THE JOURNAL FOR MEMBERS OF THE TAX INSTITUTE

Taxation in Australia

VOL 54(4) OCT 2019

The black economy measures: how they affect you and your clients

Paul Banister, CTA

ATO perspective on large super funds

Nadia Alfonsi and Chris Thomson

Are all dwellings "substantial and permanent structures"?

David Krunic, CTA

THE TAX INSTITUTE

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Invitation to write

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Tax News – at a glance

by TaxCounsel Pty Ltd

September – what happened in tax?

The following points highlight important federal tax developments that occurred during September 2019. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 166 (at the item number indicated).

Review of corporate residency rules

The Treasurer has requested the Board of Taxation to conduct a review of the operation of Australia's corporate tax residency rules. **See item 1.**

Tax incentives: early stage investors

The Commissioner has issued a draft determination which considers what is meant by an "expense" that is "incurred" for the purposes of the definition of an "early stage innovation company" in s 360-40 ITAA97 (TD 2019/D5). **See item 2.**

Foreign resident capital gains

A draft determination that was recently released by the Commissioner is to the effect that Subdiv 855-A ITAA97 (disregarding a capital gain or loss by foreign residents) does not disregard a capital gain that a foreign resident beneficiary of a resident non-fixed trust makes because of s 115-215(3) ITAA97 (TD 2019/D6). **See item 3.**

Source concept and non-resident beneficiary

A draft determination that has been issued by the Commissioner is to the effect that the source concept in Div 6 ITAA36 is not relevant when determining whether a non-resident beneficiary of a resident trust (or trustee for them) is assessed on an amount of a trust capital gain arising under Subdiv 115-C ITAA36 (TD 2019/D7). **See item 4.**

Personal services income

In two decisions handed down on 12 August 2018 on appeals by taxpayers from decisions of the AAT, Griffiths J considered the operation of the results test and the unrelated clients test that apply under the personal services income rules (*Douglass v FCT* [2019] FCA 1246 (results test) and *Fortunatow v FCT* [2019] FCA 1247 (unrelated clients test)). **See item 5.**

Income split unsuccessful

The AAT has upheld amended assessments that were issued by the Commissioner on the basis that an individual taxpayer, an information technology specialist, was assessable on the whole of his earnings despite arrangements which sought to split the income as to 30% to his spouse (*Ariss and FCT* [2019] AATA 2958). **See item 6.**

Foreign income tax offset

The Full Federal Court has by majority (Steward and Jackson JJ, Logan J dissenting) affirmed the decision of McKerracher J at first instance that an assessment, issued by the Commissioner to the taxpayer on the basis that he was not entitled to a foreign income tax offset in respect of US tax paid on the discount component of a capital gain, was correct (*Burton v FCT* [2019] FCAFC 141). **See item 7.**

Loans and penalties

The recent decision of Steward J in *Sole Luna Pty Ltd as Trustee for the PA Wade No. 2 Settlement Trust v FCT* [2019] FCA 1195 considers a number of issues relating to loans, including fundamentally whether loans did exist, and also reasonable care and reasonably arguable issues relating to penalties. The decision is considered in the Tax Tips column in this issue of the journal. **See page 170.**

President's Report

by Tim Neilson, CTA

A nation of (sometimes reluctant) gamblers

President Tim Neilson on living with risk.

October is the month when the Spring Racing Carnival gets into gear, when many Australians, who would otherwise never gamble, study the form guides and place a bet — and mostly lose.

Risk-taking isn't always bad. A willingness to take risks, at least by risking time and effort, was an essential catalyst at the start of most successful businesses and enterprises. I read somewhere that, back in the 19th century, one of the founders of BHP lost a sixteenth of the company on a hand of cards — but if he and his colleagues hadn't had that kind of mentality, the "Big Australian" may never have come into existence.

As participants in the tax system, most of us spend a lot of time trying to calculate and mitigate tax risks. Some taxpayers bring a considerable tolerance of risk to their tax strategies, but most of us work primarily for people or organisations aiming for "no surprises" from tax. And even those who are happy to take on risk usually prefer it to be calculated risk.

That's one of the reasons why The Tax Institute has always argued against retrospective tax laws, at least where there's any possibility of retrospective detriment to taxpayers. Of course, retrospective detriment is simply unjust, but it also discourages productive activity because it distorts the calculation of the risks and rewards of the activity toward higher risk, and thus towards a decision not to proceed.

Retrospective legislation is not the only type of tax risk that taxpayers can face. Lack of clarity in the tax laws is another. Recently, we reiterated (this time to the Senate Economics Legislation Committee) our concerns about the dangers of the proposed legislation denying deductions in relation to "vacant land", including dangers arising from lack of clarity about what "land" is meant to be considered, and what constitutes it being "vacant". At the time of writing, I don't know whether we've had any success.

Taxpayers can also face uncertainty with regard to the way in which tax laws will be administered. The Tax Institute has sometimes disagreed with the ATO about what does or does not constitute a so-called "U-turn" by the ATO, but it is clear (for example, from PS LA 2011/27) that the ATO has gone to some lengths to address the issues that arise when it proposes to adopt a view which others in the tax community might have had good reason not to anticipate. This is obviously a difficult issue for the ATO, which has a duty to apply the law, but which is also charged with exercising the Commissioner's general power of administration.

Even where there's no question of a "U-turn", there can be genuine disagreements about interpretation. Taxpayers and advisers who have thought "the law can't possibly mean that" can urge the ATO to adopt a pragmatic approach to some anomaly, and the ATO may believe that its powers just don't extend that far. At a recent NTLG meeting, there was a discussion of the Commissioner's statutory remedial power. There have been very few exercises of that power, which invites the question as to whether it is operating as intended. The low number of uses of it is explicable in the context of the power as it currently exists, but perhaps the scope of the power needs to be reviewed.

Risks don't arise solely from inherent uncertainties. President George W Bush's adviser Donald Rumsfeld was pilloried, unjustifiably in my view, for distinguishing between "known unknowns" and "unknown unknowns". "Known unknowns" are quite easy to deal with for those of us who have the luxury of being mere advisers — we can just write an advice saying "the matter is not free from doubt, but in our view the better view is" etc. "Unknown unknowns" are far more dangerous, and of course by their nature are inherently difficult to protect oneself against. One of the biggest problems is just the sheer volume of legislation, extrinsic materials, case law and other guidance materials, and the risk that somewhere deeply buried is one small section or pronouncement that changes everything.

We can't eliminate that risk, but we can mitigate it. That's a big part of the value of being involved with the Institute. Perhaps I shouldn't admit this: I don't click every link in *TaxVine* and I don't always thoroughly read every article in the blue journal, but I always scan them in case there's something that may update or improve my knowledge … and there usually is.

And, of course, as an Institute member, you get to hear from the best experts in tax at Institute events, and perhaps even get to ask them the question that's been preying on your mind.

October and November are Spring Racing Carnival months, but they are also big months for Tax Institute events. So, in addition to increasing your risk by putting your trust in horses, why not reduce a whole lot of uncertainties by getting together with fellow Institute members at an Institute event? I can assure you that they're a good investment.

CEO's Report

by Giles Hurst

'Tis the season for CPD

CEO Giles Hurst on what's coming up at The Tax Institute.

As the weather slowly becomes warmer, it is events season here at the Institute. As always, our CPD teams are working hard with our volunteer network and committees to deliver first-class events for members and the tax profession.

October offers a wide range of exciting events, including the Victorian 7th Annual Tax Forum which will feature topical issues in Div 7A, M&A updates, and current issues from the ATO (and much more).

The Tasmanian State Convention remains the state's premier taxation event, with a focus on a broad range of tax issues confronting professionals.

The South Australian Tax Intensive will be a fantastic forum of small, highly interactive discussion groups working through practical case studies relevant to SME clients.

In its fifth year now, the WA Tax Intensive offers an interactive program dedicated to ensuring that attendees leave with the practical knowledge they need to provide immediate value to their firms and clients.

The undeniable popularity of the Noosa Tax Intensive sees it become a member-only event for the first time. I am confident that the event will once again generate the usual compelling and insightful discussions in the SME segment.

I look forward to seeing you at one, if not all, of these exciting events!

AOTCA conference

October sees the 17th General Meeting of the Asia Oceania Tax Consultants' Association (AOTCA) and the AOTCA International Tax Conference take place in Busan, Korea. Professional bodies from across our region will converge to discuss the common challenges that face tax professionals across the many countries that make up this body.

The Tax Institute will be formally represented by our 2018 president, Tracey Rens, CTA. However, she will be joined by other members of the Institute as we seek to ensure that Australia continues to take a more active and energetic role in regional activities on behalf of our profession.

The Tax Summit 2020

By now you will know about the significant enhancements we are making to The Tax Institute's flagship event held in March next year. This "combined" event will bring you the very best of two of our most popular events: the National Convention and the NSW Tax Forum. To be held at the International Convention Centre in Sydney, The Tax Summit 2020 will redefine the role that the Institute plays in tax here in Australia. More than 60 sessions will be delivered by local and global tax experts, across SME, corporate and hot topic streams. The Tax Summit also includes keynote sessions and four new streams: professional practice, emerging leaders, international, and technology.

It will be substantially bigger than anything we will have witnessed before at The Tax Institute, while maintaining the popular networking opportunities that these two events have become known for, including the welcome reception and, of course, our gala dinner featuring The Tax Adviser of the Year Awards.

I would like to take this opportunity to express how thrilled I am at the response for the 2020 tax awards. Recognising the hard work of professionals across the tax landscape is essential for nurturing and developing the leaders of the future. There is already no doubt that this year's awards will be very memorable.

TPB review

Our Tax Policy and Advocacy team has been working tirelessly behind the scenes in relation to the review of the Tax Practitioners Board. This is one of the most significant reviews to affect our registered agent members, and we have invested significant resources to ensure that we have consulted widely with members to gather relevant feedback and insights.

The Institute has also attended numerous stakeholder meetings, along with all affected parties and numerous members of National Council. I also met separately with the chair and deputy chair of the review. I want to thank volunteers and our Tax Policy and Advocacy team for being so generous with their time and expertise. I have no doubt that we have done everything possible to contribute to the enrichment of the review and now await the report, the delivery of which will be made to the government at the end of October.

Tax Counsel's Report

by Angie Ananda, CTA

Tax debt disclosure

Under proposed changes, the ATO will be able to report tax debts of at least $100,000 that have been outstanding for more than 90 days to credit reporting bureaus.

A controversial topic that has been front of mind recently is the ATO's power to disclose certain tax debt information to credit reporting bureaus.

This is a power that has the potential to have extremely detrimental effects on taxpayers and small businesses if not administered properly.

Given the potential detrimental effects, one has to ask whether such a power is justified.

Legislation permitting disclosure

The *Taxation Administration (Tax Debt Information Disclosure) Declaration 2019* (the Declaration) declares the classes of entities whose tax debt information may be disclosed to credit reporting bureaus by the ATO under s 355-72(1) of Sch 1 to the *Taxation Administration Act 1953* (Cth) (TAA).

The Declaration provides that the following entities fall within the declared class of entities:

- entities that are registered in the Australian Business Register, other than as deductible gift recipients, complying superannuation funds, registered charities or government entities; and
- entities that have one or more tax debts, the total of which is at least $100,000, that have been overdue for more than 90 days.

The Declaration provides that a tax debt will not contribute to the tax debt threshold to the extent that the entity is formally disputing a decision in relation to the debt. Only an active dispute will result in the tax debt not contributing to meeting the tax debt threshold. An active dispute might involve:

- lodging a taxation objection;
- applying for a review of an objection decision with the Administrative Appeals Tribunal or appealing to the Federal Court against an objection decision; or
- making a complaint to the Inspector-General of Taxation that is, or could be, the subject of an investigation under the *Inspector-General of Taxation Act 2003*.

