
OECD
base erosion and profit shifting.......472
base erosion and profit shifting project...474
earnings-based best practice model..62
Pillar One...60, 472
Pillar Two......60, 84–86, 304, 366, 472
Transfer Pricing Guidelines...............472
Offences
indictable...376
Offshore estates
testamentary trusts..............................197
Offshore receipts in respect of intangible property rule (UK).............85
Onus of proof
default assessments................307, 308, 383–386, 476
Ordinary concepts test
residence status, individual taxpayers...477
Ordinary family or commercial dealings...35, 201
Ordinary income
fame of an individual.............................63
gifts constituting........................442, 443
Otherwise deductible rule
FBT, FIFO employees.... 64, 65, 119, 307
Overdue tax returns
small business lodgment amnesty......11
Overseas R&D activities.............436, 437
Overseas travel expenses......................63
Overtime meal allowances
expenses, reasonable amounts..........63
Ownership interest
deceased estates........................418–420
dwelling, CGT relationship breakdown roll-over relief..... 479–482

P
Partnerships
CGT, retiring partner..................125, 126
corporate limited partnerships, "crediting" an amount......................474
Pasturalists
tax accounting, livestock..........509–511
Patent box regimes
intangible integrity measure...................................82, 84, 85
Payday superannuation..................36, 37, 224, 304
PAYG instalments.....................................35
FBT..307
PAYG withholding
employee or independent contractor...............370, 371, 450–452
Payroll tax
medical practices.......................304, 409
Penalties
Commonwealth penalty unit increase... 368
default assessments............................476
disqualified entities, reporting........430
family law superannuation splits....350
small business lodgment amnesty.....................................11, 33, 34
tax adviser misconduct......................124
tax promoter penalty laws........124, 225, 304, 306, 409, 410
trust beneficiaries, recklessness......372
unregistered tax agents............371, 372
Pensions
death benefit payments............143–145
foreign trusts...197
transition to retirement........................93
Permanent incapacity
superannuation conditions of release...91
Permanent retirement
superannuation conditions of release.. 89, 90
Personal services income
fame of an individual.............................63
Policy
collaborative development..................60
Post-marital and family relief trusts..196
Prepared food
GST.. 228
Present entitlement
deceased estates....................... 243–247
trust income, resident beneficiaries... 198
Preservation age
superannuation.......................................88
transition to retirement pension........93
Preserved benefits
superannuation, components............. 87
Primary production
tax accounting, livestock..........509–511
vacant land deduction exclusion..... 232
Private companies
dividends, family law settlements....317
superannuation funds, non-arm's length expenses...................97, 100, 101
Probate of wills...147
Productivity
self-coaching...............................204–206
Professional practices
allocation of profits................................33
increased regulation...........................304
legal practice, retiring partner..125, 126
Project Wickenby.......................................65
Promoter penalty laws......124, 225, 304, 306, 409, 410, 428, 432
Property — see also **Residential property**
commercial and industrial, tax reform (Vic)...............................453, 454
definition...............................150, 152, 153
Property development
assessable income........................178, 179
profits diverted to SMSFs............64, 101
Property investments
build-to-rent projects, lower fees... 368
transfer duty.................................210, 211
Property taxes
harmonisation..6
Protective trusts
testamentary discretionary trusts...151, 152
Proximity
trust beneficiaries................................497
Public interest
unregistered tax agent..............371, 372
Public interest register
Tax Practitioners Board.................... 429
PwC
measures........ 225, 226, 368, 375, 377
tax leaks.. 124

Q
Qualified domestic minimum top-up tax...472
intangible integrity measure..............84
Queensland
non-foreign discretionary trust amendments..104
Quotable purpose
definition...176

R
Rates of tax
family trust distribution tax....422–424
foreign trusts, Australian beneficiaries.......................191, 192, 200
individuals... 412
lump sum death benefits................... 144
minor beneficiaries of trusts.....150, 151
pension benefits.................................. 145
R&D activities
claims, improvement................434–440
tax incentives..369
Record-keeping
breeding stock.. 511
FBT... 61
loans and gifts............................339, 340
lost trust deeds............14–19, 207, 208, 337–339
R&D claims........................434–**436, 440**
trust beneficiaries, amounts received by..372
trusts...488, 489
Redundancy
army reserve transfer..........................373
Reforms — see also **Tax reforms**
fraud prevention......................... 175, 226
minor beneficiaries of trusts, concessions...................................150, 151
tax adviser misconduct.............124, 125
Tax Practitioners Board.................... 226
taxation of gifts..........................443, 444
trust issues...34
Refunds
surcharge duty/land tax...........102, 103
Reimbursement agreements
ATO guidance................................... 34, 35
being a party to.................................... 221
share buy-back.................................66, 67
trusts.................................... 501, 502, 506
Reimbursements
or receipt of gain, whether employment...89
Relationship breakdown — see also **Divorce**
family law settlements................317, 318
family law superannuation splits...349, 350
main residence CGT exemption....... 263
– CGT roll-overs.......... 263, 264, 267, 268, 479–482
– foreign residents............... 268, 269
sale of jointly owned property........... 78
testamentary discretionary trusts...153, 154
Release authority
withdrawal of superannuation funds, tax liability............................ 286
Rental properties
absence rule...76
ATO focus on rental income claims....37
deductibility of expenses..............67, 68
family home becomes investment property...76
later used as home..................................77
Reporting obligations
country-by-country reporting....................................... 60, 474
disqualified entities..................428–430
gifts.. 444
integrity provisions imposing........... 410
tax practitioners......................... 427–432
transparency...63
Research and development — see **R&D**
Residency
deceased estates........................ 247–249
individual taxpayers............................477
Residency assumption
foreign source income...............189, 195
Residency tests
foreign companies................................ 122
individuals............................10, 11, 35, 125
Resident
definition.. 122
Resident beneficiaries
conduit foreign income...................... 195
foreign source income.........................156, 157, 189–201
present entitlement to trust income... 198
tax rates... 192, 193
Residential property
foreign investment fee increases.... 412
housing affordability................................6
losses on purchase and sale, allowable deduction..................312–315
main residence CGT exemption.. 76–79
Residential vacant land
whether deductible............................ 233
Restricted non-preserved benefits
superannuation...................................... 87
Resulting trusts
advancements and..........502–504, 506
bare trusts confused with.................. 513
Retirement
army reserve transfer.........................373
CGT, retiring partner..................125, 126
definition..88
superannuation conditions of release.. 88–91
transition to retirement pension........93
Retrospectivity
medical practices, payroll tax.......... 304
proposed measures............................ 304
thin capitalisation................................ 366
uncertainty caused by....................... 366
Reversionary pensions
death benefit payments............143, 144
Reward or receipt of gain
whether employment............................89
Risk assessment
foreign incorporated companies......122
professional practice profits...............33
reimbursement agreements........ 34, 35
sale and purchase of business...........43
Roll-overs
sale and purchase agreements.....................................44, 45
Royal commission on taxation...........510
Royalties
intangible integrity measure..............83
software and intellectual property rights...412–414
Royalty withholding tax....................................27, 29, 82, 84, 85

S
Sale and purchase agreements
completion... 41, 42
earnouts... 42, 43
enterprise value.......................................39
equity value adjustment.......................40
financial accounting..............................39
foreign tax elections..............................45
locked box mechanism.........................42
maintainable earnings.................. 39, 40
net cash/debt adjustment............ 40, 41
roll-overs, documenting............... 44, 45
tax warranties.................................. 43, 44
unlodged returns.....................................45
value assignment............................ 41, 42
working capital................................ 40–42
Sale of business
sale and purchase agreements....39–46
small business CGT concessions......................................21, 22
Sale of land
contracts, timing issues..................... 183
taxable supply..............................415, 416
Scheme
definition.. 131
School
meaning...8

Scrip-for-scrip roll-overs
sale and purchase agreements.....44, 45
SMEs, tax consolidation............135, 136
Secrecy provisions
need for reform............................124, 125
Self-assessment
individuals, residency tests.............10, 11
Self-coaching
time management and productivity...............................204–206
Self-dealing
trustee duties to not engage in... 389, 390
Self-education
expense deductions..................... 37, 226
Self-education expenses
deductibility..................................474, 475
Self-employed
definition 88
Self-managed superannuation funds
BDBNs 47–49, 148, 491, 497, 506
conditions of release
– compassionate grounds.........93, 94
– first home super saver 94
– health-related............................91–93
– preservation components........... 87
– retirement.................................. 88–91
– severe financial hardship 94
– spouse contribution splitting......95
– transition to retirement pension 93
death benefit payments.............141–145
family law, splitting notices 349, 350
“fast death tax”...........................341–343
inheritance of fund.................................88
limited recourse borrowing arrangements 90
non-arm’s length expenses
– amendment 304
– pending changes 392–394
non-arm’s length income, loans...129–133
preservation components 87
property development profits diverted to 64, 101
property investments, transfer duty 210, 211
staff discount policies..................516, 517
voluntary disclosure to ATO...... 106, 107
Senate Economics Legislation Committee.....................................392, 428
Separation
foreign residents, life events test....267
Settlement proceedings
deductibility of expenditure............11, 12
Share buy-back
reimbursement agreements.........66, 67
Share sale agreements
deferred consideration............325–335
Shareholders
control, connected entities........... 71–74
Shares
small business CGT concessions
– share sale compared with asset sale 21, 22
– shares owned by deceased....... 289
Shortfall interest charge........................177
Significant global entities
intangible assets anti-avoidance rule.......................................26–30, 82–86
Single entity rule...........................136, 346
Skills and training boost.........................33
Small business
disposal via asset sale or share sale 21, 22
energy incentive...........33, 63, 174, 304
Federal Budget 2023–24 measures..32, 33
instant asset write-off 33, 174, 304
lodgment penalty amnesty.....11, 33, 34
pooling rules..33
skills and training boost.................33, 62
Small Business Litigation Funding Program 119
tax debt...175
technology investment boost 33, 62
temporary full expensing......................32
Small business CGT concessions
asset sale compared with share sale 21, 22
connected entities 70
death
– 15-year exemption............288–290
– deceased individuals, CGT assets owned by 288, 289
– impact on 288–290
– shares owned by deceased....... 289
family law settlements........................ 318
scrip-for-scrip roll-overs.............. 44, 45
Small business entities
aggregated turnover 70
tax concessions.......................................70
Small Business Litigation Funding Program... 119
Small-to-medium businesses
energy incentive...........33, 63, 174, 304
instant asset write-off 304
tax consolidation, CGT roll-overs...................................... 135–137
Software arrangements
character of payments........................ 413
intellectual property rights, royalties..412–414
Sole or primary use test...................... 453
South Africa
Australia–South Africa DTA................102
South Australia
non-foreign discretionary trust amendments 104
stamp duty...6
Special disability trusts.........................152
Specific entitlement
capital gains and franked distributions 447
Spouses
BDBNs 47–49
CGT relationship breakdown roll-over relief.......................... 479, 480
superannuation contribution splitting..95
superannuation dependants............. 142
Staff discount policies
SMSFs...516, 517
Stamp duty
commercial and industrial property (Vic) 453, 454
harmonisation...6
South Australia...6
Start-ups
early-stage innovation company scheme..238–240
Statutory interpretation
by High Court of Australia..................172
intangible assets anti-avoidance rule.. 26–30
Streaming rules
capital gains and franked distributions 447
deceased estates................................ 243
Structure in use or available for use
vacant land deductions 233
Student accommodation
commercial property (Vic) 453
Subject to tax rule..................................472
Substantial and permanent structure
vacant land deductions 233
Succession and estate planning
BDBNs 47–49, 141–143, 148
books of accounts 339, 340
“fast death tax”...........................341–343
gifts 339, 340
gifts made by attorney 109–111
inheritance of superannuation fund 88
loans.. 339, 340
lost trust deeds 337–339
testamentary discretionary trusts... 147–154
trusts.....................................488, 497, 500
Superannuation
balances above $3m, new 15% levy 225, 285–287
BDBNs, death benefits 47–49, 141–143, 148
certainty for superannuants............ 224
complexity and cost of system..........60
concessions, amendments 225
conditions of release
– compassionate grounds........93, 94
– first home super saver 94
– health-related............................91–93
– preservation components........... 87
– retirement.................................. 88–91
– severe financial hardship 94
– spouse contribution splitting......95
– transition to retirement pension 93
employee or independent contractor 1, 370, 371, 450–452
family law, splitting notices 349, 350
“fast death tax”...........................341–343
inheritance of fund.................................88
non-arm’s length income rules 37, 50, 51, 96–101, 129–133
payday superannuation.................36, 37, 224, 304
proposals for change.......................... 224
SG contribution shortfall 36
transfer balance cap
– defined benefit income streams.. 306
– effect on income streams 36
Superannuation benefits
documentation 87
early access.. 87
Superannuation death benefits
BDBNs 47–49, 141–143, 148
“fast death tax”...........................341–343
payments...141–145
taxation 144
Superannuation dependant
definition 144
Superannuation earnings........... 285–287
Superannuation guarantee shortfall...36
Superannuation trustee
services provided to fund, non-arm’s length expenses.......99, 100
Surcharge purchaser duty
NSW, validity 102–104
Switch-over rule......................................472