The Institute's position

The Tax Institute has recently prepared a submission to the Senate Economics Legislation Commission in relation to their inquiry into Treasury Laws Amendment (2019 Tax Integrity and Other Measures No. 1) Bill 2019 (Bill).

In this submission, The Tax Institute strongly opposed the tax debt disclosure provisions. The Institute took the position that the current proposal does not provide adequate checks and balances. Given the potential detriment that can be caused as a result of the application of the provisions, more checks and balances are required.

Further, the provisions need to provide clear and adequate remedies and compensation if a mistake is made and an incorrect report is made to a credit bureau.

The Institute raised the following issues:

- given the potential detriment of being reported to a credit bureau, there needs to be more checks and balances;
- the approach taken in New Zealand in relation to tax debt disclosures should be considered. In New Zealand, all the thresholds are higher than those proposed in Australia. For example, debts need to be outstanding for 12 months and notice periods are longer. The Institute questioned why the proposed Australian thresholds are all much lower than in New Zealand;
- under the provisions, the ATO can report debts unless the taxpayer is disputing the debt under Pt IVC TAA. The proposed provisions do not provide for the fact that some debts cannot be disputed via Pt IVC. For example, the proposed provisions would permit reporting where the disputed amount relates to PAYG(W), estimates of PAYG(W), estimates of GST and director penalty notices. These examples cannot be disputed through Pt IVC. The provisions should prevent the reporting of a debt unless the taxpayer has had adequate opportunity to dispute the debt and has failed to do so (or the dispute action has failed); and
- the Institute also noted that the proposed notice period of 21 days is unlikely to be sufficient.

Conclusion

Given the potential impact of the tax debt disclosure provisions, it is surprising that there has not been more debate in relation to the measures.

Personally, I do not think the ends justify the means in relation to this issue. In addition to more checks and balances, the issue of compensation needs to be addressed. Mistakes happen and given the potentially detrimental effects of these measures, the issue of compensation needs to be addressed.

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Tax News – the details

by TaxCounsel Pty Ltd

September – what happened in tax?

The following points highlight important federal tax developments that occurred during September 2019.

Government initiatives

1. Review of corporate residency rules

The Treasurer has requested the Board of Taxation to conduct a review of the operation of Australia's corporate tax residency rules.

The purpose of the review is to ensure that these rules are operating appropriately, in light of modern, international, commercial board practices and international tax integrity rules.

The terms of reference set out by the Treasurer are for the board to consider whether the existing rules:

- minimise commercial uncertainty and ambiguity;
- are consistent, and aligned, with modern day corporate board practices;
- protect the tax system against multinational profit shifting; and
- otherwise support Australia's tax integrity rules as they apply to multinational corporations.

The board has been asked to report back to the government before 31 December 2019. The board expects to issue a consultation paper shortly and to conduct round table discussions in Melbourne, Sydney and Perth.

The Commissioner's perspective

2. Tax incentives: early stage investors

The Commissioner has issued a draft determination which considers what is meant by an "expense" that is "incurred" for the purposes of the definition of an "early stage innovation company" in s 360-40 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) (TD 2019/D5).

Under the expense tests in s 360-40(1)(a)(ii) and (1)(b), the company in which the investor is investing must only take into account "expenses" which have been "incurred" as at the test time.

The draft determination states that in these provisions:

- expenses are amounts recognised as expenses under general accounting concepts;
- "incurred" has the same meaning as for the purposes of the general deduction provision (s 8-1 ITAA97); and
- test time means the time immediately after the company has issued shares to the investor.

The draft determination also states that, as a practical matter, the Commissioner considers there is low compliance risk in a company and its investors relying on the amount reported as "total expenses" in the company tax return, without separately identifying whether those expenses have been "incurred" in the tax sense. Accordingly, the Commissioner would not ordinarily devote compliance resources to query or adjust the company's incurred total expenses that use the reported amount of total expenses in the company's tax return. However, compliance action may be taken to verify that the amount of total expenses reported in the tax return is correct.

Also, if the Commissioner is asked to amend an assessment or required to state a view (for example, in a private ruling or in submissions in a litigation matter), the Commissioner will act consistently with the views set out in the draft determination.

3. Foreign resident capital gains

A draft determination that was recently released by the Commissioner is to the effect that Subdiv 855-A ITAA97 (disregarding a capital gain or loss by foreign residents) does not disregard a capital gain that a foreign resident beneficiary of a resident non-fixed trust makes because of s 115-215(3) ITAA97 (TD 2019/D6).

The draft determination points out that s 855-40 ITAA97 only disregards a capital gain that a foreign resident beneficiary makes because of s 115-215(3) if the trust is a fixed trust. Section 855-10 ITAA97 does not disregard a capital gain that a foreign resident (or temporary resident) beneficiary of a resident trust makes because of s 115-215(3).

The position is the same in the case of a temporary resident (s 768-915(1) ITAA97).

The draft determination does not deal with the application of Australia's double tax agreements.

Example (from TD 2019/D6)

During the 2016 income year, the trustee of a resident discretionary trust derived income from a business. The trustee also made non-discount capital gains from the sale of 5,000 listed shares that it had owned for less than 12 months. The shares were not taxable Australian property. The trustee resolved to make a foreign resident beneficiary presently entitled to all of the trust income (in this case, the business income).

On these facts, as there was no beneficiary specifically entitled to any of the trust gains, all of the gains will be attributable to the foreign resident beneficiary. Section 115-220 ITAA97 will operate so that the trustee is assessed under s 98(3) of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) on the beneficiary's attributable capital gain.

The foreign resident beneficiary is also taken to have made capital gains under s 115-215(3). The beneficiary will receive a refundable tax offset under s 98A(2) ITAA36 for tax paid by the trustee.

Example (from TD 2019/D6) (cont)

As the trust is not a fixed trust, s 855-40 does not apply to disregard the foreign resident beneficiary's capital gain attributable to the non-TAP trust assets. Nor does that section apply to disregard the capital gain which the foreign resident beneficiary is taken by Subdiv 115-C ITAA97 to have made.

4. Source concept and non-resident beneficiary

A draft determination that has been issued by the Commissioner is to the effect that the source concept in Div 6 ITAA36 is not relevant when determining whether a non-resident beneficiary of a resident trust (or trustee for them) is assessed on an amount of a trust capital gain arising under Subdiv 115-C ITAA36 (TD 2019/D7).

For the purposes of the draft determination, the phrase "source concept" refers to the limitation in Div 6 on the assessment of non-residents (or trustees) to amounts "attributable to sources in Australia".

The same view applies in relation to a non-resident beneficiary's share of "taxable Australian property" gains of a non-resident trust and a trustee's share of a capital gain to which s 115-222 ITAA97 applies.

The draft determination does not deal with the application of Australia's double taxation agreements.

Example 1 (from TD 2019/D7)

The OZ Trust is a resident non-fixed trust estate. The trustee of the trust holds shares in a land-rich Australian company (LandCo) and shares in an Australian company that owns no taxable Australian property (OtherCo). The trustee sells all the shares by contract executed in the United Kingdom in the 2014 income year and makes non-discount capital gains totalling $70,000 and $30,000, respectively.

Pursuant to the trust deed, the trustee resolves to treat the gains as income of the trust for that year. There is no other trust income. The trustee further resolves to make Edward, a non-resident beneficiary who is not under a legal disability, presently entitled to 100% of the trust income.

The trustee is assessed under s 98 ITAA36 on the $100,000 of trust capital gains attributable to Edward. The source concept in s 98(2A) has no application in relation to these capital gains as s 115-220 increases the amount assessable to the trustee under s 98 without regard to those conditions.

Capital gains totalling $100,000 are included in the calculation of Edward's net capital gain for the income year. However, Edward is entitled to a refundable tax offset for the tax the trustee paid on his behalf under s 98A(2).

The same outcome would arise if the trustee did not treat the gains as income but Edward was made specifically entitled to the amounts of capital gains.

Example 2 (from TD 2019/D7)

If the trust had instead been a fixed trust, Edward may be able to access the exemption in s 855-40 to disregard the capital gain of $30,000 in relation to the shares in OtherCo.

Recent case decisions

5. Personal services income

In two decisions handed down on 12 August 2018 on appeals by taxpayers from decisions of the AAT, Griffiths J considered the operation of the results test and the unrelated clients test that apply under the personal services income rules (*Douglass v FCT*[1] (results test) and *Fortunatow v FCT*[2] (unrelated clients test)).

Results test

In the *Douglass* case, the taxpayer was an electronics engineer who, during the relevant income years (2013 and 2014), provided services through a partnership with his wife (partnership). The services related to his role as a "lead engineer" at Port Hedland harbour in respect of a project being carried out by BHP Billiton to expand its iron ore operations in the Pilbara region of Western Australia. The income of the partnership for the relevant income years were included by the Commissioner in the taxpayer's assessable income on the basis that it was his "personal services income" within the meaning of s 86-15(1) ITAA97.

The taxpayer objected on the basis that, during the relevant income years, the partnership was carrying on a "personal services business" within the meaning of s 86-15(3). This issue turned on whether the partnership met one or more of the "personal service business tests" in s 87-15(2) ITAA97. Relevantly, the taxpayer contended that the partnership satisfied the "results test" in s 87-18(3) ITAA97. On review, the AAT rejected the taxpayer's contentions and concluded that the partnership did not meet any of the three criteria of the "results test".

Griffiths J upheld the decision of the AAT.

Unrelated clients test

In the *Fortunatow* case, the taxpayer was a business analyst and was at all relevant times the sole director of Fortunatow Pty Ltd (the company). Through contracts between the company and various recruitment or similar agencies, the taxpayer was engaged to provide services to organisations such as government departments, utilities, defence contractors, universities, banks and large corporations. In the income years 2012 and 2013, income of approximately $166,000 and $121,000 respectively was returned in the company's income tax returns. The income related to the provision of the taxpayer's personal services to eight different end clients during those two taxation years. No remuneration was paid by the company to the taxpayer and he returned no income in his personal income tax returns for the relevant years.

The company transferred income generated by the taxpayer's personal services to the Fortunatow Family Trust (the family trust), which was characterised as "management fees" payable to the family trust. These fees were claimed as

deductions and had the effect of reducing the company's taxable income to nil. The trust income was offset against the trust's rental losses.

The taxpayer contended that he met the requirement in s 87-20(1)(b) ITAA97 (that the individual or personal services entity made offers or invitations to the public at large or to a section of the public to provide the relevant services) because of his active profile on LinkedIn and his marketing by word of mouth at industry functions. He said that he kept his LinkedIn profile up to date and that he included a note that the company would be available for a new assignment on a certain date, namely after completion of his current assignment. The taxpayer contended that his LinkedIn profile was a form of advertising.

Although the AAT accepted that the taxpayer's advertising on LinkedIn constituted the making of an offer or invitation to the public, it concluded that s 87-20(2) operated to deny the taxpayer's claim. That subsection provides that the individual or personal services entity is not treated, for the purposes of para (1)(b), as having made offers or invitations to provide services merely by being available to provide the services through an entity that conducts a business of arranging for persons to provide services directly for clients of the entity.

Griffiths J accepted the taxpayer's submission that s 87-20(2) only concerns itself with the issue arising under s 87-20(1)(b) as to whether "offers or invitations to provide services" have been made. It is not concerned with the separate issue of the provision of services or any causal connection or link between the offers or invitations and the provision of services.

The decision in this case is considered in the Tax Cases column in this issue of the journal (see page 215).

6. Income split unsuccessful

The AAT has upheld amended assessments that were issued by the Commissioner on the basis that an individual taxpayer, an information technology specialist, was assessable on the whole of his earnings despite arrangements which sought to split the income as to 30% to his spouse (*Ariss and FCT*[3]).

The taxpayer was an information technology specialist in software systems designed by Oracle Corporation and provided professional services to large corporations to assist them to manage their supply chains.

In each of the relevant income years, the taxpayer and his spouse lodged income tax returns declaring distributions from the Agency Resource Management Services (Global) Trust (ARMS) as trust income.

The taxpayer was not an employee of ARMS, but rather a "sole trader". He was assisted by his spouse, who worked under his supervision and instruction. There was a tenuous correlation between her hours of work and the 30% of the taxpayer's income that she was allocated. However, the AAT accepted that in busy periods when the taxpayer was paid more, she was likely to have undertaken more work. There was no formal employment relationship or partnership between the taxpayer and his spouse, and she was not an independent contractor.

The taxpayer was paid a daily rate and, although he described working on "projects", his work was not dependent on project completion. The taxpayer was paid regardless of where any "project" was up to, a payment was never delayed if a project was not completed, and he did not have to remedy any defaults at his expense.

The taxpayer undertook his work from a dedicated home office using laptops belonging to the clients to access their networks, in addition to using his own laptops to complete tasks.

The AAT accepted that there was no formal written contract in place between the clients and the taxpayer directly, due to the taxpayer already having established relationships with the clients.

The evidence did, however, tend to suggest that there were standard form consultancy agreements in place between ARMS and the clients. The consultancy agreements did not reflect the reality of the relationship between ARMS and the clients. The taxpayer was not a party to the consultancy agreements (but was named as a "delegate").

The AAT accepted that the taxpayer entered into the arrangement with ARMS to reduce the administrative burden of running a business and to simplify his business administration. The extent of the taxpayer's arrangement with ARMS was that the taxpayer advised ARMS of the number of hours that he had worked for each client; at which point, ARMS invoiced the clients, withheld PAYG and superannuation contributions, and allocated an income split of the 70% to 30% ratio between the taxpayer and his spouse. ARMS only acted as directed by the taxpayer, which was indicative that ARMS was a bare trust.

The taxpayer's spouse did not directly receive any of the money apportioned to her. The amounts apportioned to her went into the business account of the taxpayer.

The AAT held that:

- the distributions from ARMS were the ordinary income of the taxpayer at the time the amounts were paid to ARMS by the clients;
- in the relevant income years, the taxpayer was paid for performing work and providing services, rather than producing a result. Specifically, the taxpayer charged a daily rate regardless of where any "project" was up to. Payment was never delayed if a project was not completed, and the taxpayer did not have to remedy any defaults at his expense. There was no evidence of any custom or practice. Consequently, the taxpayer did not meet the "results" test; and
- the taxpayer was not entitled to a deduction for the amounts paid in respect of his spouse.

Finally, the AAT held that the Commissioner was not statute barred from issuing the amended assessments because of the amendment power conferred where there is a scheme benefit.

7. Foreign income tax offset

The Full Federal Court has by majority (Steward and Jackson JJ, Logan J dissenting) affirmed the decision of McKerracher J at first instance that an assessment, issued

by the Commissioner on the taxpayer on the basis that he was not entitled to a foreign income tax offset in respect of US tax paid on the discount component of a capital gain, was correct (*Burton v FCT*[4]).

The taxpayer's contention was that the foreign income tax offset provisions (Div 770 ITAA97), on their proper construction, contemplated that an amount is "included in" assessable income if it was part of the calculation of assessable income. On this argument, a capital gain was included in assessable income even though it may be subject to a discount or reduced by unrelated capital losses.

McKerracher J rejected the taxpayer's contention.

On appeal, Steward J said that the effect of applying the discount percentage to an amount of a capital gain was to exclude an amount of that gain from inclusion in a taxpayer's assessable income. The concept of what is included in a taxpayer's assessable income is a critical feature of the ITAA97. It forms a vital part of the formula for determining the taxable income on which tax is payable.

Steward J also rejected the taxpayer's contention that he was entitled to relief as a result of art 22(2) of the Australia–US double tax agreement. That contention had also been rejected by McKerracher J at first instance.

Jackson J (who with Steward J formed the majority) expressed his general agreement with Steward J's views but expressed his own reasons in relation to the key question of the proper construction of art 22(2).

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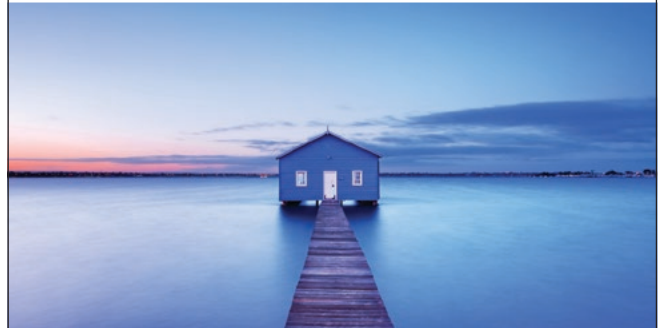
3 [2019] AATA 2958.
4 [2019] FCAFC 141.



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by TaxCounsel Pty Ltd

Were there loans?

A recent decision of the Federal Court dealt with a number of important issues, including whether certain amounts were loans and the operation of aspects of the penalty regime.

Background

The Federal Court decision is that of Steward J in *Sole Luna Pty Ltd as Trustee for the PA Wade No. 2 Settlement Trust v FCT*[1] and the decision considered a range of issues that arose out of alleged foreign currency loans made by the trustee of the PA Wade No.2 Settlement Trust (the Wade Trust). It is said "alleged" foreign currency loans because the Commissioner disputed whether the loans in fact existed and the analysis of Steward J on this issue is of considerable interest and importance.

If the loans existed (as Steward J held was the case), there was an issue of whether the trustee of the Wade Trust incurred a loss (in the 2013 income year) arising from the repayment of the loans that was deductible pursuant to the general deduction provision (s 8-1 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97)) or, alternatively, pursuant to former Div 3B of Pt III of the *Income Tax Assessment Act 1936* (Cth) (ITAA36).

There also arose an issue of whether the trustee of the Wade Trust incurred a capital loss when part of an Australian dollar-denominated loan (the Commissioner denied the existence of such a loan) was forgiven in the 2013 income year.

Finally, there was a question of whether both the trustee of the Wade Trust and Mr Wade were liable to penalties, and, if so, whether the Commissioner erred in law in failing to remit those penalties.

The facts of the case were rather complex and there were a number of issues considered. On the principal issues relevant to the liability of the taxpayers to tax, Steward J held against the taxpayers which then raised for decision whether penalties had been correctly imposed by the Commissioner.

This article discusses one issue relating to the substantive questions, in particular, whether certain alleged loans existed. It also discusses the reasoning of Steward J in relation to the operation of the reasonable care and reasonably arguable concepts in the penalty provisions.

The basic facts

In 1979, Mr Wade, who was born in Australia, established a successful travel agency business in the United Kingdom called "Travelbag". It was owned by a company incorporated in the UK called Travelbag plc. In 1991, Mr Wade sold his shares in that company (which comprised about 50% of its issued capital) to Delphos Holdings Ltd (Delphos) in exchange for 100% of the issued shares (being one share) in Delphos.

In 1998, the Delphos share was transferred to the Wade Trust which was established within the Bailiwick of Guernsey. Among others, Mr Wade was a named beneficiary of that trust. The Wade Trust was initially managed by an accounting firm on the island of Guernsey. In 1999, Mr Wade engaged Mr Phillip Evans (Mr Evans), of the accounting firm Moore Stephens Services SAM (Moore Stephens) in Monaco, to take over the management of the Wade Trust. A new trustee was appointed (Port of Hercules Trustees Ltd (POHTL)).

In 2000, Mr Wade started to spend more time in Australia and, eventually, Australia became his main home. Also in 2000, the trustee of the Wade Trust became the owner of the shares formerly held by Delphos in Travelbag plc. Shortly thereafter, the trustee of the Wade Trust sold some of those shares to a UK company called "3i Group" for £500,000. The trustee of the Wade Trust then transferred the balance of its shares to a company called Travelbag Holdings Ltd (THL) in return for an issue of shares in THL. Certain other original shareholders also transferred their shares in Travelbag plc to THL. In 2003, all of the shares in THL were then sold to another UK company called "Ebookers plc" for £52,380,806. The Wade Trust's share of these proceeds was around £32.4m. The evidence about what the Wade Trust did with this money was described by Steward J as "thin".

It seemed to be accepted that the trustee of the Wade Trust owned a subsidiary company called Starburst Enterprises Ltd (Starburst) which had been incorporated in the British Virgin Islands (BVI). The trustee of the Wade Trust owned another company incorporated in the state of Delaware in the United States called Three Stars, Inc. (Three Stars) and another BVI company called El Condor Ltd (El Condor).

Foreign currency payments to Starburst

It was accepted by the parties that the trustee of the Wade Trust made payments to Starburst between 2002 and 2007 in different currencies. The payments amounted to £16,163,377 (comprising nine payments), US$2,318,356 (comprising four payments) and €5,686,7969 (comprising two payments).

The taxpayers (the trustee of the Wade Trust and Mr Wade) contended that each of these payments constituted a loan made by the Wade Trust to its subsidiary. The Commissioner, however, disagreed and contended that the taxpayers had not shown that the making of each of these payments created a relationship of debtor and creditor. This was an important issue. If the payments were not made by way of loan, the taxpayers would fail in each tax appeal concerning primary tax.

The taxpayers also contended that the trustee of the Wade Trust lent a considerable sum of Australian dollars to Starburst in 2007. Unlike the payments of foreign currency, the Commissioner never conceded that such a payment had been made. The Wade Trust's affairs were migrated to Australia and it became a resident in the 2013 income year.

In its return for the 2013 income year, the trustee of the Wade Trust claimed a deduction of $16,775,094 for a foreign exchange loss that it contended had been realised on the repayment of those parts of the loan or loans expressed in foreign currencies. The tax return also claimed a net capital loss of $4,182,991 which was said to arise from the forgiveness of the balance of the Australian dollar-denominated loan owing by Starburst.

Evidence concerning the nature of the payments

A written loan agreement was eventually entered into on 18 March 2013 by Sole Luna (as lender) and Starburst (as borrower) (the loan agreement). The loan agreement was signed by Mr Wade as a director of Starburst and by Ms Giovanna Faraone, Mr Wade's financial adviser, as sole director of Sole Luna in its capacity as trustee of the Wade Trust. The recitals to this document referred to a loan having been made by advances being made by the lender to the borrower on various dates up to 1 March 2013 and stated that the lender and the borrower had agreed to enter into the agreement to set out the terms and conditions on which the loan was advanced to the borrower.

Steward J said that the recitals were not evidence concerning the nature of the foreign currency and Australian dollar-denominated payments made as described above. Neither Mr Wade nor Ms Faraone were involved in the making of any of those payments. At best, they might reflect the understanding of the parties in 2013 as to what the payments represented. That understanding might be right; it might also be wrong.

The taxpayers also relied on what was stated in various financial statements of the Wade Trust and Starburst. The authenticity of these documents was not in issue, but the Commissioner objected to their admission into evidence.

After quoting the recitals, Steward J said:

> "One starts with the proposition that ordinarily books of account cannot be used to prove the existence of the underlying transactions which give rise to the entries made in them, subject now to the operation of s 1305 of the Corporations Act: see *Potts v Miller* [1940] HCA 453; (1940) 64 CLR 282 at 303 per Dixon J. What the accounts do is measure the financial performance of an entity, and they may usually be tendered as evidence of that performance (again, subject to the operation of s 1305, if applicable). However, for the moment, what is relied upon by the taxpayers is not an entry or entries in the balance sheet or profit and loss statement of the accounts of the Wade Trust, but rather the representation in the notes. If admitted as a business record, in my view, that statement is proof of the existence of a loan or loans between the Wade Trust and Starburst in the amounts stated for the 2004 to 2006 years. The fact that this statement appears in the accounts is neither here nor there. It is a statement in a business record of the corporate trustee of a trust."