T

Tasmania
non-foreign discretionary trust amendments 104
Tax Academy..................................302, 303
Tax accounting – see **Accounting**
Tax advisers
misconduct 124, 125
Tax agents
Code of Professional Conduct, significant breaches of........... 376, 377
deregistration 127, 128, 310
judicial review proceedings 126, 127
misconduct 368
new notification obligations 375–378
not fit and proper person 310
unregistered entity.....................371, 372
Tax avoidance
promoter penalty laws.................124, 225, 304, 306, 409
Tax Avoidance Taskforce.......................175
Tax concessions – see also **Small business CGT concessions**
main residence CGT exemption.....76–79
small business entities 70
superannuation 225
Tax consolidation
consolidated groups, discretionary trusts within 345–348
SMEs, CGT roll-overs.................. 135–137
Tax credits
input tax and fuel, time limits 475, 476
Tax cuts
cost of living... 412
Tax debts
freezing orders issued..........................177
Tax education
CommLaw2 Dux Award, study period 3, 2022
– Chris Green 139
Corporate Tax Dux Award, study period 1, 2023
– Vincent Oldani..............................425
Corporate Tax Dux Award, study period 3, 2022
– Tanim Islam 24
CTA1 Foundations Dux Award, study period 2, 2023
– Daksh Aggarwal............................379
CTA2A Advanced Dux Award, study period 3, 2022
– Bryan Hartanto 81
CTA3 Advisory Dux Award, 2023
– Mitchell Bird................................... 241
Graduate Certificate in Applied Tax Law 25
Graduate Diploma of Applied Tax Law 25, 139
Tax Academy...............................302, 303
Tax for Trusts Dux Award, study period 1, 2023
– Yuxi Dedic...187
Tax for Trusts Dux Award, study period 2, 2023
– Marianne Dakhoul....................... 483
Tax exploitation schemes 124, 225, 304
Tax incentives
R&D activities 369, 434, 435
Tax Knowledge Exchange database... 303
Tax liabilities
increases and reductions.................. 366
unrealised, family law settlements...................................317, 318
Tax losses
“financial resource”..............................317
Tax offsets
digital games.....................................35, 36
foreign income
– Australian beneficiaries 200
– mismatches 201
loss carry back rules...................185, 186
R&D tax incentives...............................369
Tax practitioners
advising individuals.................................37
Code of Professional Conduct... 427–431
Federal Budget 2023–24 measures...32, 33
reporting obligations................ 427–432
Tax Practitioners Board
appointments...............................428, 431
deregistration of tax agent.....................................127, 128, 310
independence 427
James review 427
judicial review proceedings 126, 127
new notification obligations 375–378
operational changes 432
powers 432
public interest register...................... 429
reforms.. 226
sanctions regime 368
tax adviser misconduct 124, 125
unregistered entity.....................371, 372
Tax rates – see **Rates of tax**
Tax reform
commercial and industrial property (Vic) 453, 454
Tax reforms – see also **Reforms**
short consultations............................. 304
thin capitalisation........................... 60, 62
transparency 63
Tax returns
GST, taxpayers correcting errors..... 125
small business lodgment amnesty......11
unlodged, sale and purchase agreements..45
Tax risk – see **Risk assessment**
Tax sharing agreements
consolidated groups, discretionary trusts within 345, 346
Tax thresholds 412
Tax warranties
sale and purchase agreements..................................... 43, 44
Taxable superannuation earnings
new 15% tax.............225, 285–287, 304
Taxable supply
sale of land.....................................415, 416
Taxation of financial arrangements
deferred consideration.............331–333
Taxi industry
fairness fund payment.......177, 178, 306
Taxpayer liabilities
increases and reductions.................. 366
Technology investment boost..............33
Temporary full expensing measure.....32

Temporary incapacity
superannuation conditions of release...92, 93
Temporary residents
foreign source income...192
Terminal medical condition
life events test...267
superannuation conditions of release...91, 92
Termination of employment
documentation...90, 91
retirement...89
Testamentary discretionary trusts
benefits...147
commencement...149, 150
family law disputes...153, 154
insolvency...151–153
minors...150, 151
protective trusts...151, 152
wills...147–149
Testamentary trusts
offshore estates...197
The Tax Institute
Annual General Meeting...222
CPD events...5, 303, 470, 471
goal setting...171
Local Tax Clubs...170
member involvement...408
membership benefits...471
membership renewal...5, 471
Scott Treatt, CEO...222, 223
shaping the tax system...409
Tax Knowledge Exchange database...303
Tax Policy & Advocacy team...432
The Tax Summit 2023...4, 120, 121
– Commissioner's address...175, 176
volunteering...5, 471
Thin capitalisation rules
debt creation rules...274, 277, 282, 283
debt deductions, limitation...282, 283
fixed ratio test...275–278
general class investors...275
group ratio test...278, 279
multinational enterprises...274–283, 304
retrospectivity...366
third party debt test...274, 279, 280
transfer pricing...280–282
Third party debt test
thin capitalisation...274, 279, 280
Throwback interest
Australian resident beneficiaries...156, 189, 200
Time management
self-coaching strategies...204–206
Timing issues
absence rule...262
contracts...180–183
death benefit payments...143
Div 7A loan repayments...34
fuel tax credits...475, 476
input tax credits...475, 476
sale and purchase agreements, completion...41, 42
superannuation benefits, access...90
superannuation guarantee contributions...36
temporary full expensing measure...32
Total superannuation balance
above $3m, new 15% levy...225, 285–287, 304
Trading stock
cars, quotable purpose...176, 177
goods taken from...363
livestock, tax accounting...509–511
property development profits...178, 179
Transfer balance account
transition to retirement pension...93
Transfer balance cap
defined benefit income streams...306
effect on income streams...36
Transfer duty
commercial and industrial property (Vic)...453, 454
Transfer pricing
proposed OECD Two-Pillar Solution...472
thin capitalisation changes...280–282
Transferor trust rules...192, 195–197
Transition to retirement pension
superannuation conditions of release...93
Transitional compliance approach
fame of an individual...63
Transparency
proposed reforms...63
Travel expenses
FBT, FIFO employees...64, 65, 119
reasonable amounts...63
Treaties — see **Double tax agreements**
Trust beneficiaries
Australian, resident and non-resident trusts...189–201
distribution resolutions...446–449
lost trust deeds...337–339
penalties, recklessness...372
proximity...497
rights to documents...390
Trust deeds
absence of...513–515
administrative provisions...489–492
definition of "income"...447, 448
distribution resolutions...446–449
lost...14–19, 207, 208, 337–339, 492, 493
scope of trustee powers...490
Trust disclaimers...500, 501, 507
Trust distributions
discretionary trusts...487–507
Trust estate
amount of property of...190
beneficiary of...191
corpus, ordinary meaning...194
definition...190, 191
income of...446
Trust income
Australian beneficiaries, foreign source income...156, 157, 189–201
distribution resolutions...446–449
present entitlement to...67, 447
taxation regime...446, 447
Trust property
beneficial enjoyment...199
Trust vesting
ATO position...498
Trustee duties
acting in best interests of beneficiaries...389
beneficiary rights to trust documents...390
knowing terms of trust deed...492, 493
no conflict rule...388, 389
self-dealing, rule against...389
Trustees
appointment of new trustee...490
bankruptcy and insolvency...487, 488, 504, 505
BDBNs...47–49
discretion, exercise of...493–497
lost trust deeds, consequences for...207, 208, 337–339, 492, 493
record-keeping...488, 489
services provided to superannuation fund...99, 100
testamentary discretionary trusts...147
Trusts
acquisition of dwelling from, CGT relationship breakdown roll-over relief...481, 482
asset protection benefits...487, 488
disclaimers...500, 501, 507
disputes...488, 492, 495, 498
Div 7A reforms...34
estate planning...497, 500
express and implied trusts...513, 514
guardianship...489, 490
reimbursement agreements...34, 35, 501, 502, 506
resulting trusts...502–504
taxation benefits...487
vesting...498

U
Undertaxed payment rule...472
United Kingdom
offshore receipts in respect of intangible property rule...85
United States
base erosion anti-abuse tax...85
Unpaid present entitlements
Div 7A loan issues...34, 228, 229
foreign trusts...198, 199
Unrealised tax liabilities
family law settlements...317, 318
Unrestricted non-preserved benefits
superannuation...87

V
Vacancy fees
foreign investment increases...412
Vacant land
deductions...231–236
whether adjacent land...256
Value of businesses
sale and purchase agreements...39–46
Vertical fiscal imbalance...322
Vesting
trusts...498
Victoria
annual property tax...6
commercial and industrial property...453, 454
electric vehicle customs and excise duty...304, 320–323
fairness fund payment, taxi industry...177, 178, 306
foreign surcharge purchaser duty...103, 104
Voluntary disclosure
foreign source income...193
Voluntary disclosure of information
SMSFs...106, 107
Volunteering
whether employed...88

W
Wealthy individuals
foreign trusts, Australian beneficiaries of...189–201
Weekender
family member occupation...77
Wellness...58
Western Australia
non-foreign discretionary trust amendments...104
Whistleblower reforms...226, 430, 432
Wills
deceased estates, taxation...243
definition of "income"...243, 244
dwelling acquisition rule, CGT...418–420
protective trusts...151, 152
superannuation death benefits...141
testamentary discretionary trusts...147–149
Withholding tax
foreign residents...368
royalties...27, 29, 82, 84, 85
– software and intellectual property rights...412–414
superannuation death benefits...144
Work-related expenses
ATO focus on claims...37
motor vehicles
– cents per kilometre rate...37
– deductibility...415
– electric vehicles, home charging rate...414
self-education...37, 226, 474, 475
Working capital
sale and purchase agreements...40–42
Working from home
versus carrying on a business...77, 78
work-related expenses...37
Work-life balance...58

Z
Zero or low emissions vehicles
customs and excise duty (Vic)...320–323, 409
electric car discount...36

Legislation

A New Tax System (Goods and Services Tax) Act 1999...62, 125, 416
Div 99...57, 68
Div 129...35
s 11-25...476
s 11-30...476
s 13-10(b)...228
s 29-10(1)...476
s 29-10(2)...476
s 29-40...75
s 38-2...228
s 38-3(1)(c)...228, 469
s 129-20(1)...38
s 195-1...416
Sch 1...228, 469
A New Tax System (Goods and Services Tax) Regulations 2019...62
A New Tax System (Luxury Car Tax) Act 1999...125
s 9-5(1)...176
A New Tax System (Wine Equalisation Tax) Act 1999...125
Acts Interpretation Act 1901
Pt 5...172
s 15AA...172
s 15AB...378
s 37...378
Administration and Probate Act 1919 (SA)
s 69...491
Administrative Appeals Tribunal Act 1975
s 43...385
Administrative Decisions (Judicial Review) Act 1977...126
Anti-Money Laundering and Counter-Terrorism Financing Act 2006...343
Bankruptcy Act 1966
s 5...152
s 58...152
s 116...152, 488
s 116(2)...507
s 116(2)(a)...152
Civil Aviation Act 1988
s 30DE(2)...378
Commonwealth of Australia Constitution Act
s 51(ii)...324
s 90...320–323
s 99...324
s 114...321
Commonwealth Places (Mirror Taxes) Bill 1998...322, 324
Commonwealth Places Windfall Tax (Collection) Act 1998...324
Commonwealth Places Windfall Tax (Imposition) Act 1998...324
Controlled Substances Act 1984 (SA)
s 32(1)(b)...376
Conveyancing Act 1919 (NSW)
s 54A...183
Coronavirus Economic Response Package (Payments and Benefits) Act 2020
s 9(1)...309
s 9(2)...309
s 9(4)...309
Corporations Act 2001...99, 339, 431
Ch 2M...63
s 197...390
s 254T...348
s 708(8)...210
s 1305...372
s 1322(4)...507
Crimes Act 1914
s 4G...376
Defence Act 1903
s 58B...373
Disability Services Act 1986
s 8(1)...144
Duties Act 1997 (NSW)...104
s 104JA(1)...149
Duties Act 2000 (Vic)...103
s 3...210
s 3(1)...211
s 34(1)(b)...513
s 44...318
s 77...210
s 78(1)(a)(ii)(C)...210
Duties Act 2001 (Qld)...104
Duties Act 2001 (Tas)...104
Duties Act 2008 (WA)...104
Evidence Act 1995
s 128...127
Evidence Act 1995 (NSW)...207
s 140...208
s 140(1)...17

Evidence Act 2008 (Vic) ... 207
s 140 ... 15, 208
s 140(1) ... 15
Fair Work Act 2009 ... 450
Fair Work Legislation Amendment (Closing Loopholes No. 2) Act 2024
s 15AA(1) ... 450
Family Law Act 1975 ... 142, 144, 148, 153, 504
s 4 ... 505, 508
s 75(2) ... 153, 317
s 79 ... 153, 505
s 79(1) ... 508
s 87 ... 479
Family Law (Superannuation) Regulations 2001 ... 349
Financial Sector (Collection of Data) Act 2001 ... 275
Financial Transaction Reports Act 1988 ... 343
Foreign Acquisitions and Takeovers Fees Imposition Act 2015 ... 412
Foreign Acquisitions and Takeovers Fees Imposition Amendment Bill 2024 ... 412
Sch 1 ... 412
Sch 2 ... 412
Franchise Fees Windfall Tax (Collection) Act 1997 ... 322, 324
Franchise Fees Windfall Tax (Imposition) Act 1997 ... 322, 324
Fringe Benefits Tax Assessment Act 1986 ... 62
s 31(2) ... 307
s 31A ... 307
s 31E ... 307
s 52 ... 64
s 58GA ... 75
Fuel Tax Act 2006 ... 475
Subdiv 41-A ... 476
Subdiv 42-A ... 476
s 43-5 ... 476
s 65-5(1) ... 476
s 65-5(2) ... 476
s 65-5(3) ... 476
Income Tax Assessment (1936 Act) Regulations 2015 ... 436
reg 14 ... 441
reg 17 ... 202, 203
Income Tax Assessment (1997 Act) Regulations 2021 ... 276
reg 995-1.06 ... 91
Income Tax Assessment Act 1922 ... 512
s 17 ... 509–511
Income Tax Assessment Amendment Act 1979 ... 201
Income Tax Assessment Amendment Bill (No. 5) 1978 ... 157, 189, 195
Div 6 ... 189
Income Tax Assessment Bill 1936 ... 512
Income Tax Assessment (Cents per Kilometre Deduction Rate for Car Expenses) Determination 2023 ... 38
Income Tax Assessment Regulations 1997
reg 303-10.01 ... 273
Income Tax Rates Act 1986
Sch 10
– Pt 1 ... 507
Income Tax (Transitional Provisions) Act 1997 ... 37, 62, 174
Subdiv 40-BB ... 38, 75
Subdiv 328-E ... 38
s 118-110 ... 273
s 118-195 ... 265
s 328-180 ... 38
s 328-181 ... 37, 38
Industry Research and Development Act 1986
s 27A ... 440, 441
s 28A ... 441
s 28C ... 436, 437, 441
s 28C(1)(a) ... 369, 437
s 28C(2) ... 441
s 28D ... 436, 441
International Tax Agreements Act 1953 ... 412
s 3(4) ... 192
Interpretation Act 1987 (NSW)
Sch 4 ... 376
ITAA36 ... 70
Pt III
– Div 6 ... 190, 192, 202, 229, 252, 446, 447, 487
– Div 6AA ... 150, 193
– Div 6AAA ... 448
– Div 6E ... 447
– Div 7A ... 34, 38, 57, 199, 228, 229, 304, 318, 339, 422, 439, 476
– Subdiv EA ... 229
– Div 16G ... 274, 283
Pt IVA ... 28, 29, 35, 82, 270, 342, 347, 392, 410, 413, 472, 502
Pt X ... 448
s 6 ... 122
s 6(1) ... 10, 83, 190, 191, 203, 280, 412, 420, 477
s 6(1)(d) ... 23
s 6B ... 192, 200
s 6B(2A)(a)(ii) ... 192
s 21 ... 202
s 23AK ... 202
s 23L ... 202
s 24H ... 202
s 25(1) ... 201
s 25A ... 315
s 26(a) ... 180, 315
s 26(b) ... 201
s 26AAA ... 133, 181
s 26AAA(1)(b) ... 183
s 26AAA(1)(c) ... 183
s 26AAA(2) ... 183
s 26AH ... 197
s 28 ... 510
s 32 ... 510
s 44 ... 229
s 47 ... 194
s 47A ... 199
s 52 ... 315
s 70B ... 334
s 82KZM ... 75
s 82KZMD ... 75
s 90 ... 277
s 94M ... 474
s 95 ... 195, 202, 447, 448
s 95(1) ... 190, 195, 247, 252
s 95(2) ... 252
s 95(3) ... 252
s 95A ... 201
s 95A(1) ... 245, 246, 447
s 95A(2) ... 446
s 97 ... 156, 192, 195, 372, 446, 448, 508
s 97 to 99A ... 196, 202
s 97(1) ... 334, 446, 507
s 97(1)(a) ... 446, 500
s 97(1)(b) ... 446
s 97(1)(c) ... 446
s 97(2) ... 449
s 97(3) ... 449
s 98 ... 156, 195, 449
s 98(4) ... 194, 195
s 99 ... 156, 249, 447, 487
s 99(4) ... 252
s 99(5) ... 252
s 99A ... 192, 195, 245, 249, 447
s 99A(2)(a) ... 507
s 99B ... 156, 157, 189–201, 253
s 99B(1) ... 156, 190–192, 194, 195, 199
s 99B(2) ... 156, 191, 193, 195, 196, 199, 253
s 99B(2)(a) ... 157, 194
s 99B(2)(b) ... 194, 195
s 99B(2)(c) ... 195
s 99B(2)(c)(i) ... 195, 202
s 99B(2)(d) ... 196
s 99C ... 156, 189, 191–194, 197–199, 253
s 99C(1) ... 198
s 99C(2) ... 156, 198, 199
s 99C(2)(c) ... 156, 199
s 99C(2)(d) ... 199
s 99C(2)(e) ... 199
s 99D ... 249
s 99D(1) ... 249
s 99D(2) ... 249
s 100A ... 34, 35, 66, 67, 201, 221, 249, 253, 347, 439, 501, 502
s 100A(8) ... 67
s 100AA ... 244
s 100AB ... 245, 246
s 100AB(5) ... 246
s 101 ... 201, 447
s 102 ... 201, 449
s 102AA(1) ... 150
s 102AA(4) ... 150
s 102AAL ... 197
s 102AAM ... 157, 200, 203
s 102AAM(1A)(a) ... 200
s 102AAM(1C) ... 203
s 102AAM(5) ... 190, 203
s 102AAU(2) ... 202
s 102AAZB ... 202
s 102AAZD ... 156, 196
s 102AG(2)(a) ... 150, 507
s 102AG(2AA) ... 151
s 109(3) ... 229
s 109D ... 229
s 109D(1) ... 448
s 109D(3) ... 229, 339
s 109E(1) ... 38
s 115-30(1) ... 197
s 159GZZZP ... 67
s 160ZZM ... 264
s 161AA ... 203
s 167 ... 12, 383, 386
s 170 ... 75, 201
s 170(1) ... 177, 441
s 170(10AA) ... 202, 333
s 177M ... 82
s 214A ... 200
s 260 ... 28
s 262A ... 440
s 264 ... 127
s 317 ... 202, 203
s 318 ... 83
s 320 ... 202, 203
s 342(a) ... 196
Sch 2F ... 278
– s 271-90 ... 177
– s 272-5(1) ... 253
– s 272-10(2) ... 424
– s 272-87 ... 423
– s 272-87(3) ... 424
– s 272-90 ... 422, 424
– s 272-90(4) ... 422, 424
– s 272-90(5) ... 422–424
– s 272-95(1)(a) ... 424
– Subdiv 272-A ... 424
ITAA97 ... 8, 62, 106
Pt 2-40 ... 373
Pt 3-1 ... 254
Div 26 ... 82
Div 36 ... 276
Div 40 ... 22, 33, 136, 227, 276
Div 43 ... 227, 276
Div 70 ... 22
Div 115 ... 180
Div 128 ... 251, 253, 420
Div 149 ... 195
Div 152 ... 75, 135, 288
Div 160 ... 38, 75
Div 170 ... 186
Div 230 ... 83, 331, 333, 335
Div 245 ... 335
Div 293 ... 394
Div 296 ... 225, 285, 286
Div 615 ... 135, 137
Div 770 ... 200
Div 820 ... 62, 274–276, 281
Div 855 ... 195, 241
Subdiv 40-D ... 276
Subdiv 40-E ... 276
Subdiv 40-H ... 276
Subdiv 40-I ... 276
Subdiv 83-C ... 373
Subdiv 115-C ... 252, 447, 448, 497
Subdiv 118-B ... 254, 262, 273, 482
Subdiv 118-I ... 46, 326, 335
Subdiv 122-A ... 135, 196
Subdiv 122-B ... 135
Subdiv 124-M ... 44, 135–137
Subdiv 124-N ... 135
Subdiv 126-A ... 263, 264, 268, 318, 480, 482
Subdiv 152-A ... 21
Subdiv 152-C ... 23
Subdiv 152-D ... 23
Subdiv 207-B ... 252, 447, 448
Subdiv 230-C ... 336
Subdiv 295-C ... 51, 394
Subdiv 302-B ... 145, 197
Subdiv 302-C ... 145
Subdiv 305-B ... 197
Subdiv 328-D ... 33, 75
Subdiv 328-F ... 75
Subdiv 815-B ... 280, 281
Subdiv 820-EAA ... 62, 282
Subdiv 855-B ... 196
Subdiv 900-B ... 63
Subdiv 960-D ... 192
Subdiv 960-S ... 202
s 4-5 ... 236
s 6-5 ... 63, 315, 413, 442
s 6-5(1) ... 84
s 6-10 ... 158
s 6-25 ... 229
s 8-1 ... 8, 9, 97, 125, 183, 200, 226, 235, 236, 315, 369, 474, 475
s 8-1(1)(a) ... 226, 314
s 8-1(1)(b) ... 226
s 8-1(2)(b) ... 314, 315
s 10-5 ... 191
s 15-2 ... 331
s 15-20 ... 413
s 15-75 ... 202
s 20-25 ... 335
s 25-5 ... 98, 200
s 25-35 ... 334
s 25-35(1)(a) ... 334
s 25-35(1)(b) ... 334
s 25-90 ... 282
s 26-102 ... 231–236
s 26-102(1) ... 232–234, 236
s 26-102(1)(a) ... 234
s 26-102(1)(b)(i) ... 236
s 26-102(2) ... 236
s 26-102(3) ... 232, 236
s 26-102(4) ... 234–236
s 26-102(5) ... 236
s 26-102(6) ... 236
s 26-102(7) ... 236
s 26-102(8) ... 232, 236
s 26-102(9) ... 232, 235, 236
s 26-110 ... 26–29, 82–85
s 26-110(1) ... 82
s 26-110(2) ... 26, 29, 83
s 26-110(2)(b) ... 82, 83
s 26-110(2)(c)(ii) ... 84
s 26-110(3)(b) ... 84
s 26-110(4)(b)(i) ... 84
s 26-110(4)(b)(ii) ... 84
s 26-110(4)(b)(iii) ... 84
s 26-110(5)(b) ... 84
s 26-110(6) ... 83
s 26-110(6)(a) ... 83
s 26-110(6)(b) ... 83
s 26-110(7) ... 83
s 26-110(7)(a) ... 83
s 26-110(7)(b) ... 83
s 26-110(8) ... 84
s 26-110(9) ... 30, 84
s 26-110(10) ... 84
s 26-110(10)(e) ... 84
s 40-30 ... 30
s 40-30(4) ... 227, 414
s 40-35 ... 227, 414
s 40-82 ... 38
s 40-85(1) ... 38
s 40-285 ... 38
s 40-285(1) ... 38
s 40-295 ... 38
s 40-880(2A) ... 75
s 59-30 ... 202
s 70-10(1) ... 178
s 70-35(1) ... 178
s 83-175(1) ... 373
s 102-5 ... 158, 195, 196, 246
s 102-5(1) ... 158, 334
s 103-5 ... 202
s 103-10(2) ... 327
s 103-25 ... 482
s 103-25(2) ... 255
s 104-10 ... 272
s 104-10(1) ... 183
s 104-10(2) ... 183
s 104-10(3) ... 183
s 104-25 ... 23
s 104-35(1) ... 183
s 104-35(2) ... 183
s 104-55 ... 348
s 104-80 ... 253
s 104-150 ... 419
s 104-155 ... 177
s 104-155(3) ... 178
s 104-160 ... 270
s 104-215 ... 253
s 104-510 ... 138
s 108-55(2) ... 257