Later, after concluding that the documents were admissible into evidence, his Honour said:

> "In finding that the conceded payments made by the Wade Trust to Starburst were loans or a loan, I have also had regard to the objective reality of the circumstances as they existed between Starburst and the Wade Trust as privately owned entities. In my view, and practically speaking, Starburst could have only received the conceded payments in one of three ways. The payments (in whole or in part) might have been: (i) a gift; (ii) a contribution of capital; or (iii) a loan. The memorandum of association and articles of association of Starburst were before me. Clause 7 of the memorandum provided that the authorised capital of the company was US$50,000. I infer, that the payments to Starburst, to the extent they exceeded this sum, were not contributions of capital. I reject the Commissioner's contention that the directors could always have increased the amount of authorised capital as speculation. Nor, I infer, were the payments a series of gifts. If they had been they probably would have been booked as a profit by Starburst in its accounts: cf *Federal Commissioner of Taxation v Slater Holdings Ltd* [1984] HCA 78; (1984) 156 CLR 447 at 460-461 per Gibbs CJ. They were not. The Commissioner contended that because the balance sheets were not accurate, this inference was not available to be made. In my view, that observation diminishes the force of, but does not preclude, the making of the inference that the payments were not a gift. It follows that, on the balance of probabilities, it is more probable than not that the payments were advances by way of loan. When all the circumstances are taken into account, that inference accords 'with the probabilities of ordinary human experience': *The Republic of Nauru v WET040 [No 20]* [2018] HCA 60; (2018) 93 ALJR 102 at [35]."

Steward J said that, on balance, he had decided to impute to the parties an intention that each advance was a distinct loan agreement. Relevant to this conclusion was the fact that the loans were made in three different currencies.

Penalties

Steward J said that, as he had found that the foreign exchange loss was not deductible and that there was no capital loss, he was satisfied that false statements about these matters were made. The Commissioner further claimed that, in connection with the making of each statement, the taxpayers did not take reasonable care (s 284-75(5) of Sch 1 to the *Taxation Administration Act 1953* (Cth) (TAA)) and also contended that the Wade Trust and Mr Wade made statements about the treatment of income tax law that were not reasonably arguable (s 284-75(2)).

A base penalty, for the purposes of s 284-90 of Sch 1 TAA, of 25% was imposed by the Commissioner on the basis that there had been a failure, either by the taxpayers or their agent, to take reasonable care (item 3 of the table in s 284-90(1)), or on the basis that either the taxpayers or their agent had treated the ITAA36 and/or the ITAA97 as applying in a way that was not reasonably arguable (item 4 of the table in s 284-90(1)). The Commissioner also contended that a penalty of 50% of the shortfall amount payable was then justified in the case of Sole Luna because that shortfall had resulted from the recklessness of that taxpayer or their agent (item 2 of the table in s 284-90(1)).

Reasonable care

Steward J said that, in relation to the issue of reasonable care, there was no dispute as to the applicable principles. The reasonable care test "calls upon a taxpayer to exercise the care that a reasonable person would be likely to have exercised in the circumstances of the taxpayer in fulfilling the taxpayer's tax obligations".[2]

His Honour said that the issue of reasonable care arose in two ways.

First, it appeared in s 284-75(5) as a defence to be invoked by a taxpayer (as here). No penalty for making a false

statement can be imposed if the taxpayer and its agent "took reasonable care in connection with the making of the statement". Where, as here, the statement is an assertion or conclusion of law about the application of the ITAA36 or the ITAA97 to particular facts, care is needed to ensure that the test of reasonable care is not confused with a consideration as to whether that application of law was reasonably arguable. However, there may be cases where, practically speaking, there may be some overlap between the two tests.

Second, the test of reasonable care appears as an item in s 284-90 as a measure of the degree of penalty to be imposed. Steward J said that the evidence supported the following findings:

– leaving aside the legal and evidentiary conclusions underpinning the statements in the "2013 Wade Trust Return", there was nothing about the preparation of this return which appeared to be in any way careless or negligent. The same observations may be made about the returns filed by Mr Wade in relation to the capital loss claimed; and
– the "2013 Wade Trust Return" was the product of the advice and work of Mr Skoglund (of an Australian accounting firm). It was not suggested that he was not a properly qualified tax agent. Steward J also inferred that they were the product of advice given by Mr De Zilva (a partner at Deloitte) or his firm at the time. He, and a solicitor at Deloitte, Mr Neil, had worked out how the loans to Starburst could be repaid immediately without the incurrence of a significant tax liability. It was not suggested that either individual lacked the necessary skill to give tax advice. In that respect, Mr De Zilva was a reasonably well-known tax lawyer.

His Honour said that this was not a case where a taxpayer had failed to take reasonable care because, for example, it negligently and mistakenly miscalculated an integer of a tax return. This was a case concerning a view taken of the law and an application of that view to facts reasonably perceived. In that respect, for the purpose of making a claim in a tax return, ordinarily a taxpayer is not required in exercising reasonable care to have the capacity to know what might or might not be admissible in court or be probative as a matter of the law of evidence. He went on:

> "All that is required is that a taxpayer should form a view of the taxable facts underpinning a statement made in a return in a reasonable way and at a standard suitable for that taxpayer. Where transactions are not documented, the taxpayer (for the purpose of making statements in a return) may rely on recollection, hearsay statements, and in a given case, even the collective corporate assumption about what might have happened in the past, so long as, on each occasion it was reasonable to do so. It may rely on logical deductions flowing from the adoption of a given corporate structure, and measure their probability by broader commercial practices and by any particular mercantile culture pursued by the taxpayer. But it cannot rely on speculation or conjecture. Thus here, it was reasonable in my view for the taxpayers and their advisers to assume that the foreign currency payments made to Starburst by the trustee of the Wade Trust were loans, even though, it was probably only Mr Evans who had direct knowledge of that matter. It was also, in my view, reasonable for them to assume that an Australian dollar payment had been made by the Wade Trust to Starburst which was a loan.
>
> Whether reasonably held assumptions, hearsay evidence and logical deductions would ever be sufficient to constitute a discharge of the onus of proof in a court is another matter.
>
> In my view, Mr Wade and the trustee of the Wade Trust also took reasonable and prudent steps to retain a qualified tax agent and took reasonable and prudent steps to seek tax advice about the application of the 1936 and 1997 Acts from suitably qualified tax experts. Migrating a group of companies and a trust structure from overseas to Australia is a complex process and calls for a deft hand. This judgment shows that the decision to claim the deduction and capital loss was wrong. But it would not follow from that conclusion that reasonable care had not been taken."

It followed, his Honour said, that s 284-75(5) was satisfied and no penalty was payable for the making of false statements in the returns about the claiming of the foreign exchange loss as a deduction and the capital loss for the purposes of s 284-75(1).

Reasonably arguable

Steward J said that, as to whether the position taken by the taxpayers was reasonably arguable, there was again no dispute about the applicable principles. His Honour referred to the decisions of the Full Federal Court in *Cameron Brae Pty Ltd v FCT*[3] and *Allen v FCT*,[4] and to the decision of Hill J in *Walstern v FCT*.[5]

In relation to the facts of the case, Steward J said that the application of the ITAA36 and the ITAA97 to the deductibility of foreign exchange losses pursuant to s 8-1 or former Div 3B had been the subject of much debate within the tax profession over the years. In particular, whether the Acts required the presence of physical conversions of money, whether one or more conversions were required and whether notional conversions of amounts into Australian dollars could be sufficient to realise a loss had long been the subject of detailed debate at "tax discussion groups" across the country. In 1993, the Commissioner issued a ruling (TR 93/8) concerning the deductibility of foreign exchange losses. It assumed that no physical conversions of currency were required in order to crystallise such a loss.

Then, in 1996, the High Court published its reasons in *FCT v Energy Resources of Australia Ltd*.[6] The Commissioner was then obliged to withdraw his ruling. Thereafter, he adopted a "practice" of not disturbing assessments based on his earlier ruling. Following the decision of the Full Federal Court in *Messenger Press*,[7] that practice was withdrawn. In the judgment at first instance in that case, a number of important observations were made about the possible reach of Div 3B which were neither rejected nor accepted by the Full Court on appeal. In 2003, new Div 775 ITAA97 was enacted in order to, among other things, clarify the law. Thus, in the explanatory memorandum to the New Business Tax System (Taxation of Financial Arrangements) Bill (No.1) 2003 (Cth) (which introduced the new Div 775), the following appears:

> "This bill also outlines the proposal to address a number of uncertainties and anomalies relating to the tax treatment of foreign currency."

Steward J went on to say:

> "In my view, the law relating to the claiming of a deduction for foreign exchange losses pursuant to s 8-1 and former Div 3B has not been

fully certain. At least one critical issue — namely, the need for physical conversions — was expressly not decided by the High Court. Whilst the introduction of Div 775 may have resolved some of those uncertainties, I was not taken to any authority of this Court concerning the application of that Division. Moreover there appears to have been no authorities concerning the relationship between the incurrence of a loss for the purposes of Div 775 and the gaining of income, whether or not exempt. The fact that the Commissioner himself has changed his position concerning one of the issues before me — the existence of a foreign exchange loss — dramatically on two occasions, suggests to me, and with respect, that he should have adopted a far less zealous and more moderate approach to the issue of penalty here.

Using the language from *Cameron Brae*, I have reached the view that the contentions relied upon by the taxpayers in support of their claim to foreign exchange losses were 'open to debate in the sense of being arguable'. While I have disagreed with those contentions, respectfully they were, given the state of the law, 'about as likely as not as correct'. Therefore, I respectfully disagree with the Commissioner's contention that the taxpayers' or their agents' treatment of the 1936 and 1997 Acts to its claimed loss was not reasonably arguable because of what was said by the High Court in *Energy Resources of Australia*. The obiter dicta of the learned primary judge at first instance in *Messenger Press* requires that submission to be rejected."

Steward J also described certain other arguments put by the taxpayers as being reasonably arguable.

Conclusion

It will be readily appreciated that the decision of Steward J has practical implications.

And there were other matters considered in his Honour's judgment, including an argument based on the way the definition of "net income" was drafted to overcome the decision of the High Court in the *Union Fidelity* case.[8]

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References

1 [2019] FCA 1195.

2 *Aurora Developments Pty Ltd v FCT (No. 2)* [2011] FCA 1090 at [38] per Greenwood J.

3 [2007] FCAFC 135.

4 [2011] FCAFC 118.

5 [2003] FCA 1428.

6 [1996] HCA 10.

7 *FCT v Messenger Press Pty Ltd* [2013] FCAFC 77.

8 *Union-Fidelity Trustee Co of Australia Ltd v FCT* [1969] HCA 36.

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Mid Market Focus

by Guy Brandon, CTA, HLB Mann Judd

ASX listed junior exploration companies and tax losses: part 1

One of the largest amounts in the financial statements of an ASX listed junior exploration company may relate to tax losses.