s 109-5 .... 183, 272
s 110-25(2) 327
s 110-25(4) 236
s 110-45(3) 335
s 110-55 236
s 110-55(2) 327
s 112-20 .... 251, 448
s 112-20(1)(c) 133
s 115-25(1) 183
s 115-40 .... 180, 181
s 115-115 79
s 115-215 195
s 115-220 195
s 115-222 195
s 115-228 449
s 115-228(1) 252
s 116-10 335
s 116-20(1) 327
s 116-20(1)(a) 327
s 116-20(2) 178
s 116-30 .... 252, 332, 334, 448
s 116-30(2)(b)(i) 133
s 116-30(3A) 336
s 116-45 333
s 116-45(1)(b) 333
s 118-20 200
s 118-25(4) 79
s 118-30 273
s 118-110 .... 79, 253, 255, 267, 315
s 118-110(2) 253
s 118-110(2)(a) 273
s 118-110(3) 79, 269, 272
s 118-110(4) 79, 272, 420
s 118-110(5) 79, 267
s 118-115 .... 255, 256
s 118-120 255
s 118-120(5) 256
s 118-120(6) 256, 257
s 118-125 255
s 118-130 .... 255, 420
s 118-135 .... 79, 420, 482
s 118-140 .... 79, 250, 258, 261
s 118-145 .... 79, 255, 258, 261, 262, 264, 265, 267, 268, 270–272, 420
s 118-145(1) 420
s 118-145(2) 79
s 118-145(3A) 272
s 118-145(4) 272
s 118-147 261
s 118-147(3) 261
s 118-147(4) 261
s 118-150 .... 79, 255, 262, 263
s 118-165 .... 79, 255, 272
s 118-170 .... 257, 258, 272
s 118-178 .... 263, 268, 269, 480, 481
s 118-180 .... 263, 482
s 118-180(2) 482
s 118-185 .... 79, 258, 259, 262, 265
s 118-185(3) 272
s 118-190 .... 79, 259, 264, 265, 272
s 118-190(1)(c) 272
s 118-190(2) 260, 261
s 118-190(3) 265
s 118-190(4) 265
s 118-192 .... 78, 79, 260, 262, 265, 270
s 118-192(2) 261
s 118-195 .... 253, 255, 264, 265, 420
s 118-195 to 118-210 79
s 118-195(1)(c) 268
s 118-195(1A)(a) 268
s 118-195(1A)(b) 268
s 118-197 264
s 118-200 .... 264, 272
s 118-200(1) 272
s 118-200(2) 272, 273
s 118-200(3) 273
s 118-200(4) 273
s 118-205 265
s 118-205(4) 272, 273
s 118-210 .... 265, 266, 418
s 118-210(1) 418, 419
s 118-210(2) 419, 420
s 118-210(2)(c) 420
s 118-210(3) 420
s 118-210(4) 420
s 118-210(5)(a) 273, 420
s 118-210(5)(b) 419
s 118-210(6) 273, 420
s 118-222 266
s 118-230 265
s 118-245(3) 272
s 118-300 197
s 118-305 197
s 118-565 326
s 118-565(1) 43
s 118-565(1)(a) 326
s 118-565(1)(f) 326, 327, 330
s 118-565(1)(g) 326, 327
s 122-20 137
s 122-20(3) 137
s 122-50(1) 137
s 124-780(2)(a)(i) 137
s 124-780(2)(c) 45, 46
s 124-780(3)(d) 46
s 124-780(5)(a) 137
s 124-783(7) 46
s 124-785(2) 137
s 124-875(1) 137
s 126-5 .... 79, 269
s 126-5(1) 267, 482
s 126-5(2) 482
s 126-5(4) 482
s 126-5(5) 482
s 126-5(6) 482
s 126-15 482
s 126-15(1) 482
s 126-140(2) 350
s 128-15 265
s 128-15(4) 251
s 128-20 264
s 152-10 .... 22, 137
s 152-10(1)(a) 22
s 152-10(1)(d) 22
s 152-10(1A) 22
s 152-10(2) 22
s 152-10(2A) 23
s 152-15 75
s 152-20 256
s 152-35 22
s 152-40 .... 22, 30, 75
s 152-40(3)(b) 22
s 152-55 290
s 152-60 .... 23, 290
s 152-80 288–290
s 152-80(2) 290
s 152-80(3) 288
s 152-110 .... 289, 290
s 152-110(1)(d) 289, 290
s 152-125 289
s 202-75(3) 38
s 207-35(1) 448
s 207-58 449
s 207-122(b)(i) 369
s 207-150 .... 67, 508
s 207-150(1) 67
s 207-155 67
s 230-25 335
s 230-25(3) 335
s 230-45 331
s 230-50(1) 333
s 230-60 332
s 230-60(1) 331
s 230-435 332
s 230-435(1)(b) 334, 335
s 230-440(1) 336
s 230-445 .... 332, 334
s 230-450 333
s 230-455 333
s 230-460(13) 336
s 230-465 334
s 230-505 .... 327, 331–333, 335
s 230-505(2) 331, 336
s 230-505(3) 333
s 230-505(7) 331
s 230-510 .... 332, 333
s 245-10 335
s 245-85 335
s 290-60(3) 38
s 290-65(1A) 38
s 295-550 .... 64, 96, 97, 129, 158, 392, 516
s 295-550(1)(b) 392
s 295-550(1)(c) 392
s 295-550(5) 129, 131, 132
s 295-550(5)(a) 131, 132
s 295-550(5)(b) 132
s 296-15 286
s 302-195 145
s 307-15 342
s 307-230(1)(d) 286
s 325-125 236
s 325-130 236
s 328-110 70
s 328-115 70
s 328-120(2) 75
s 328-125 .... 70, 71, 174
s 328-125(2) 74, 174, 175
s 328-125(2) to (4) 72
s 328-125(4) 174, 175
s 328-125(5) 74
s 328-125(6) 71–74, 174
s 328-180 37
s 328-185 to 328-210 38
s 328-185(1) 38
s 328-215(4) 38
s 355-25 441
s 355-210(1)(a) 441
s 355-210(1)(d) 441
s 355-210(1)(e) 441
s 355-405 441
s 355-710(1) 441
s 355-710(2) 441
s 355-710(3) 441
s 360-40(1) 238, 369
s 360-40(1)(a) 238
s 360-40(1)(e) 238
s 360-45 238
s 615-5(1)(a) 137
s 615-5(1)(b) 137
s 615-20(2) 138
s 701-1 .... 138, 348
s 701-25 138
s 701-35 138
s 701-60 138
s 703-10(1) 137
s 703-15 348
s 703-20 348
s 703-30 348
s 705-45(2) 136
s 705-60 332
s 705-65(5B) 336
s 705-70(1AA) 332
s 705-70(1AB) 332
s 705-112 283
s 707-320 348
s 721-15(3) 348
s 768-5(2) 195
s 768-910(2) 192
s 770-10 197
s 770-10(1) 334
s 770-15 197
s 770-130 200
s 770-190 201
s 786-970 192
s 802-17 195
s 815-130 10
s 815-140 280–282
s 820-37 275
s 820-40(1) 275
s 820-40(3)(a) 275
s 820-46(2) 275
s 820-46(3) 283
s 820-46(4) 283
s 820-47(2)(a) 283
s 820-47(4) to (7) 283
s 820-48 283
s 820-50(1)(a) 283
s 820-50(1)(b) 283
s 820-50(1)(d) 276
s 820-50(3) 283
s 820-51(1) 283
s 820-51(2) 283
s 820-52 283
s 820-52(2) 283
s 820-52(3) 283
s 820-52(6) 283
s 820-52(8) 283
s 820-53 283
s 820-53(1) 283
s 820-54 283
s 820-54(5) 283
s 820-55(3) 283
s 820-57 283
s 820-58 283
s 820-59(4) 283
s 820-59(5) 283
s 820-310 30
s 820-423A(2) 283
s 820-423A(5) 283
s 820-423D 283
s 820-427(4) 283
s 820-427A(2) 280
s 820-427A(3) 283
s 820-427A(3)(d) 283
s 820-427C 283
s 820-427D 283
s 820-590(3) 283
s 820-590(4) 283
s 820-590(7) 283
s 820-590(8) 283
s 820-592 283
s 820-594 283
s 820-920 283
s 820-985 283
s 832-625(3) 29
s 832-625(3)(b) 29, 30
s 855-10 .... 190, 195, 247, 248, 497
s 855-15 .... 253, 273
s 855-40 .... 248, 497
s 855-50 196
s 900-115 415
s 950-100(1) 190
s 950-258(2) 84
s 960-50(1) 202
s 960-50(6) 202
s 960-100 236
s 960-115 186
s 960-130 348
s 960-130(1) 348
s 960-135 348
s 960-258 .... 30, 82
s 960-258(1) 84
s 960-258(2) 28, 84
s 960-258(2)(d) 30
s 960-258(4) 82, 84
s 960-258(5) 84
s 960-555 86
s 995-1 .... 91, 197, 200, 202, 264, 432
s 995-1(1) 133, 232, 275, 482

Judiciary Act 1903
s 39B 126

Land Tax Act 1956 (NSW) 104

Land Tax Act 2004 (ACT) 104

Land Tax Act 2005 (Vic) 103

Land Tax Act 2010 (Qld) 104

Legal Profession Act 1987 (NSW)
s 79A(2)(a) 376, 377

Life Insurance Act 1995
s 9 202

Limitation of Actions Act 1958 (Vic) 496

New Business Tax System (Integrity and Other Measures) Bill 1999 180

Powers of Attorney Act 1980 (NT) 111

Powers of Attorney Act 1998 (Qld) 48, 111
s 73 48

Powers of Attorney Act 2000 (Tas) 111

Powers of Attorney Act 2003 (NSW) 111

Powers of Attorney Act 2006 (ACT) 111

Powers of Attorney Act 2014 (Vic)
s 67 111

Powers of Attorney and Agency Act 1984 (SA) 111

Probate and Administration Act 1898 (NSW)
Pt 2
– Div 3 154

Property Law Act 1969 (WA) 111

Radiocommunications Act 1992 83

Recovery of Imposts Act 1963 (NSW) 323
s 2(1) 324
s 2(2) 324

Retail Leases Act 2003 (Vic) 454

Social Security Act 1991 152
s 1209M 155

Stamp Duties Act 1923 (SA) 104

Statute Law Revision Act 1981 172

Succession Act 1981 (Qld)
s 33R 154

Succession Act 2006 (NSW) 49, 148

Superannuation (Better Targeted Superannuation Concessions) Imposition Bill 2023 285
s 5 285

Superannuation Guarantee (Administration) Act 1992 370
s 12 451
s 12(1) 450
s 12(3) 370

Superannuation Industry (Supervision) Act 1993 .... 64, 148, 349
s 10 .... 48, 148
s 15A 88, 89

s 17A ... 141
s 17A(1)(f) ... 101
s 17A(1)(g) ... 101
s 17A(2)(c) ... 101
s 17A(2)(d) ... 101
s 17B ... 99, 393
s 34(1) ... 350
s 55A ... 49
s 59 ... 47
s 59(1A) ... 149, 498
s 129 ... 106

Superannuation Industry (Supervision) Regulations 1994 ... 106, 148
Div 7A.2 ... 349, 350
reg 1.03 ... 350
reg 1.03C ... 91
reg 1.04AAAA ... 142, 144, 148
reg 6.01 ... 88
reg 6.01(2) ... 92
reg 6.01(5) ... 94
reg 6.01A ... 91
reg 6.17 ... 498
reg 6.17A ... 47, 143, 145, 149
reg 6.17A(6) ... 498
reg 6.17A(7) ... 498
reg 6.19A ... 93
reg 6.21 ... 47, 145
reg 6.44 ... 95
reg 7A.02 ... 350

Supreme Court (General Civil Procedure) Rules 2015 (Vic)
order 54 ... 491
r 54.02 ... 16, 507

Tax Agent Services Act 2009 ... 226, 304, 375, 427
Pt 3 ... 127
Subdiv 60-G ... 433
s 2-5 ... 433
s 3-5 ... 378
s 20-5(1)(a) ... 310
s 20-25 ... 433
s 30-10 ... 310
s 30-10(2) ... 378
s 30-10(15) ... 432
s 30-10(16) ... 432
s 30-10(17) ... 433
s 30-12 ... 433
s 30-20(1)(d) ... 433
s 30-35(1)(ba) ... 378, 433
s 30-35(2)(ba) ... 378, 433
s 30-35(3)(ba) ... 378, 433
s 30-35(4)(b) ... 375
s 30-40(1) ... 375, 432
s 30-40(2) ... 375
s 30-40(3) ... 375
s 45-5 ... 428
s 45-5(2) ... 432
s 45-5(6) ... 432
s 45-10(1) ... 432
s 45-10(2) ... 432
s 45-10(3) ... 432
s 45-20 ... 432
s 50-5(1) ... 371
s 60-25(4) ... 433
s 60-25(5) ... 433
s 90-1(1) ... 376, 432
s 90-1(2) ... 432

Tax Agent Services (Code of Professional Conduct) Determination 2023 ... 431

Tax Agent Services Regulations 2022 ... 226

Tax and Superannuation Laws Amendment (2015 Measures No. 6) Bill 2015 ... 326, 327, 335

Tax Laws Amendment (2011 Measures No. 5) Bill 2011 ... 245

Tax Laws Amendment (2013 Measures No. 2) Act 2013 ... 307

Tax Laws Amendment (Research and Development) Bill 2010 ... 441

Tax Laws Amendment (Small Business) Bill 2007 ... 75

Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008 ... 331–333, 336

Taxation Administration Act 1953 ... 286, 370
Pt IIA ... 200
Pt IVC ... 383, 384
Pt IVD ... 432
s 8AAD ... 200
s 8AAZLGA(2) ... 441
s 8C ... 375
s 8K ... 377
s 8K(1) ... 378
s 8N ... 377
s 8T ... 377
s 8U ... 377
s 8V(1) ... 377
s 8V(2) ... 377
s 14ZZJ ... 385
s 14ZZK ... 384, 385, 415
s 14ZZK(b)(i) ... 385, 386
s 14ZZO ... 12, 384, 385
s 14ZZO(b)(i) ... 386
Sch 1
– Div 290 ... 306, 410, 432
– Div 358 ... 252
– s 12-35 ... 373, 450
– s 284-90 ... 441
– s 284-90(1C) ... 86

Taxation Administration (Country by Country Reporting Jurisdictions) Determination 2024 ... 477

Taxation (Interest on Overpayments and Early Payments) Act 1983 ... 200

Treasury Laws Amendment (2018 Superannuation Measures No. 1) Act 2019 ... 101

Treasury Laws Amendment (2019 Measures No. 3) Act 2020 ... 151

Treasury Laws Amendment (2019 Tax Integrity and Other Measures No. 1) Act 2019 ... 231

Treasury Laws Amendment (2022 Measures No. 4) Act 2023 ... 62
Sch 1 ... 38
Sch 4 ... 38
Sch 5 ... 38

Treasury Laws Amendment (2023 Measures No. 1) Act 2023 ... 375, 428–432
s 28(1) ... 378
s 28(2) ... 378
Sch 3
– Pt 5 ... 375

Treasury Laws Amendment (2023 Measures No. 1) Bill 2023
Sch 3 ... 428
Sch 5 ... 35

Treasury Laws Amendment (2023 Measures No. 2) Act 2023
Sch 4 ... 35

Treasury Laws Amendment (2023 Measures No. 2) Bill 2023 ... 8

Treasury Laws Amendment (A Tax Plan for the COVID-19 Economic Recovery) Bill 2020 ... 185

Treasury Laws Amendment (Better Targeted Superannuation Concessions) Bill 2023 ... 285, 286

Treasury Laws Amendment (Cost of Living — Medicare Levy) Bill 2024 ... 412

Treasury Laws Amendment (Cost of Living Tax Cuts) Bill 2024 ... 412

Treasury Laws Amendment (Foreign Investment) Bill 2024 ... 412

Treasury Laws Amendment (Making Multinationals Pay Their Fair Share — Integrity and Transparency) Bill 2023 ... 62, 86, 274–277, 279–283

Treasury Laws Amendment (Measures for Consultation) Bill 2022 ... 427

Treasury Laws Amendment (Measures for Consultation) Bill 2023 ... 26, 50, 51, 98, 101

Treasury Laws Amendment (Measures for Future Bills) Bill 2023 ... 274, 276, 278, 282

Treasury Laws Amendment (Reducing Pressure on Housing Affordability Measures) Act 2019 ... 266

Treasury Laws Amendment (Support for Small Business and Charities and Other Measures) Bill 2023 ... 174, 392, 393, 517
Sch 7 ... 304, 392

Treasury Laws Amendment (Tax Accountability and Fairness) Bill 2023 ... 432
Sch 3
– Pt 2 ... 433

Treasury Laws Amendment (Tax Integrity and Other Measures) Bill 2018 ... 22

Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Act 2018 ... 30

Trustee Act 1925 (NSW) ... 14
s 46 ... 247
s 63 ... 16, 17, 491, 507
s 81 ... 507
s 86A ... 17–19, 507
s 86A(1) ... 18
s 86B(1) ... 19

Trustee Act 1936 (SA)
s 91 ... 491

Trustee Act 1958 (Vic) ... 14
s 63 ... 16, 208, 507
s 63A ... 507

Trustees Act 1962 (WA)
s 92 ... 19

Wills Act 1997 (Vic)
s 48 ... 154

Wills Act 2000 (NT)
s 43 ... 154

Wills Act 2008 (Tas)
s 58 ... 154

Zero and Low Emission Vehicle Distance-based Charge Act 2021 (Vic)
s 7(1) ... 320, 321

Rulings and other materials

Australian Accounting Standards Board
AASB 17 ... 174
AASB 116 ... 511, 512
AASB 141 ... 511, 512

Australian Taxation Office
CR 2022/63 ... 330
GSTD 2009/1 ... 202
GSTR 2009/4 ... 35
ID 2003/635 ... 333
ID 2003/636 ... 333
ID 2003/1112 ... 262
ID 2003/1113 ... 262
ID 2004/66 ... 202
ID 2004/882 ... 272
ID 2006/34 ... 272
ID 2009/34 ... 272
ID 2009/63 ... 328
ID 2010/55 ... 253
ID 2010/85 ... 508
ID 2010/211 ... 202
ID 2011/93 ... 190
ID 2013/64 ... 336
IT 2167 ... 260, 272
IT 2346 ... 197
IT 2504 ... 197
IT 2512 ... 202
IT 2622 ... 197, 244, 247, 252
IT 2650 ... 10
IT 2673 ... 79, 259
IT 2681 ... 10
LCR 2021/2 ... 50, 96–101, 393, 394, 516, 517
LCR 2021/3 ... 136
LCR 2023/D1 ... 306, 307
LI 2023/D13 ... 125
LI 2023/D18 ... 307
LI 2023/D19 ... 307
LI 2023/D20 ... 307
LI 2023/D21 ... 307
LI 2023/D22 ... 307
LI 2023/D23 ... 307
MT 2024/D1 ... 475
PBR 1012616654481 ... 202
PBR 1051346488294 ... 252
PBR 1051437446368 ... 344
PBR 1051485266678 ... 329, 330
PBR 1051583203973 ... 333
PBR 1051593007881 ... 79
PBR 1051618374747 ... 202
PBR 1051630156354 ... 252
PBR 1051630967428 ... 202
PBR 1051652180989 ... 333
PBR 1051659115719 ... 327, 329, 330
PBR 1051693349071 ... 202
PBR 1051714149928 ... 424
PBR 1051760637680 ... 252
PBR 1051830400148 ... 202
PBR 1051910296871 ... 202
PBR 1051914995135 ... 344
PBR 1051943938848 ... 253
PBR 1051970330207 ... 202
PBR 1052020105622 ... 325–327
PBR 1052020371737 ... 325–327
PBR 1052059680727 ... 202
PBR 1052085239358 ... 253
PBR 1052091672127 ... 344
PBR 1052097327812 ... 344
PBR 1052162946778 ... 344
PCG 2017/13 ... 38
PCG 2017/D11 ... 63
PCG 2018/9 ... 122
PCG 2018/9DC1 ... 122
PCG 2019/5 ... 253, 266
PCG 2020/5 ... 51, 393, 516
PCG 2021/4 ... 33
PCG 2021/D4 ... 27
PCG 2022/2 ... 34, 502
PCG 2023/1 ... 37
PCG 2023/2 ... 370, 371, 450–452
PCG 2023/D1 ... 37
PCG 2023/D2 ... 10, 27, 86
PCG 2024/2 ... 414
PS LA 2003/8 ... 33
PS LA 2003/12 ... 507
PS LA 2005/24 ... 35
PS LA 2006/8 ... 366
PS LA 2007/11 ... 366
PS LA 2007/21 ... 191
PS LA 2010/4W ... 38
PS LA 2023/2 ... 227, 228
QC 45254 ... 344
QC 58416 ... 253
SGR 2005/1 ... 370
SMSFRB 2020/1 ... 101
TA 2015/2 ... 35
TA 2018/2 ... 10, 27
TA 2020/1 ... 27
TA 2021/1 ... 190
TA 2022/1 ... 502
TA 2022/2 ... 10
TA 2023/2 ... 64
TA 2023/3 ... 368, 369
TA 2023/4 ... 369, 438, 441
TA 2023/5 ... 369
TA 2023/6 ... 369, 370
TD 51 ... 255
TD 92/147 ... 263, 272
TD 92/171 ... 255, 256
TD 92/174 ... 258
TD 95/10 ... 194
TD 1999/43 ... 258
TD 1999/53 ... 264
TD 1999/66 ... 79, 260, 261
TD 1999/67 ... 256
TD 1999/68 ... 256
TD 1999/69 ... 257
TD 1999/70 ... 272
TD 1999/71 ... 272
TD 1999/74 ... 272, 419
TD 2016/19 ... 334
TD 2017/13 ... 257
TD 2017/22 ... 195
TD 2017/23 ... 157, 190, 195, 248
TD 2017/24 ... 157, 190, 195, 202, 247
TD 2021/9 ... 441
TD 2022/11 ... 34, 229
TD 2022/12 ... 249, 497
TD 2022/13 ... 248, 497
TD 2023/3 ... 63
TD 2023/4 ... 63
TD 2023/5 ... 174, 175
TD 2023/7 ... 363
TD 2023/D1 ... 158–160
TD 2023/D2 ... 70–75, 179
TR 93/30 ... 259
TR 97/7 ... 315
TR 98/17 ... 10
TR 2004/4 ... 234
TR 2004/15 ... 122
TR 2004/D25 ... 272, 514
TR 2005/3(W) ... 200
TR 2005/9 ... 507
TR 2006/14 ... 251–253