Introduction

At the timing of writing (and at similar times in prior years), considerable effort is had by preparers or reviewers of the income tax notes for Australian Stock Exchange (ASX) listed junior exploration companies' annual financial statements, in particular whether tax losses can be carried forward. Some issues that may be dealt with as part of the preparation and review include:

- Be aware of what is detailed in the tax losses schedule in the most recent completed tax return:
  - Are the losses available?
  - Do the losses satisfy the continuity of ownership test (COT) and the continuity of business test (the same business test (SBT) and, from 1 July 2015, the similar business test (SiBT))?
  - Are they group losses or transferred losses?
  - If there are transferred losses, has the correct available fraction been calculated?
  - Are the losses listed in the correct year that they were incurred?
- Are the tax losses to be recognised as a deferred tax asset (DTA)? (Note that a DTA that is used to offset a DTL is recognised).
- Be mindful of the *apparent* satisfying of the "10% test" by an ASX listed junior exploration company in the current year. This alone does not mean that the tax losses are available.
- Care should be taken when an ASX listed junior exploration company goes into production. Does it satisfy the continuity of business test (SBT or SiBT) in the absence of failing COT? More in part 2 of this article.

Modified COT test

Schedule 1 to the Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Bill 2005 reformed the loss recoupment rules for companies by introducing a new modified COT that applied to losses incurred in income years commencing on or after 1 July 2002.

Companies that are widely held or eligible Div 166 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) companies are able to access the modified COT, which:

- requires testing for continuity of ownership at the end of each income year, following a takeover bid or similar transaction and after a substantial capital raising; and
- contains tracing rules that simplify the tracing of ownership interests.

Context of the modified COT

In the absence of the modified COT, the COT is satisfied if the same people hold more than 50% of the voting power and rights to dividends and capital at all times during the relevant test period. To apply the COT, a company must trace its ownership through companies, trusts and other entities to identify the people who ultimately hold (directly or indirectly) voting power and rights to dividends and capital distributions. This is practically difficult in many circumstances and causes significant compliance costs.

The modified COT simplifies the application of the COT for companies that are widely held by providing tracing rules that make it unnecessary for an eligible company to trace the ultimate owners of shares held by certain intermediaries and small shareholdings.

The modified COT applies to widely held companies and companies that are more than 50% owned (directly or indirectly) by widely held companies, certain entities that are treated as ultimate owners, non-profit companies or charitable bodies.

Companies applying the modified COT must test for continuity of ownership at the end of each income year and at certain other specified times, rather than continuously as required by the ordinary COT.

Example

JuniorEx Ltd (JuniorEx) is listed on the ASX.

A review of the most recent losses schedule appears to have JuniorEx as having tax losses pursuant to Subdiv 36-A ITAA97 (subject to Div 165 and Div 166 ITAA97) of:

- FY 2015: $200,000;
- FY 2016: $4,300,000;
- FY 2017: $1,800,000; and
- FY 2018: $1,200,000.

An assessable gain during FY 2019 was $5,000,000 on the sale of a tenement.

Issued capital at 1 July 2014 being 50,000,000 ordinary shares in the sum of $10,000,000.

Capital raising on 20 November 2015 (the end of the offer period) being 15,000,000 shares at 10 cents each.

Capital raising on 2 December 2016 (the end of the offer period) being 9,750,000 shares at 30 cents each.

Capital raising on 27 April 2018 being (the end of the offer period) 10,000,000 shares at 25 cents each.

Example (cont)

Is the JuniorEx Group eligible for the modified COT?

JuniorEx is a widely held company as it is listed on an approved stock exchange.

Shareholders holding less than a 10% direct stake in JuniorEx:

1/7/2014	58.0%
30/6/2015	54.0%
20/11/2015	62.7%
30/6/2016	62.7%
30/6/2017	60.0%
1/12/2017	60.0%
27/4/2018	60.0%
30/6/2018	60.0%
30/6/2019	70.0%

Caution

The individual tax returns should be reviewed to determine whether the losses schedule is correct. Anecdotal evidence in a situation similar to this example had the FY 2015 and FY 2016 losses around the wrong way. Why is this critical? The SiBT is applicable to tax losses in income years commencing on or after 1 July 2015. If FY 2015 and FY 2016 were around the wrong way in the example, the $4,300,000 tax loss would not be subject to the SiBT (rather than the $200,000 tax loss).

The tracing rules

It is noted that, from para 1.22 of the explanatory memorandum (EM) to the Bill, a widely held company or eligible Div 166 company has the right to elect that the modifications in Div 166 do not apply in relation to an income year. The choice must be made on or before the day the company lodges its income tax return for the year, or before a later day if the Commissioner allows.

The COT is satisfied if there is substantial continuity of ownership between the beginning of the loss year and each test time in the test period.

The test period runs from the start of the loss year to the end of the income year. The test times are the end of each income year in the test period and the end of certain corporate changes.

The test for substantial continuity of ownership is the alternative test in Div 165, but with several modifications. The alternative test requires a company to trace its ownership through to persons who are not companies.

If the company fails the modified COT, the company can nevertheless deduct the tax loss if it satisfies the SBT for the income year (and now if it satisfies the SiBT for tax losses incurred in a tax year commencing on or after 1 July 2015).

The SBT (and SiBT, if applicable) compares the business carried on by the company in the income year with the business carried on immediately before the company failed the COT. If the company does have substantial continuity of ownership at a particular test time, the SBT/SiBT is applied to the business carried on immediately before that test time.

What is a substantial continuity of ownership?

There is substantial continuity of ownership if (and only if) the company satisfies the alternative tests for voting power and rights to dividend and capital distributions.

Broadly, the alternative tests are satisfied if, during the test period:

- the same persons other than companies and trustees, directly or indirectly, hold more than 50% of the voting power in the tested company; and
- the same persons other than companies, directly or indirectly, hold for their own benefit more than 50% of the rights to any:
  - dividends the tested company may pay; and
  - distributions of capital the tested company may make.

When testing for substantial continuity of ownership, there are two key modifications to the alternative tests in Subdiv 165-D ITAA97:

- tracing rules can limit the tracing required by a company in determining who holds voting power or dividend and capital rights; and
- ownership is tested at the end of each income year and at the end of certain corporate changes, not continuously.

Test times

To satisfy the COT in Div 165, a company must maintain the same owners continuously from the start of the loss year to the end of the income year.

This rule is modified for widely held and eligible Div 166 companies by requiring substantial continuity of ownership between the start of the test period and certain specified times. There is no need to satisfy the modified COT continuously.

The end of each income year in the test period is a test time, other than for the purposes of Subdiv 166-B ITAA97. The end of a corporate change in the test period is also a test time.

End of a corporate change

The most reviewed transaction to determine whether there has been a corporate change is the end of an offer period for an issue of shares in the company that increases the issued capital or the number of shares by 20% or more.

Others include:

- the end of the bid period of a takeover bid for the company (whether or not the takeover bid is successful);
- the end of a court approved scheme of arrangement involving more than 50% of the company's shares;
- the end of any other arrangement involving the acquisition of more than 50% of the company's shares, regulated under either the *Corporations Act 2001* (Cth) or a foreign law; and
- there is also a corporate change if one of the above events happens to another company that holds more than 50% of voting power, or dividend or capital rights in the tested company.

Continuing the example

JuniorEx will satisfy the modified COT if it can establish substantial continuity of ownership between 1 July of the respective tax loss year and the following respective tax times:

- FY 2015: 30 June 2016, 20 November 2015, 30 June 2017, 1 December 2017, 30 June 2018 and 30 June 2019;
- FY 2016: 30 June 2017, 1 December 2017, 30 June 2018 and 30 June 2019;
- FY 2017: 1 December 2017, 30 June 2018 and 30 June 2019; and
- FY 2018: 30 June 2019.

The capital raise on 20 November 2015 results in a change of 30% of issued shares and is therefore a corporate change event.

The capital raise on 1 December 2017 results in a change of 25.4% of share capital and is therefore a corporate change event.

The capital raise on 27 April 2018 results in a change of 13.4% of issued shares and 17.3% of share capital and is therefore not a corporate change event.

Caution

There is anecdotal evidence to the effect that some individuals, when determining whether tax losses are available, only review the top 20 shareholders in a company's most recent annual report, and determine whether the aggregate of shares directly held in the company of less than 10% represent more than 50% of the shareholding in that year.

It clear from the example that a review of the top 20 shareholders in a company's most recent annual report is flawed from even a "back of the envelope" review of the 10% test because:

- the top 20 shareholders listed are generally close to the issuing of the annual report (eg 20 September 2019), so do not relate to the end of the income year or a corporate change event; and
- this only looks at a single point in time and not the end of the relevant income years and intervening corporate change events.

The 10% test

The 10% test, being *the* modified COT, is a misnomer. It is a part of a broader series of concessional tracing rules in Subdiv 166-E to make it easier for companies to test for substantial continuity of ownership. These concessional tracing rules are:

- a *direct* stake of *less* than 10% is attributed to a *single notional entity*. There is only one single notional entity that relates to this point;
- an *indirect* stake of *less* than 10% is attributed to the *top interposed entity*;
- a stake (direct or indirect) of between 10% and 50% (inclusive) held by a widely held company is attributed to the widely held company as an ultimate owner;
- a stake (direct or indirect) held by an entity deemed to be a beneficial owner (a superannuation fund, an approved deposit fund, a special company or managed investment scheme) will generally be attributed to that entity as an ultimate owner;
- an *indirect* stake held by way of bearer shares in a foreign listed company is attributed to a single notional entity in certain circumstances; and
- an *indirect* stake held by a depository entity through shares in a foreign listed company is attributed to the depository entity as an ultimate owner in certain circumstances.

The first two (most common) points are reviewed below.

Direct stake of less than 10%

For all registered shareholdings carrying less than 10% of voting power, the voting power is taken to be controlled by a single notional entity. The same rule applies in relation to rights to dividends and distributions of capital. Note that, if there are different percentages of voting power to dividends and capital, say, 25% for voting but only 2.5% dividends and capital, the dividend and capital rights would be allocated to the single notional entity, but the voting rights would not. For the example, they are ordinary shares with equal rights.

The single notional entity is taken to be a person (other than a company), and is therefore regarded as an ultimate owner for the purpose of the alternative test.

If a nominee company is the registered shareholder but holds the shares for more than one other entity, the tested company *may* treat the parcels of shares held by the nominee company as separate stakes for the purpose of this tracing rule. This means that, if the nominee company's registered shareholding carries 10% or more of voting power or rights, but the entities for which it holds the shares each have less than 10% of voting power or rights, each of the stakes of less than 10% can be attributed to the single notional entity — noting that there may be a practical difficulty when determining such a breakdown.

Indirect stake of less than 10%

The top interposed entity is taken to hold the relevant voting stake, dividend stake or capital stake. The top interposed entity is the entity in which the stakeholder with a less than 10% interest has a direct interest. It need not be a company. If a stakeholder holds an indirect interest in a company as a beneficiary in a trust or as a shareholder in another company, the trust or the other company respectively would be the top interposed entity.

Similar to the direct stake of less than 10%, the tested company may treat a nominee company as holding a separate indirect stake in respect of each entity for which the nominee company holds shares.

Voting, dividend and capital stakes are dealt with separately.

Same share same interest rule

When applying the normal COT, a company can only take account of interests held by persons if they are the same interests and are held by the same persons throughout the test period. The rule ensures that a loss is not available for deduction if it has been substantially duplicated through

CGT events happening to direct or indirect interests in the company.

Note that the same share same interest rule does not apply to the direct stakes of less than 10% attributed to the single notional entity.

Minimum interests rule

A minimum interests rule applies to stakes taken to be held by a single notional entity under the tracing rule relating to direct stakes of less than 10% (or the tracing rule relating to bearer shares).

The minimum interests rule restricts the total proportion of voting power, dividend rights and capital rights attributed to the single notional entity to the proportion attributed to it at the beginning of the test period. It is only an increase in the aggregate proportion that is taken to be held by the single notional entity that is prevented.

From the example, care must be taken that the tax losses made in FY 2016 have a 54% direct stake of less than 10% at 1 July 2015. Even though those stakes are greater than that at each later test time, the minimum that can be used is 54%.

Savings provisions

The same share same interest rule is subject to a savings provision. The savings provision in effect negates the same share same interest rule if there is not substantial duplication of the tax loss, notional loss, bad debt or unrealised net loss (as the case may be) through CGT events occurring in respect of direct or indirect interests in the tested company during the test period.

Continuing the example

If the example was changed insofar as:

- JuniorEx had acquired a 100% interest in JuniorSub Pty Ltd (JuniorSub) on 1 July 2014 (known as the JuniorEx Group);
- JuniorEx has not formed a consolidated group for the purposes of Pt 3-90 ITAA97; and
- for the purposes of the example, JuniorEx has no tax losses in its own name,

this would affect what provisions in Div 166 would be used to determine whether the substantial continuity of ownership has been satisfied:

- the tested company is now JuniorSub and not JuniorEx (noting that it is not a tax consolidated group);
- no entity has a direct stake in JuniorSub of less than 10%, as 100% of the direct stakes is owned by JuniorEx;
- JuniorEx is not treated as an ultimate owner of a direct or an indirect stake (in its own capacity) in JuniorSub, as the stake is not between 10% and 50% (inclusive);
- reviewing the shareholdings in JuniorEx, the minimum shareholdings at any test point is 54% for shareholdings of less than 10% each. Therefore, each of those less than 10% shareholdings must

Example (cont)

necessarily be less than 10% indirect shareholding in JuniorSub;

- therefore, those shareholdings are attributed to the *top interposed entity*, ie JuniorEx;
- as JuniorEx has held its direct interest in JuniorSub since 1 July 2014, it does not fail the same share same interest rule, and those percentages of the voting, dividend and capital rights are taken into consideration when determining the test for substantial continuity of ownership; and
- there is an argument that it is easier for a loss making (continuing 100%) subsidiary to satisfy a modified COT than if it were the parent making the losses as the *minimum interest rule* is only relevant to direct stakes of less than 10%.

Further reading

The EM to the Bill sets out a number of examples that can assist in this often-misinterpreted area.

Part 2

In part 2 of this article (to be published in the December 2019 issue of the journal), a review of the continuity of business test (SBT and, from 1 July 2015, SiBT) for ASX listed junior exploration companies will be made.

Guy Brandon, CTA
Tax Consulting Partner
HLB Mann Judd

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Tax Education

How tax study can have a real impact

The Tax Institute's courses provide comprehensive knowledge for the tax practitioner's daily tasks. Hannah Edwards shares her experience with us.

Hannah Edwards, tax and audit manager at HQB Chartered Accountants and dux graduate, shares insights on the practical value that CommLaw2 Entities and Business Structures and CommLaw3 Property has had on her career.

A common concern about postgraduate study is whether investing in learning will apply to the job. Especially if you have moved countries.

Hannah has 10 years' experience in audit and over two years in tax and superannuation. She is also a dux graduate to The Tax Institute subject CTA2A Advanced. She says that, before her current job, she had very limited knowledge of Australian tax, especially as she is from the United Kingdom.

She says that studying with The Tax Institute has been a great benefit to her career because it supported her move into tax, which landed her a promotion.

"I started the Tax Agent Program, which includes commercial law for entities, business structures and property, so that I can become a qualified tax agent next year," she says.

"My background is in audit, but I moved from the city to a regional town to work for a firm that required a much wider knowledge of both audit and tax. I started studying at The Tax Institute to try and bring my knowledge up to speed as quickly as possible."

Equipped to assist struggling clients

Hannah says that CommLaw2 Entities and Business Structures furthered her understanding of bankruptcy and insolvency law, an area in which she had only a little knowledge before studying.

"Now this knowledge has increased considerably, and in the current climate, this is very important to assist struggling clients," she admits.

"I also learned a lot more about insurance law in CommLaw3 Property, and this is really important when assisting clients to make decisions about the best way to protect their assets and businesses."

How to manage work and study

Hannah says it can get hard when you have various tax and other deadlines that need to be met at work and which may require more than working 9 to 5.

"I would suggest doing as much study upfront as you can so that you still have the time to continue to meet work obligations during busy periods without worrying that you are getting behind in your studies," she says.

"I think the Tax Agent Program is a really great program to undertake in terms of the course materials and information that you learn, and it is very applicable to real-life situations."

And where to now?

Hannah says, "My tax education will continue through the regular updates that I receive from The Tax Institute and by attending courses and webinars. Tax laws are constantly changing, which means that my education will never stop and presents the challenge of keeping up to date and continually learning. This is one of the aspects that I really enjoy about my job."

Member Profile

This month's column features Leanne Connor, CTA, from WGC Business Advisors Pty Ltd, Victoria.

Member since

1999

Areas of specialty

My specialisation is providing taxation and strategic advice to SMEs, retirees and high net wealth individuals. This involves both income tax and superannuation planning, with particular emphasis on issues affecting SMSFs, private companies and family trusts. My passion is the ability to convey complex tax and strategic ideas in a way that can be understood and implemented by both clients and staff alike.

Why are you a member of The Tax Institute?

I became a member of The Tax Institute because my boss told me to — I remain a member of The Tax Institute because of the people. I recently addressed the inaugural meeting of the first Institute tax discussion group in Victoria. My core message to many eager young faces in the room was that the people around the table will become your colleagues, your friends and your source of both knowledge and professional inspiration. This is the strength of The Tax Institute — to build a tax community of like-minded people that nurtures professional excellence.

How is your membership beneficial to your practice and clients?

As a partner in a small city practice, the Institute provides an invaluable platform for myself and our staff to access technical programs and publications, while also providing us with the opportunity to spend time with other tax practitioners at educational and membership events. It is the willingness of so many members of The Tax Institute to share their knowledge and experience with others that is critical to the delivery of quality services to our clients.

How did you end up in tax?

The first 10 years of my career were spent in regional Victoria as a chartered accountant, without any thought of being a tax specialist but dealing with tax matters on a daily basis. On moving to Melbourne, I was fortunate to join WGC which has always had a commitment to delivering highly technical tax advice to clients. The firm is genuinely passionate about tax, and actively encourages all staff to have an inquisitive mind, to refer to the legislation and to develop a deep understanding of the issues that arise in the practice. With my bent for making complex issues digestible, tax advisory just found me, I guess.

What are the challenges for tax practitioners this year?

The biggest challenges for tax practitioners are uncertainty and a tax system that is still crying out for reform. The tax community is increasingly frustrated with politicians of all political persuasions making policy and other announcements during an election or budgetary process that either experience delayed implementation or are never enacted. The ongoing challenge is to continue advising clients who take a long-term vision for their business and financial security in an environment where the policy decision-makers appear so constrained by the pressures of politics.

Most memorable career moment to date

I can certainty recall the most nerve-racking moment of my career — leading my first workshop at the Institute's Noosa Tax Intensive some years ago. Looking around the room, I was terrified that I'd make a hash of it, but I must have passed, as I front up again in November this year. Seriously, it is an honour to represent the Institute and to be asked to address members at various seminars and forums. These opportunities are certainly the most memorable, and the skills developed are immediately transferrable to being a better tax adviser.

How do you relax?

If I'm not in the office, many of my weeknights are spent at tax discussion groups, Tax Institute council and committee meetings, or not-for-profit board commitments. On Friday nights and weekends, I can generally be found on the side of a basketball court somewhere in Victoria watching my daughters participate in their various Big V, representative or domestic teams. Yes, I'm a typical, passionate, somewhat biased basketball mum.

Advice to those entering the profession

Have an enquiring mind and get involved. You will need to make a commitment to continual learning and be humble enough to listen and learn from others. It is a rewarding career, full of challenges. Take the time to develop relationships with both your clients and colleagues in the profession — and enjoy the journey.

The black economy measures: how they affect you and your clients

by Paul Banister, CTA, Partner, Grant Thornton

While the ATO's tax gap project commenced in 2015, its influence on the Commissioner of Taxation's strategic direction and its potential to impact on every business and their advisers is only now emerging. This was inevitable, given the mutual impact of tax gap reporting on the Black Economy Taskforce (BET). The BET was established in late 2016, reported to the federal government during October 2017, and since then the government and its agencies have been busy adopting most of its 80 recommendations. Taxpayers and advisers are coming to terms with the impact of "separate" significant new legislative and administrative reforms, including digital business initiatives like single touch payroll and e-invoicing, new withholding and reporting requirements, non-compliant payments, and the Commissioner's greater collection and enforcement powers, all of which are BET outcomes to some degree. As strategies to close tax gaps are emerging, it is timely to consider the BET's influence in reforms, especially to plan for what is to come.

Overview

Since responding to the Black Economy Taskforce's (BET's) final report in May 2018, the government has been extremely active with the implementation of promised measures. The myriad of announcements, consultations, exposure drafts, Bills and new law has provided much to absorb. In the effort to disrupt the black economy, these measures, along with others affecting the management of tax compliance obligations, herald the most significant change in tax compliance in a generation. This tax evolution (or is it revolution?) shines a light on our client's operations in a different way. This article will reveal:

- what tax measures are already in place and what is to come;
- how they impact much more than the black economy;
- some other measures that are affecting clients commercially;
- how the black economy measures fit alongside other recent and proposed reforms to modernise the conduct of business and administration of the tax and transfer system; and
- surviving and thriving in this new regime.

The focus of this article is not the "why" — it is largely based around the "what". That is, of the intended policies announced, what tax measures have been implemented? What issues arise with that implementation? What is in progress? What is still to come?

This article considers developments and material available up to 19 September 2019.

Context

The effort and investigations made to understand and combat the black economy have been very significant. From a broader perspective though, the move on the black economy is not occurring within a vacuum — there's a confluence of matters that together are affecting and disrupting the way business is conducted. As noted in the points below, I consider that the attack on the black economy is part of a focus on changing "tax culture", ie what is expected of businesses in meeting their obligations. But in this technology-enriched world, the black economy measures are also enabled by, and fit within, efforts being made in other areas, including:

- a lack of trust in institutions:
  - global tax avoidance: #LuxLeaks, #PanamaPapers, #ParadisePapers and more recently, #MauritiusLeaks;
  - rising cost of living, especially housing and energy;
  - increasing concentration of wealth;
  - globalisation cost versus benefit;
  - political polarisation; and
  - reports emanating from various Royal Commissions (eg into the banking sector, institutional responses to child sexual abuse, aged care, and so on);
- new technologies;
- global regulatory collaboration/data sharing;
- an inability to limit phoenixing and similar activities to desired extent;
- a desire to change "tax culture":
  - BEPS;
  - greater transparency; and
  - black economy;
- leverage technology to deepen/speed up information flows;
- tougher compliance, including more piercing of the corporate veil; and
- contractor reform.

Within all of that, the community's perceptions and expectations are that "it's all someone else's doing", for example, multinationals … the "big end of town", regulators not pushing/prosecuting enough, the tax system can't cope and needs reform. Whatever the extent of truth in such

perspectives, the ATO's work on identifying "tax gaps"[1] has shed a very different light on this matter. For example, income tax gaps alone have been identified as being:

- large corporate groups: $1.833b (equivalent to 0.5% of FY2020 income tax receipts[2]), representing 4.4% of expected tax from this group;
- small business: $11.1b[3] (3.2% of FY2020 income tax receipts), representing 12.5% of expected tax from this group; and
- individuals non-business $8.76b[4] (2.56% of FY2020 income tax receipts), representing 6.4% of expected tax from this group.

Information about the income tax gaps in other categories, especially tax gaps for high wealth individuals and medium business, is expected to be released in coming months.