TR 2007/D10 ....325, 326, 328, 335
TR 2010/1 ....36, 98
TR 2010/3 229
TR 2010/3W 38
TR 2012/D1 ....446, 448, 449
TR 2013/2 8
TR 2014/3 264
TR 2017/D1 227
TR 2018/5 122
TR 2018/6 498
TR 2020/1 226
TR 2021/5 441
TR 2021/D4 ....27, 86
TR 2022/4 ....221, 253, 502
TR 2022/4A1 221
TR 2023/1 ....10, 11, 35, 202, 266
TR 2023/2 ....8, 9, 10
TR 2023/3 231–236
TR 2023/4 ....370, 450–452
TR 2023/D1 226
TR 2023/D2 227
TR 2024/1 ....414, 415
TR 2024/2 474
TR 2024/3 ....474, 475
TR 2024/D1 ....412, 413, 472

Double tax agreements
Australia–Finland
– art 23 102
Australia–Germany
– art 24 102
Australia–NZ
– art 24 102
Australia–South Africa
– art 23A 102

International Accounting Standards
IAS 16 ....511, 512
IAS 41 ....511, 512

OECD
Model Tax Convention on Income and on Capital 192
– art 12 27

State Revenue Office Victoria
Revenue Ruling DA 057 211

Tax Professionals Board
TPB(PN) 5/2022 428
TPB(I) D51/2023 ....428–430, 432

Cases

A
Active Sports Management Pty Ltd and Industry Innovation and Science Australia [2023] AATA 4078 440
Addy v FCT [2019] FCA 1768 10
Addy v FCT [2021] HCA 34 ....102, 103
Adnunat Pty Ltd v ITW Construction Systems Australia Pty Ltd [2009] FCA 499 343
Advanced Holdings Pty Ltd as Trustee for The Demian Trust v FCT [2020] FCA 1479 128
Advanced Holdings Pty Ltd as Trustee for The Demian Trust v FCT [2021] FCAFC 135 490
Al-Freah v Thompson [2023] QCA 175 183
Alcan (NT) Alumina Pty Ltd v Commr of Territory Revenue [2009] HCA 41 30
Allders International Pty Ltd v Commr of State Revenue (Vic) [1996] HCA 58 ....322, 323
Allen (Trustee), in the matter of Allen's Asphalt Staff Superannuation Fund v FCT [2011] FCAFC 118 202
Allen v Carbonel [1975] HCA 14 183
Anderson v Commr of Taxes (Vic) [1937] HCA 24 172
Annalong Pty Ltd v FCT [1972] HCA 45 183
Application by Ellasil Pty Ltd [2023] VSC 69 490
Application of NBT Pty Ltd [2023] NSWSC 919 343
Archer Bros Pty Ltd v FCT [1953] HCA 23 202
Archer Capital 4A Ltd as Trustee for the Archer Capital Trust 4A v Sage Group Plc [2015] FCA 960 181
Ascot Investments v Harper [1981] HCA 1 508
Atkins & Hunt [2020] FamCAFC 252 153
Attorney General v Blake [2001] 1 AC 268 390
Attorney-General (Cth) v Breckler [1999] HCA 28 507
Attorney-General v Milne [1914] AC 765 172
Austin v Commonwealth of Australia [2003] HCA 3 172
Australasian Annuities Pty Ltd (in liq) v Rowley Super Fund Pty Ltd [2015] VSCA 9 ....390, 391
Australian Broadcasting Commission v Australasian Performing Right Association Ltd [1973] HCA 36 507
Australian Building Systems Pty Ltd (in liq); FCT v [2015] HCA 48 202
Australian Trade Commission v WA Meat Exports Pty Ltd (1987) 75 ALR 287 132
Automotive Invest Pty Ltd v FCT [2023] FCAFC 129 176
AXA Asia Pacific Holdings Ltd; FCT v [2010] FCAFC 134 ....131, 133
Aymsheen Pty Ltd v Chief Commr of State Revenue [2023] NSWSC 1237 323

B
B&F Investments Pty Ltd as trustee for the Illuka Park Trust v FCT [2023] FCAFC 89 ....35, 66, 221, 378, 508
Bains and FCT [2023] AATA 2477 ....177, 306
Baird v Baird [1990] 2 AC 548 49
Balken & Vyner [2020] FamCA 955 341
Bamford; FCT v [2010] HCA 10 ....202, 244, 446, 447
Barber v Law Society of NSW (No. 2) [2001] NSWSC 861 376
Barker v FCT [2015] QCA 215 202
Barnes v Addy (1874) LR 9 Ch App 244 389
Barp Nominees Pty Ltd [2016] NSWSC 990 ....17, 18, 343
Barton; FCT v (1957) 96 CLR 359 30
BBlood Enterprises Pty Ltd v FCT [2022] FCA 1112 ....35, 69, 502
BCI Finances Pty Ltd (in liq) v Binetter [2018] FCAFC 189 390
Bechtel Australia Pty Ltd v FCT [2023] FCA 676 ....64, 118
Bendel and FCT [2023] AATA 3074 ....228, 304
Blair v Duncan [1902] AC 37 155
Blake; FCT v [1984] 2 Qd R 303 445
Boardman v Phipps [1966] 3 All ER 721 ....390, 391
Boros v Pages Property Investment [2021] NSWCA 288 391
Bosanac v FCT [2019] HCA 41 ....386, 387
Bosanac v FCT [2022] HCA 34 ....503, 513–515
Bowerman and FCT [2023] AATA 3547 312–315
BPFN and FCT [2023] AATA 2330 129
Brailey Holdings Pty Ltd ACN 001 190 441, In the application of [2018] NSWSC 1493 19
Breen v Williams (1996) 186 CLR 71 ....30, 86
Brewing Investments Ltd; FCT v [2000] FCA 920 202
Brown v FCT [2002] FCAFC 75 ....442, 445
Brunton v Commr of Stamp Duties for NSW [1913] AC 747 172
Buddhist Society of Western Australia Inc v FCT (No. 2) [2021] FCA 1363 8
Bullhead Pty Ltd v Brickmakers Place Pty Ltd (in liq) (2018) 58 VR 91 391
Burton v FCT [2019] FCAFC 141 334
Burton, Re; Wily v Burton [1994] FCA 1146 ....153, 507
Byrnes v Kendle [2011] HCA 26 507
Bywater Investments Ltd v FCT [2016] HCA 45 122

C
Calverley v Green [1984] HCA 81 ....343, 514
Calvert v Wainwright [1947] KB 526 444
Campbell and FCT [2019] AATA 2043 ....157, 190, 196
Cantor Management Services Pty Ltd v Booth [2017] SASCFC 122 47
Capital Duplicators Pty Ltd v Australian Capital Territory (1992) 177 CLR 248 ....321, 323
Cardaci v Filippo Primo Cardaci as executor of the estate of Marco Antonio Cardaci [No. 5] [2021] WASC 331 ....489, 490
Carter; FCT v [2022] HCA 10 500
Chadwick v Pearl Life Insurance Co [1905] 2 KB 507 328
Chan v Zacharia [1984] HCA 36 390
Chase v Chase [2020] NSWSC 1689 338
Chevron Australia Holdings Pty Ltd v FCT [2017] FCAFC 62 ....132, 175
Chief Commissioner of State Revenue v Shell Energy Operations No. 2 Pty Ltd [2023] NSWCA 113 322
Civil Aviation Safety Authority v Alligator Airways Pty Ltd (No. 3) [2012] FCA 601 377
Cleeve Group Pty Ltd, Re [2022] VSC 342 ....16, 339
Clifford and Tax Practitioners Board [2023] AATA 2068 126
Colonial Mutual Life Assurance Society Ltd v FCT (1953) 89 CLR 428 ....328, 329
Commissioner of Stamp Duties (Qld) v Livingston [1964] UKPC 2 48
Commonwealth Bank of Australia v Smith [1991] FCA 375 391
Condon v FCT [2023] FCA 561 ....12, 386, 387
Consolidated Media Holdings Ltd; FCT v [2012] HCA 55 30
Construction, Forestry, Maritime, Mining and Energy Union v Personnel Contracting Pty Ltd [2022] HCA 1 ....450, 452
Container Homes Designer Domain Pty Ltd and FCT [2023] AATA 1815 68
Cooper Brookes (Wollongong) Pty Ltd v FCT [1981] HCA 26 ....30, 172
Copley and FCT [2024] AATA 8 415
Copperart Pty Ltd v FCT [1993] FCA 462 133
Cowan v Scargill [1985] Ch 270 391
Cridland v FCT (1977) 140 CLR 330 30
Cromwell & Cromwell [2006] FamCA 1454 317
CVMW and FCT [2023] AATA 4039 372

D
D'couto and Tax Practitioners Board [2023] AATA 3485 309
Dagenmont Pty Ltd v Lugton [2007] QSC 272 343
Dalco; FCT v [1990] HCA 3 386
Davis v FCT (1989) 89 ATC 4377 30
De Vries v Timbercorp Finance Pty Ltd (in liq) [2021] VSCA 265 343
DEK Technologies Pty Ltd as trustee for DEK Technologies Unit Trust, Application of [2023] NSWSC 544 ....16, 17, 19
Desalination Technology Pty Ltd; FCT v [2015] FCAFC 96 ....439, 441
Di Lorenzo Ceramics Pty Ltd v FCT [2007] FCA 1006 340
Dickenson's Arcade Pty Ltd v Tasmania [1974] HCA 9 320
Diesel Holdings Pty Ltd v Waters [2023] VSC 455 378
Directed Electronics OE Pty Ltd v OE Solutions Pty Ltd (No. 8) [2022] FCA 1404 391
DiStefano and FCT [2023] AATA 1697 67
Dixon; FCT v [1952] HCA 65 ....442, 444, 445
Donovan v Donovan [2009] QSC 26 ....48, 49, 143
DR McKendry Nominees Pty Ltd [2015] VSC 560 339
Drew v Nunn (1879) 4 QBD 661 111
Duke Group Ltd (in liq) v Pilmer [1998] SASC 6529 391
Duke Group Ltd (in liq) v Pilmer [1999] SASC 97 391
Duke of Westminster; IR Commrs v [1936] AC 1 172

E
Edmunds v Pickering (1999) 75 SASR 407 391
Egerton-Warburton v DCT [1934] HCA 40 ....328, 329
Ellison v Sandini Pty Ltd [2018] FCAFC 44 264
Estate of JR Cawthen and FCT [2008] AATA 1168 272
Evans v Friemann [1981] FCA 85 420
Everett; FCT v [1980] HCA 6 446

F
Farah Constructions Pty Ltd v Say-Dee Pty Ltd [2007] HCA 22 391
Farrant v Blanchford (1863) 1 De GJ & Sm 107 391
Fay v Moramba Services Pty Ltd [2009] NSWSC 1428 508
Fidge and FCT [2023] AATA 4245 373
Finch v Telstra Super Pty Ltd [2010] HCA 36 507
Firebird Global Master Fund II Ltd v Republic of Nauru [2015] HCA 43 30
First Provincial Building Society Ltd v FCT [1995] FCA 1101 179
Fischer v Nemeske Pty Ltd [2015] NSWCA 6 343
Fordyce v Ryan [2016] QSC 307 ....507, 508
Foreman v Kingstone [2004] 1 NZLR 841 391
Freeston's Charity, Re [1978] 1 WLR 741 391
Furs Ltd v Tomkies (1936) 54 CLR 583 390

G
Galea v Camilleri; The Estate of Patricia Camilleri [2023] NSWSC 206 211
Gashi v FCT [2013] FCAFC 30 ....383, 386
George v Rockett [1990] HCA 26 377
Gibb v FCT [1966] HCA 74 202
Gleeson v Commr of State Revenue [2009] VSC 464 515
Glencore Coal Queensland Pty Ltd v State of Queensland (2022) 12 QR 295 323
Glencore Investment Pty Ltd v FCT [2019] FCA 1432 133
Glencore Investment Pty Ltd; FCT v [2020] FCAFC 187 133
Governor & c. of the Poor of Kingston-upon-Hull v Petch [1854] EngR 995 182
GP International Pipecoaters Pty Ltd v FCT [1990] HCA 25 ....327, 330, 335
GR Securities Pty Ltd v Baulkham Hills Private Hospital Pty Ltd (1986) 40 NSWLR 631 183
Granby Pty Ltd v FCT [1995] FCA 1217 ....131, 133
Grant v Grant; Grant v Grant (No. 2) [2020] NSWSC 1288 111
Greenhatch v FCT [2013] HCATrans 104 244
Greenhatch; FCT v [2012] CAFC 84 ....244, 448
Greig v FCT [2020] FCAFC 25 314
Grimaldi v Chameleon Mining NL (No. 2) [2012] FCAFC 6 ....390, 391
Guardian AIT Pty Ltd ATF Australian Investment Trust v FCT [2021] FCA 1619 501
Guardian AIT Pty Ltd ATF Australian Investment Trust; FCT v [2023] FCAFC 3 ....35, 221, 508
Guazzini v Pateson [1918] NSWStRp 39 390