It is observed that the small business and individuals non-business income tax gaps combined comprise nearly 40% of the BET's estimated size of the whole black economy. Having made this point presenting on this topic shortly before the small business tax gap was confirmed, the Commissioner provided further information in his media release[5] that $7.0b of the $11.1b small business income tax gap is attributable to the black economy. So roughly one-third of the tax gap for small business is attributable to mistakes and inadvertent errors.

It is noted that that media release asserts that the BET estimated "that the black economy costs the community as much as $50 billion" — this appears incorrect as page 1 and chapter 2 of the BET final report speak of the size of the black economy as a whole being roughly $50b. But, as chapter 2 notes, measuring the size and extent is very difficult. The Commissioner's tax gap work to date suggests that $50b in evaded obligations may be closer to the mark.

If one makes a similar adjustment for mistakes by individuals non-business, that still leaves over 25% of the BET's estimated size of the whole black economy being represented by unpaid income tax for small business and individuals non-business combined. Whether that means that the black economy is much larger than estimated remains to be seen. Assessing the tax gaps for the years when the measures discussed in this article have been in place will help determine this. It is noted, however, that such information may not be available for another two to three years.

Given the relative size of the income tax gaps, it is obvious where much of the ATO's activity will be directed. In this regard, I expect that mixing new tools (eg artificial intelligence, data analytics and data matching) with the old (eg field work and asset betterment testing) will provide powerful information to assist the ATO in its quest.

What is the black economy?

You should refer to the BET's publications on this topic. However, some brief information is provided below.

The BET reported to the federal government in October 2017. Key findings in its 377-page report were:

- the black economy could be as large as 3% of GDP (roughly $50b); and
- 80 recommendations were made (including supplementary recommendations) spanning the whole economy.

In May 2018, the federal government published the taskforce's report and released its detailed response. It plans to adopt most of the taskforce's 80 recommendations. Both the taskforce report and the government's response divide black economy measures into three broad overlapping components:

1. identification/reporting;
2. collection; and
3. enforcement — penalties/incentives.

Some relevant points about the black economy include:

- the black market/economy reflects something "in the dark", "out of sight of the law" (*New world encyclopedia*);
- the BET considered the black economy comprised:
  - people who operate entirely outside the tax and regulatory systems; or
  - people who are known to authorities but do not correctly report their tax obligations; and
- Investopedia.com suggests that there are four types of black economies:
  - the illegal economy;
  - the unreported economy;
  - the unrecorded economy; and
  - the informal economy.

Some examples of behaviour classed as occurring within the black economy include:

- demanding or paying for work cash in hand to avoid obligations;
- underpayment of wages;
- not reporting or under-reporting income;
- sham contracting, that is, presenting an employment relationship as a contracting arrangement;
- illegal phoenixing, that is, liquidating and re-forming a business to avoid obligations
- bypassing visa restrictions and visa fraud;
- identity fraud;
- ABN, GST and duty fraud; and
- money laundering.

The BET acknowledged that the ATO and other regulators have access to many existing tools, including:

- business benchmarking (key financial ratios used to compare businesses in the same industry);
- risk models and increased focus on tax risk management;
- ATO audits/reviews;
- culpability penalties;
- data matching;
- garnishee notices;
- security bonds;
- director penalty notices (DPNs) (PAYG and superannuation only); and
- the taxable payment reporting system (TPRS).

Other than the latter, which has been very successful in the building and construction industry (discussed later in this article), the tools have had limited success with black economy participants; hence, the 80 recommendations for change.

Finally, the term "black economy" has taken hold, not just in Australia, but also in many places across the world, but I feel that it may no longer reflect appropriate language. Isn't it time to call it for what it really is? Why not just the "cheating economy" or "rule-breaking economy" or "dishonest economy"?

Content

This article will consider the following key tax measures in detail:

- the impact of a new provision that denies tax deductions for certain "non-compliant payments" (s 26-105 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97)); and
- extensions of the TPRS.

Other aspects covered are:

- the impact of a single touch payroll (STP) system;
- employer and other business-related liability reforms, including the strengthened DPN regime; and
- some other important measures.[6]

When looking at what measures are still to come, the broader operating environment will also be considered.

Appendix 1 includes a summary of key amending legislation and Bills, including a synopsis of changes considered and dates of passage.

Appendix 2 summarises each measure that has been announced or introduced in recent years that impacts the black economy. As you will see, the extensive list highlights how much progress has been made.

No deduction for "non-compliant payments"

It has been quite some time since there has been a substantive change to a tax deduction provision affecting the whole business community, so this change is significant. New s 26-105 will deny a tax deduction for "non-compliant payments", ie those where the associated PAYG withholding obligations are not complied with. Introduced by the *Treasury Laws Amendment (Black Economy Taskforce Measures No. 2) Act 2018*, s 26-105 applied for labour payments arising from 1 July 2019.

The measure is designed to "provide greater incentive for employers and entities engaging contractors to comply with their withholding obligations".[7] "A small unquantifiable gain to revenue" is expected from the measure. This should be contrasted with the extension of the TPRS from which a net gain of $545.8m is expected over the forward estimates period.[7] Given this difference, some will question the necessity for this measure at all.

In this regard, the potential denial of deductions for labour costs could be existential in nature, depending on the business, and each separate labour payment is potentially at risk. The non-deduction provides a seemingly large incentive to apply, but some may question this in light of the fact that there continues to be non-compliance with superannuation guarantee charge (SGC) obligations despite the non-deductible rules introduced more than 27 years ago.

Practically, advisers will need to have a greater awareness of the *Taxation Administration Act 1953* (Cth) (TAA) obligations to help their clients prevent the lost tax deduction. More generally, the likely impact is that non-black economy participants will become agents to bring more people into the tax and regulatory system. In this regard, I consider that greater emphasis and potential refinement of the no-ABN withholding rule could deliver better results, but maybe that is to come at a later time.

Readers can make their own assessment as to whether the compliance cost impact will be "minimal",[7] although it is acknowledged that, from an employer perspective, many will already have been impacted by the costs of transitioning to the STP system — a system that should generate much of the information to assist in complying with parts of this measure.

This measure is designed to implement BET recommendation 7.5. However, it is noted that it only affects tax deductibility rather than, as recommended by the BET, to also affect capital allowance cost bases and CGT cost bases.

Obligations affected

Payments

The tax deductibility status of a payment is potentially impacted by s 26-105 if any of the provisions set out in Table 1 require an amount to be withheld from the payment.

The first four categories in Table 1 relate to employer withholding obligations for payments for work and services. The last one is for B2B payments where no ABN is quoted and an exception does not apply.

Non-cash benefits

The tax deductibility status of a non-cash benefit is also potentially affected if s 14-5 of Sch 1 TAA would require an amount to be paid in cash to the Commissioner. This provision imposes an obligation to pay an amount to the Commissioner, in addition to the value of the non-cash benefit provided, if, had the amount been paid in cash, the

Table 1. Payments affected by non-compliant payment rules

TAA provision	Relates to …
S 12-35	Payments of salary, wages, commission, bonuses or allowances paid to an individual as an employee.
S 12-40	Payments of remuneration to a company director or member of a committee of management.
S 12-47	Payments to religious practitioner.[8]
S 12-60	Payments pursuant to a labour hire arrangement.
S 12-190	Payment for a supply where the payee has not quoted its ABN (excluding supplies of goods and real property).

amount would have been subject to withholding by any of the provisions listed in Table 1.[9]

Application

If the PAYG withholding provisions in Table 1 apply from 1 July 2019 to a *payment*, s 26-105 will deny the tax deduction[10] if either:

- there was a failure to withhold at all;[11] or
- the payer did not notify the Commissioner when required by s 16-150 or s 389-5 of Sch 1 TAA.[12]

Withholding an incorrect amount will not affect the entitlement to a deduction.[13] Similarly, reporting an incorrect amount *in error*[14] will not cause denial of a deduction.[15]

For a *non-cash benefit* provided from 1 July 2019 in situations where the PAYG withholding provisions in Table 1 would apply if cash had been paid, s 26-105 will deny the tax deduction[16] if no notification is made to the Commissioner as required by s 16-150.[17]

Exceptions – three situations

A deduction will remain available if the amount to be withheld or paid, as the case may be, is a nil amount.[18]

Where an employee quotes an ABN and it is subsequently found that s 12-35 of Sch 1 TAA imposed an obligation to withhold PAYG, there is a qualified exception:[19]

- when the payment is made, the payer has been given an invoice or similar document that quotes the individual's ABN (or if the supply is provided through an agent, that quotes the agent's ABN);
- when the payment is made, the payer has been given an invoice or similar document that *purports* to quote the individual's ABN, which is either incorrect or non-existent, and the payer has no reasonable grounds to believe that the individual does not have an ABN or quotes an incorrect one;
- when the payment relates to a supply made through an agent, the payer has been given an invoice or similar document that *purports* to quote the agent's ABN, which is either incorrect or non-existent, and the payer has no reasonable grounds to believe that the individual does not have an ABN or quotes an incorrect one; or
- where there is a non-cash benefit provided and similar situations to these three exceptions apply.

There is also a qualified exception to s 26-105 if you voluntarily tell the Commissioner, in the approved form, that you have failed to:

- withhold an amount; or
- comply with the notification requirements of s 16-150 or s 389-5 in relation to the amount.

This exception is only available if the payer makes the relevant voluntary disclosure "before the Commissioner tells you that an examination is to be made of your affairs relating to a taxation law for a relevant period".[20]

What if only payment obligations are not met?

Contrary to some commentary on this reform, s 26-105 does not deny the deduction if the only obligation not met is the payment to the ATO. This is consistent with the BET's recommendation 7.5 of censuring lack of compliance with withholding and reporting obligations. As noted at para 1.15 of the explanatory memorandum,[21] "total failures to withhold represent the most significant risk to government revenue and are targeted by this amendment".

Presumably, the existing framework to support payment obligations is regarded as sufficient. And if the outcomes from introduction of TPRS in the building and construction industry are any indication,[22] regular capture of information goes a long way to improving tax compliance and collections.

The existing systemic support for payment obligations remain:

- entities must pay to the Commissioner withheld amounts and amounts relating to non-cash benefits by the relevant due date (s 16-70 of Sch 1 TAA and associated provisions);
- failure to meet a payment obligation (eg s 14-5 of Sch 1 TAA for non-cash benefits) can give rise to a strict liability penalty of 10 penalty units[23] per s 16-25 of Sch 1 TAA (or the alternative administrative penalty per s 16-30 of Sch 1 TAA for the amount owing); and
- potential penalties apply for directors via Div 269 of Sch 1 TAA, ie the DPN regime.

The practical issues

Rectifying by voluntary disclosure

Pursuant to s 26-105(7), a deduction will still be available if the Commissioner is voluntarily informed, in the approved form, of a failure to withhold an amount or comply with s 16-150 or s 389-5 in relation to the relevant period. Similarly, the entitlement to a tax deduction will be sustained by s 26-105(8) if the Commissioner is voluntarily informed, in the approved form, of the failure to comply with s 16-150 in relation to a non-cash benefit.