H
Ha v New South Wales [1997] HCA 34 ....321, 322
Hains (dec'd), Re; Barnsdall v FCT [1988] FCA 192 ....131, 133
Hancock v Rinehart (Trust Documents) [2018] NSWSC 1684 391
Harding v FCT [2019] FCAFC 29 10
Haritos v FCT [2015] FCAFC 92 384–386
Harmer v FCT [1989] FCA 432 202
Harper v Minister for Sea Fisheries (1989) 168 CLR 314 323
Harries v Church Commrs for England [1992] 1 WLR 1241 391
Harris & Dewell [2018] FamCAFC 94 153
Harris & Harris [2011] FamCAFC 245 ....153, 154
Harris; FCT v (1980) 10 ATR 869 445
Hayes v FCT [1956] HCA 21 445
Hedges and FCT [2020] AATA 5307 128
Hedges v FCT [2022] FCA 1389 128
Hedges v FCT [2023] FCAFC 105 126
Herdegen v FCT [1988] FCA 419 515

Heydon v Perpetual Executors Trustees & Agency Co (WA) Ltd [1930] HCA 26 ... 343
Hill (Viscount) v Hill (Dowager Viscountess) [1897] 1 QB 483 ... 507
Hill v Zuda Pty Ltd [2021] WASCA 59 ... 143
Hill v Zuda Pty Ltd [2022] HCA 21 ... 47, 143, 149, 497
Hochstrasser v Mayes [1960] AC 376 ... 445
Holder v Holder [1968] Ch 353 ... 391
Hordern v Hordern [1910] AC 465 ... 390
Horn v GA & RG Horn Pty Ltd [2022] NSWSC 1519 ... 339
Hornsby Shire Council v Commonwealth [2023] HCA 19 ... 321
Hospital Products Ltd v United States Surgical Corporation [1984] HCA 64 ... 390, 391
Howard v FCT [2012] FCAFC 149 ... 157, 190, 194, 202

I

In the Marriage of Crapp and Crapp (No. 2) (1979) 5 Fam LR 47 ... 508
In the Marriage of Kelly and Kelly (No. 2) (1981) 7 Fam LR 762 ... 508
Incollingo v Tax Practitioners Board [2023] FCA 878 ... 126
Inland Revenue Commissioners v Duke of Westminster [1936] AC 1 ... 172
Ioppolo & Hesford v Conti [2013] WASC 389 ... 143

J

J Rowe & Son Pty Ltd v FCT [1971] HCA 80 ... 335
Jassar & Manesh Pty Ltd as trustee for the Jassar & Manesh Unit Trust and FCT [2023] AATA 3502 ... 309
Jassar & Manesh Pty Ltd as trustee for the Jassar Manesh Consultants Unit Trust and FCT [2023] AATA 3499 ... 309
JEL and DDF [2000] FamCA 1353 ... 317
JMC Pty Ltd v FCT [2023] FCAFC 76 ... 1
John Holland Group Pty Ltd v FCT [2015] FCAFC 82 ... 65
Jones v IR Commrs (1920) 1 KB 711 ... 328
Jowill Nominees Pty Ltd v Cooper [2021] SASC 76 ... 337
Jukka Pekka Kemi v Peter Hedley Wood [2013] NSWSC 180 ... 343
Jumbunna Coal Mine NL v Victorian Coal Miners' Association (1908) 6 CLR 309 ... 30
Just v FCT [1949] ALR 438 ... 328

K

Kafataris v DCT [2008] FCA 1454 ... 202, 515
Karger v Paul [1984] VR 161 ... 493
Katz v Grossman [2005] NSWSC 934 ... 143, 149
Kearney v FCT 84 ATC 4295 ... 183
Kelly and Kelly (No. 2) [1981] FamCA 78 ... 317
Kennon v Spry [2008] HCA 56 ... 153, 154, 508
Khoury v Khouri [2006] NSWCA 184 ... 183
Koitaki Para Rubber Estates Ltd v FCT [1941] HCA 13 ... 255
Koprivnjak v Koprivnjak [2023] NSWCA 2 ... 504
Kornwasser v Spigelman [2022] VSC 759 ... 508

L

Laidler v Perry (Inspector of Taxes) [1966] AC 16 ... 444
Lance and FCT [2024] AATA 11 ... 415
Le v FCT [2021] FCA 303 ... 386
Londonderry's Settlement, Re [1965] Ch 918 ... 391
Loughnan v Magistrate's Court of Victoria Sitting at Melbourne [1993] 1 VR 685 ... 377
Loughnan v McConnell [2006] QSC 359 ... 343
Lunney v FCT [1958] HCA 5 ... 65
Lutheran Church of Australia South Australia District Incorporated v Farmers' Co-Operative Executors and Trustees Ltd (1970) 121 CLR 628 ... 154
Lygon Nominees Pty Ltd v Commr of State Revenue [2005] VSC 247 ... 508

M

Ma v FCT [1992] FCA 359 ... 383
Mack v Lenton [1993] 32 NSWLR 259 ... 17
Maggbury Pty Ltd v Hafele Aust Pty Ltd (2001) 210 CLR 181 ... 86
Mahoney v FCT (1967) 41 ALJR 232 ... 202
Makrylos v FCT [2023] FCA 971 ... 178
Maks v Maks [1986] 6 NSWLR 34 ... 17, 207, 338
Malayan Shipping Co Ltd v FCT [1946] HCA 7 ... 122
Mantovani v Vanta Pty Ltd (No. 2) [2021] VSC 771 ... 14, 207, 337, 338, 492, 493
Manzi v Smith [1975] HCA 36 ... 343
Marion Elizabeth Collis v FCT [1996] FCA 1717 ... 133
Masters v Cameron [1954] HCA 72 ... 181, 183
McCormack v FCT [1979] HCA 18 ... 386
McDonald v FCT [2001] FCA 305 ... 183
McFadden v Public Trustee for Victoria [1981] 1 NSWLR 15 ... 49
McGowan & Valentini Trusts, Re [2021] VSC 154 ... 497
McIntosh v McIntosh [2014] QSC 99 ... 49, 143
McLean v FCT (No. 2) (1997) 78 FCR 140 ... 444
McPartland v FCT [2023] FCA 1260 ... 307
Minister for Immigration and Ethnic Affairs v Teoh (1995) 183 CLR 273 ... 30
Minister of National Revenue v Merritt [1969] CTC 207 ... 132
Moignard; FCT v [2015] FCA 143 ... 386
Moorhouse v Dooland [1955] Ch 284 ... 445
Mordecai v Mordecai (1988) 12 NSWLR 58 ... 390
Moreton Resources Ltd v Innovation and Science Australia [2019] FCAFC 120 ... 441
Morton & Morton [2012] FamCA 30 ... 153
Moss v Contracoin Pty Ltd [2023] FCA 976 ... 180, 181
Mulherin v FCT [2013] FCAFC 115 ... 202
Munro v Munro [2015] QSC 61 ... 49, 143
Myer Emporium Ltd; FCT v [1987] HCA 18 ... 312, 314, 315
Mylan Australia Holding Pty Ltd v FCT [2023] FCA 672 ... 282

N

N & M Martin Holdings Pty Ltd v FCT [2020] FCA 1186 ... 248
Narumon Pty Ltd, Re [2018] QSC 185 ... 48, 111
Newton; FCT v (1957) 96 CLR 577 ... 30
Niesmann v Collingridge [1921] HCA 19 ... 182
NQZG and FCT [2020] AATA 379 ... 330, 331, 335
Nyasa No. 19 Pty Ltd, In the Application of [2023] NSWSC 578 ... 17, 18, 493

O

O'Brien v Dawson [1942] HCA 8 ... 182
Ogden & Ogden [2010] FMCAfam 865 ... 153
Ogilvie v Adams [1981] VR 1041 ... 343
Ogilvie v Littleboy (1897) 13 TLR 399 ... 343
Oliver Hume Property Funds (Broad Gully Rd) Diamond Creek Pty Ltd v Commr of State Revenue (Review and Regulation) [2023] VCAT 634 ... 210
Orifici as Executor of the Estate of Rosaria Giuseppe Orifici v Orifici [2007] WASC 74 ... 343
Ormond Investment Co v Betts [1928] AC 143 ... 172
Oswal v FCT [2013] FCA 745 ... 515
Owies Family Trust, Re [2020] VSC 716 ... 495, 496
Owies v JJE Nominees Pty Ltd [2022] VSCA 142 ... 49, 208, 507
Owners of the Ship "Shin Kobe Maru" v Empire Shipping Co Inc [1994] HCA 54 ... 376
Ozone Manufacturing Pty Ltd and FCT [2013] AATA 420 ... 440

P

Papas v Co [2018] NSWSC 1404 ... 343
Paris King Investments Pty Ltd v Rayhill [2006] NSWSC 578 ... 391
Partington v Attorney-General (1869) LR 4 HL 100 ... 172
Pascoe v FCT (1956) 11 ATD 108 ... 315
Pauling's Settlement Trusts, Re [1962] 1 WLR 86 ... 391
Payne; FCT v [2001] HCA 3 ... 65
Pepsi Co, Inc v FCT (unreported, Federal Court, Victorian Registry, 20 to 29 March 2023, VID74/2022) ... 30
Perez; FCT v [2023] FCA 1221 ... 440
Permanent Building Society (in liq) v McGee (1993) 11 ACSR 260 ... 391
Permanent Building Society (in liq) v Wheeler (1994) 11 WAR 187 ... 391
Permanent Trustee Australia Ltd, Re (1997) 137 FLR 190 ... 390, 391
Permewan No. 2, Re [2022] QSC 114 ... 337
Perri v Coolangatta Investments Pty Ltd [1982] HCA 29 ... 182
Peter Greensill Family Co Pty Ltd (Trustee) v FCT [2021] FCAFC 99 ... 248, 497
Pfenning & Snow [2016] FamCA 29 ... 317
Phipps v Boardman [1967] 2 AC 46 ... 30
Pike v FCT [2019] FCA 2185 ... 10
Porlock Pty Ltd, Re [2015] NSWSC 1243 ... 16
Princess Ann of Hesse v Field [1963] NSWR 998 ... 391
Purcell; DCT v (1921) 29 CLR 464 ... 30

Q

QQRK and FCT [2023] AATA 3493 ... 308, 386, 387
Quy and FCT [2024] AATA 245 ... 476

R

Rawson Finances Pty Ltd v FCT [2013] FCAFC 26 ... 65
Rawson Finances Pty Ltd; FCT v [2023] FCA 617 ... 65
Regal (Hastings) Ltd v Gulliver [1967] 2 AC 134 ... 390, 391
Reseck v FCT (1975) 133 CLR 45 ... 335
Reuter v FCT (1993) 111 ALR 716 ... 335
Robinson v FCT [1927] HCA 8 ... 510
Rosati v Rosati [1998] FLC ¶92-804 ... 317
Ross; FCT v [2021] FCA 766 ... 386, 387
Rossiter v Miller [1877] UKLawRpCh 168 ... 182
Royal Botanic Gardens and Domain Trust v South Sydney City Council [2002] HCA 5 ... 507
Rozman; FCT v [2010] FCA 324 ... 157
Russell and Dunphy v Dunphy [2023] NSWSC 282 ... 340

S

Sage v FCT [2023] FCA 1247 ... 301
SCCASP Holdings Pty Ltd as trustee for the H&R Super Fund v FCT [2013] FCAFC 45 ... 202
Schmidt v Rosewood Trust Ltd [2003] 2 AC 709 ... 391
Schmierer v Taouk [2004] NSWSC 345 ... 343
Scott v FCT (No. 2) (1966) 10 AITR 290 ... 202
Scott v FCT [1966] HCA 48 ... 335, 442, 444, 445
Scott v National Trust for Places of Historic Interest or Natural Beauty [1998] 2 All ER 705 ... 507
Simplot Australia Pty Ltd v FCT [2023] FCA 1115 ... 228
Sinclair, Scott & Co Ltd v Naughton [1929] HCA 34 ... 182
Smith v FCT [1987] HCA 48 ... 445
Sole Luna Pty Ltd as Trustee for the PA Wade No. 2 Settlement Trust v FCT [2019] FCA 1195 ... 202
Sparkling Beverages Pty Ltd (No. 2), Re [2023] VSC 419 ... 183
Speight v Gaunt (1883) 9 App Cas 1 ... 391
Spellson v George (1987) 11 NSWLR 300 ... 391
Spellson v George (1992) 26 NSWLR 666 ... 391
Spencer v Commonwealth (1907) 5 CLR 418 ... 131
Squatting Investment Co Ltd v FCT [1953] HCA 13 ... 445
Steiner v Strang [2016] NSWSC 395 ... 343
Stock v NM Superannuation Pty Ltd [2015] FCA 612 ... 141
Stone; FCT v [2005] HCA 21 ... 445
Summergreene v Parker [1950] HCA 13 ... 182
Sunlite Australia Pty Ltd v FCT [2023] FCAFC 43 ... 378, 439, 441

T

Taffner v Taffner [2021] FamCAFC 68 ... 317
Tambakeras v UniSuper Ltd [2022] NSWSC 1162 ... 508
Tasman Group Services Pty Ltd; FCT v [2009] FCAFC 148 ... 336
Tatham v Huxtable (1950) 81 CLR 639 ... 154
Tawfik and FCT [2023] AATA 2541 ... 169
Tax Practitioners Board v Van Stroe (No. 2) [2023] FCA 1533 ... 371
TDS Biz Pty Ltd and FCT [2022] AATA 3543 ... 437
TDS Biz Pty Ltd v FCT [2023] FCA 710 ... 437
Tech Mahindra Ltd v FCT [2015] FCA 1082 ... 86
The Bell Group Ltd (in liq) v Westpac Banking Corporation (No. 9) [2008] WASC 239 ... 391
The Counsellor and FCT [2024] AATA 220 ... 476
Traknew Holdings Pty Ltd, Re v FCT [1991] FCA 129 ... 156, 157, 190
Transvaal Lands Co v New Belgium (Transvaal) Lands and Development Co [1914] 2 Ch 488 ... 390
Trautwein v FCT [1936] HCA 77 ... 386
Trustee for the Estate of the late AW Furse No. 5 Will Trust v FCT (1991) 21 ATR 1123 ... 131
Trustees of the Property of John Daniel Cummins v Cummins [2006] HCA 6 ... 508
Twigg v Twigg [2022] NSWCA 68 ... 494

U

Union Fidelity Trustee Co of Australia Ltd v FCT [1969] HCA 36 ... 189, 194, 244

V

Valuer-General Victoria v AWF Prop Co 2 Pty Ltd (2021) 65 VR 327 ... 322
Vanderstock v Victoria [2023] HCA 30 ... 304, 320–323
Vanta Pty Ltd v Mantovani [2023] VSCA 53 ... 14, 17, 207, 208, 338, 507
Visy Packaging Holdings Pty Ltd v FCT [2012] FCA 1195 ... 315
Voce v Deloraine [2012] NSWSC 1187 ... 343
Von Hatzfeldt-Wildenburg v Alexander [1911] UKLawRpCh 90 ... 182

W

W & J Investments Pty Ltd v FCT [1989] FCA 415 ... 183
Wade; FCT v [1951] HCA 66 ... 509–511
Walters v Perton (Costs) [2023] VSC 380 ... 508
Walters v Perton [2023] VSC 37 ... 497
Wareham v Marsella [2020] VSCA 92 ... 507
Warman International Ltd v Dwyer [1995] HCA 18 ... 390, 391
Webb v McCracken (1906) 3 CLR 1018 ... 111
Western Australian Trustee Executor & Agency Co Ltd v Commr of State Taxation (WA) [1980] HCA 50 ... 30
Westraders Pty Ltd; FCT v [1980] HCA 24 ... 172
Whiting; FCT v [1943] HCA 45 ... 244
Widdup v DCT [2023] FCAFC 145 ... 177
Wilkinson v Clerical Administrative and Related Employees Superannuation Pty Ltd (1998) 79 FCR 469 ... 507
Williams v Williams [2023] QSC 90 ... 47
Willmington Investments Pty Ltd v Sarich [2023] WASC 191 ... 18, 343
Wood; FCT v [2023] FCA 574 ... 11
Woodcock & Woodcock (No. 2) [2022] FedCFamC1F 173 ... 153, 508
Woodcock & Woodcock [2021] FedCFamC1F 88 ... 505
Wooster v Morris [2013] VSC 594 ... 143

X

XQDX and FCT [2021] AATA 4070 ... 441

Y

Yap v Lee [2019] VSC 743 ... 207
Yazbek v FCT [2013] FCA 39 ... 202

Ying v Song [2010] NSWSC 1500............343
York Street Mezzanine Pty Ltd (in liq), Re [2007] FCA 922............343
Youyang Pty Ltd v Minter Ellison Morris Fletcher [2003] HCA 15............343

Z
Zeta Force Pty Ltd v FCT [1998] FCA 728............202, 446
ZG Operations Australia Pty Ltd v Jamsek [2022] HCA 2............450, 452

Authors

A
Abdalla, J
The changing face of tax practitioner obligations............427
Senior Tax Counsel's Report
- 2023: a recap............304
- Design, consultation and time....60
- Interpretation of tax law............172
- Retrospective tax legislation.....366

Abraham, T
A Matter of Trusts
- State trust surcharges invalid?............102

B
Barnes, J
The proposed intangibles anti-avoidance rule............26
Bembrick, P
Mid Market Focus
- CGT and the main residence exemption............76

Bishop, G
Vanderstock and the future of federal–state tax powers............320
Brydges, N
The CGT main residence exemption: tips and traps............254
A Matter of Trusts
- Section 99B: is it safe to go back in the water?............156

Burgess, M
Tax and estate planning in 2024: what's "hot" right now?............337
Burnett, C
Intangible integrity intensity............82
Butler, D
Superannuation
- Draft NALE legislation released............50
- Employee or contractor – new ATO guidance: part 5............450
- Family law superannuation splitting notices............349
- How the NALI and the CGT provisions interact............158
- New 15% tax on $3m+ member super balances............285
- Pending NALE changes place SMSFs at risk............392
- SMSF staff discount policy: do you have one?............516
- SMSFs and voluntary disclosure to the ATO............106
- Transfer duty on property investments............210

C
Chek, A
Vanderstock and the future of federal–state tax powers............320
Chitnis, G
Mid Market Focus
- CGT roll-overs and tax consolidation for SMEs............135

Chye, J
Mid Market Focus
- Unrealised tax liabilities in family law settlements............317

Cullen, R
Alternative Assets Insights
- Victorian tax reform: an update............453

D
Day, C
The rules behind the NALI and NALE acronyms............96
Donlan, T
Successful Succession
- Gifts made by an attorney............109

Dunne, C
Due diligence, tax structuring done … what next?............39

E
Esmerian, A
Alternative Assets Insights
- Victorian tax reform: an update............453

F
Fettes, W
Superannuation
- Family law superannuation splitting notices............349
- SMSF staff discount policy: do you have one?............516
- SMSFs and voluntary disclosure to the ATO............106

Figot, B
Superannuation
- Draft NALE legislation released............50
- How the NALI and the CGT provisions interact............158

Freshwater, L
Deceased estate taxation: Frankenstein's monster?............243
Fullarton, L
Tax accounting and livestock in Australia............509

G
Gandhi, N
Mid Market Focus
- Last chance to claim loss carry back tax offset............185

Gao, J
A Matter of Trusts
- Distribution resolutions and trust income............446

Gasiuk, K
A Matter of Trusts
- Discretionary trusts in tax consolidated groups............345

Goodwin, R
Changes to the thin capitalisation rules............274

H
Hanna, N
Default assessments: the "all or nothing approach"............383
Harnischmacher, J
A Matter of Trusts
- Trust law principles and challenging BDBNs............47

Hendriks, M
Member Spotlight............485
Hennebry, E
The CGT main residence exemption: tips and traps............254
A Matter of Trusts
- Bare trusts, resulting trusts and dealings in land............513

J
Jacobson, R
In our sights at the start of a new financial year............32

K
Krishnan, S
Associate's Report
- Central management and control............122
- The OECD's Two-Pillar Solution............472

L
Lang, S
Vanderstock and the future of federal–state tax powers............320

M
Manapakkam, A
Successful Succession
- Death and the small business CGT concessions............288

Marshall, M
President's Report
- Local engagement, local connections............170
- New leadership to move us forward............222
- Tapped into the world of tax............4
- The Tax Summit: bigger, brighter and better than ever.....120
- Time to prioritise working well.....58
- A year of investment and connection............302

Mazzetti, C
CEO's Report
- The path toward our goals............171
- Reaching new heights at The Tax Summit............121
- You're at the heart of the Institute............59
- Your CPD for the rest of the year............5

Monotti, W
A Matter of Trusts
- Lost trust deeds: consequences for trustees............207

N
Ng, E
Changes to the thin capitalisation rules............274

P
Pace, S
Due diligence, tax structuring done … what next?............39
Peskett, T
Mid Market Focus
- Small business CGT: asset versus share sale............21

Pinto, D
Tax accounting and livestock in Australia............509
Psarrakos, G
Section 99B: implications for Australian beneficiaries............189

R
Raspin, I
Deceased estate taxation: Frankenstein's monster?............243
Ru, Y
Redefining the taxation of gifts......442
Russo, G
Trusts and distributions: avoiding disasters............487

S
Schaefer, S
SMSFs and death benefit payments............141
Shekhawat, A
Associate's Report
- Designing better integrity provisions............410
- Harmonising property taxes............6
- Setting the framework for superannuation stability............224

Smith, T
Mid Market Focus
- Early-stage innovation company scheme............238

Speed, P
Complications with trustee duties............388
Stead, F
Superannuation
- Employee or contractor – new ATO guidance: part 5............450
- SMSF staff discount policy: do you have one?............516
- Transfer duty on property investments............210

Steed, J
Conditions of release............87
Stein, K
Self-coaching your way to bust your busyness............204
Streeter, M
Testamentary discretionary trusts: practical implications............147
Suraweera, A
Vanderstock and the future of federal–state tax powers............320

T
TaxCounsel Pty Ltd
Tax News – what happened in tax?
- June 2023............8
- July 2023............62
- August 2023............124
- September 2023............174
- October 2023............225
- November 2023............306
- December 2023............368
- February 2024............412
- March 2024............474

Tax Tips
- Arm's length issues............129
- CGT: dwelling acquired by deceased estate............418
- Code breaches: new notification obligations............375
- Connected entity issues............70
- Contract timing issues............180
- Isolated transaction: deductible loss............312
- Lost trust deeds: "clear and convincing" proof?............14
- Main residence exemption: relationship roll-over............479
- Vacant land deductions............231

Thomas, E
Deferred consideration............325
Thompson, K
Member Spotlight............381
Tian, T
Vanderstock and the future of federal–state tax powers............320
Treatt, S
CEO's Report
- 2023: challenges, triumphs and future opportunities............303
- Acting on your feedback............471
- Have your say on our future plans............365
- Leading and listening as CEO of the Institute............223
- Shaping changes to our tax system............409

W
Want, T
President's Report
- Be active in shaping your legacy............408
- Continuing development at the Institute............470
- The Institute is what we make it............364

Wood, L
Ten things I hate about your R&D claim............434
Wu, T
The proposed intangibles anti-avoidance rule............26

Y
Yuan, H
Mid Market Focus
- Family trust elections: risks and pitfalls............422

Giving back to the profession

The Tax Institute would like to thank the following presenters from our March 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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