Some practical considerations emerge:

- given that the approved form in this case is required to inform of a failure to perform an obligation, one would have expected that a new form would have been available from 1 July 2019;
- the amending legislation does not require anything but the approved form to be completed in time, in particular, there is no requirement to rectify. Despite this, the Commissioner does not regard voluntary disclosure as being complete until a revised activity statement is submitted;
- with the move to the STP system for all businesses from 1 July 2019, mandatory same day reporting should provide the ATO with early data to act quickly, which may give rise to prompt pursuit of missed obligations, which may limit the ability to voluntarily disclose;
- while the ATO considers an STP-advised amount (eg wages) should be re-reported on the IAS/BAS, I do not interpret the provisions as requiring this; in particular, s 389-20 TAA suggests otherwise. This potential confusion risks non-compliant payments arising, which may give rise to lost deductions;
- in relation to acting quickly, the Commissioner's statement on the ATO website[24] does not provide a new "approved

form". Rather, both a letter and a revised activity statement are required according to the Commissioner;

- the letter should incorporate the following information:
  - the title "Voluntary disclosure — PAYG withholding";
  - your name or your business's name, that is, the full name of the taxpayer that should have withheld the amount;
  - your phone number and address or the name, phone number and address of your authorised contact or tax agent;
  - the name of the person or organisation you made the payment to;
  - the date you made the payment;
  - what the payment amount was;
  - what the amount you should have withheld was, or an estimate of what it should have been;
  - a signed and dated declaration as follows: "I declare the information I have given in this letter, including attachments, is true and correct and that I am authorised to disclose this information";
  - your signature; and
  - the date;
- whether or not the tax deductibility is affected, the obligations in question will remain in place and may be subject to enforcement activity, including potentially issuing DPNs to directors; and
- most DPN scenarios involve distressed situations, ie those where the non-deductibility sanction may not be a practical burden, so distressed situations are not an obvious target of these measures.

This leads to my assessment of what seems to be the practical impact (or even target) of this measure:

- complying with new rules should increase awareness of withholding and reporting obligations for (solvent) companies,
- which should lead to a tightening of procedures when engaging labour,
- thereby addressing concerns that tax obligations are not being met by persons providing labour who may otherwise take advantage of vague engagement practices.

The exceptions in s 26-105(7) and (8) are subject to an important proviso that may restrict the ability to rectify: that the voluntary disclosure occurs "before the Commissioner tells you that an examination is to be made of your affairs relating to a taxation law for a relevant period". The key practical elements need to be considered further:

- "examination": this is a broad concept:
  - it includes an audit or any other form of compliance activity;
  - it may include pre-lodgment reviews, depending on what is being examined. For example, examination of a particular transaction to determine the tax outcome may give rise to a different answer than if there was examination of a draft return pre-submission; and
  - MT 2012/3 uses the same term in the context of s 284-225 of Sch 1 TAA at para 46. It notes that this is a broad concept so, if a pre-lodgment review has occurred, it is likely that an "examination" has occurred;
- "relating to a taxation law": there is no restriction as to subject matter, so it seems that, say, a GST review could be problematic despite it having nothing to do with PAYG withholding and reporting.

  In this regard, para 62 of MT 2012/3 suggests that the review must relate to the same subject matter, but the present context makes such a restriction irrelevant. In this regard, the tax shortfall regime considered by MT 2012/3 covers multiple taxes so by nature must be broad, but PAYG withholding and reporting need not be so.

  Use of the term "taxation law" suggests a broad scope as s 995-1 ITAA97 defines this term to incorporate any legislation which the Commissioner administers. If the intent was to limit scope, more confined terms could have been used like "tax affairs" (which relates to income tax only) or simply the TAA (ie Sch 1) obligations; and
- "for a relevant period": given that the determination of taxable income is a "year of income" exercise but some reviews are for different periods, eg quarters, the question is whether the deduction is restricted for impugned amounts for reviewed quarter(s) only or for whole year of income. For example, the deduction may be sought for a year of income, but the breach may relate to a single quarter — will a review of another quarter in the same year of income deny this rectification relief? Paragraph 64 of MT 2012/3 suggests that the examination need only include the "relevant period" to potentially deny benefit from voluntary disclosure for penalty reduction purposes. This suggests that a review of part of a year will impact the full year's deduction entitlement.

The bottom line is that s 26-105 affects a tax deduction, while s 284-225 affects penalty reductions. But how can MT 2012/3 be relevant within the deduction context? In this regard, allowable deductions are one component of determining taxable income, while penalties relate to tax shortfalls that arise when taxable income is incorrectly determined. As such, the concepts do not easily fit. If the deduction limitation was meant to be restricted to the subject matter of PAYG withholding and reporting only, the extremely wide term "relating to a taxation law" would not have been used. As noted above, use of different terms would have limited this scope.

Practically, the approach in s 26-105(7) and (8) needs a rethink. The use of administrative terminology like "voluntary disclosure" to determine the operation of substantive provisions is unwelcome and potentially unworkable. It may be that the draftsperson was drawn towards the concepts utilised in MT 2012/3. However, use of those elements will not provide fair outcomes in many situations deserving of the relief to rectify, eg genuine mistakes or inadvertent omissions, especially in the short term. Perhaps the relief should be limited by use of the latter terminology if it is inappropriate to narrow the restriction's scope by the other suggestions made above.

Consider the following example of how the new law will apply in practice (using example 1.2 in the explanatory memorandum,[25] but with some altered facts):

- Caleb carries on business as a mechanic;
- he employs Bianca, an apprentice, in January 2020 and is unaware that he must withhold an amount from her wages;
- he discovered the problem in September 2020 when he visited his accountant to prepare his 2019-20 tax return;
- Caleb notifies the Commissioner of his mistakes in the approved form, which by then affects three quarters — March 2020, June 2020 and September 2020;
- situation A: no examination of affairs relating to a taxation law:
  - Caleb is entitled to claim the deduction for the cost of Bianca's wages for 2019-20 and 2020-21 YTD;
  - he may still be subject to penalties for failure to withhold;
- situation B: the Commissioner undertakes a GST review for the June 2020 quarter before Caleb notifies:
  - Caleb is entitled to claim the deduction for Bianca's wages in 2020-21 YTD as it is outside the "relevant period", however defined;
  - the "examination … of your affairs relating to a taxation law" potentially affects the 2019-20 deduction. The question is: what is the subject matter of s 26-105(7) and (8) (which is vague, unlike s 26-105(1) and (2) which is specific to particular transactions) and what "relevant period" is affected? There are three possible answers:
    - the examination was in relation to the June 2020 quarter and s 26-105 applies to each particular amount separately, so only the potential deductions for wages arising in that quarter are denied;
    - as the deduction applies to a year of income, an examination relating to a tax law for any part of that year will preclude remedying the situation for the whole year, with the result that all 2019-20 deductions in this example will be denied; or
    - the opposite extreme, being that, because only part of the year in question is subject to examination, there are periods (relevantly here the March 2020 quarter) that can be remedied, which may arguably reinstate the entitlement to deduction for all periods;

It is considered that the outcome in this example will be that Caleb will be denied a deduction for the wages in the June 2020 quarter, but the March 2020 quarter deductions are capable of being claimed. This is on the basis that:

- s 26-105(1) and (2) apply independently for each transaction, so each separate amount needs to be considered, amounts that can relate to separate periods; and
- the relief in s 26-105(7) and (8) appears to relate to the "relevant period" in relation to the "examination", which only denudes entitlement to a deduction for amounts arising in the period under review that are affected by s 26-105(1) and (2).

The downside of this conclusion is that a review of a matter that is annual in nature or that covers longer periods rather than a shorter period (eg quarterly) may limit the ability to remedy these situations

Short withholding and reporting

Where there is a failure to withhold enough tax, s 26-105(1)(b)(i) will still not deny the tax deduction where at least some amount is held from each payment. As such, there seems no doubt that businesses will retain entitlement to a tax deduction, even if a reduced amount is withheld deliberately. The adverse consequence would arise by the "failure to withhold" offence in s 16-25(1) of Sch 1 TAA.

However, the position is not as clear where the amount reported is incorrect. In this regard, s 26-105(1)(a)(ii) provides scope for the lost tax deduction where "you fail to comply, or purportedly comply" with reporting obligations (ie s 16-150 or s 389-5).

The *Collins English dictionary* defines "purportedly" in this way: "If you say that something has purportedly been done, you mean that you think that it has been done but you cannot be sure".

Accordingly, it seems difficult to argue that an intentional incorrect reporting[26] would escape the scope of s 26-105(1)(a)(ii). Misreporting in error would seem to be relieved.

This appears consistent with para 1.14 of the explanatory memorandum, which states that the entitlement to a deduction will be maintained if "because of an error" the amount reported does not reflect the amount required to be withheld or actually withheld.

Employee ABN exception

As technology continues to adapt and digital interfaces with regulators enhance, the limitation of this exception (discussed above) will narrow further.

Current issues to watch regarding qualifying for this exception include:

- ensuring that an invoice quoting an ABN is provided in relation to each payment;
- if software does not have ABN checking capability, ABN Lookup should be considered for periodic checks; and
- the exception does not relieve a payer of superannuation guarantee obligations in relation to payments for labour.

Impact on M&A for entity acquisitions

The introduction of this new self-executing provision that denies a tax deduction increases the tax risks involved in acquiring entities that are subject to PAYG withholding and reporting obligations. The undisclosed potential tax impact could be particularly large where labour cost is a significant part of operating expenses.

As such, advisers should consider:

- increasing the scope of tax due diligence for PAYG withholding and reporting obligations to help mitigate tax risks of a buyer;
- whether tax warranties need to be re-drafted to address the impact of this risk; and
- whether any retentions to support tax warranties should be increased.

Extension to the TPRS

When the TPRS was first adopted in 2012-13 for the building and construction industry, I was sceptical of whether there would be a strong enough impact by simply imposing new reporting obligations. Instead, I expected that it was a precursor to the return of the old prescribed payments system which was phased out as part of the transition to the GST. How wrong I was!

The government's response to the BET final report released in May 2018 includes some extraordinary figures[27] — that TPRS raised an additional $2.3b in tax liabilities in its first year alone (2012-13), including:[28]

- $265m from outstanding returns lodged;
- $506m in GST;
- $1.128b in PAYG withholding on wages; and
- $357m in PAYG instalments.

With this success, it is little wonder that the BET recommended an extension to the TPRS, firstly to the courier and cleaning industries (as per their interim report which was adopted by the government). Recommendation 6.1 of the BET final report recommended an extension of the TPRS to five new industries where contractors are at higher risk of either non-reporting or under-reporting of income:

- security providers and investigative services;
- road freight transport;
- computer systems design and related services;
- owner-builders; and
- home improvements.

As noted below, the government chose to adopt the first three.

Legislative response

Amendments

The TPRS affects the supply of cleaning services and courier services from 1 July 2018. This arose from *Treasury Laws Amendment (Black Economy Taskforce Measures No. 1) Act 2018*, which enabled the change by adding items 11 and 12 respectively to s 396-55 of Sch 1 TAA.

The TPRS affects the following industries from 1 July 2019:

- road freight services;
- security, investigation or surveillance services; and
- information technology services.

The *Treasury Laws Amendment (Black Economy Taskforce Measures No. 2) Act 2018* enabled the change by replacing item 12 (which now applies for "supply of a courier service or a road freight service") and adding items 13 (security, investigation or surveillance) and 14 (information technology) to s 396-55.

Building and construction services have been subject to the TPRS since 1 July 2012. Rather than s 396-55, the source of these obligations is s 405-10 of Sch 1 TAA and reg 70 of the *Taxation Administration Regulations 2017* (Cth).[29] The change in legislative structure is not explained. With one exception,[30] the elements are very similar.

Elements

The elements set out in Table 2 need to be evident for TPRS obligations to apply (each new TPRS activity is noted).

The terms "supply" and "consideration" take their meaning from GST legislation. While assessment of these terms is outside the scope of this article, some practical issues are considered in succeeding sections.

To help plan for compliance from 1 July 2019, the ATO released LCR 2018/D8 in the months leading up to 1 July 2019. LCR 2018/8 was released as a final public ruling effective from 1 July 2019.[31]

The Commissioner's instrument TPRS 2019/1 confirms the de minimis arrangements that had been proposed at appendix 1 of LCR 2018/D8, relating to reporting exemptions. These arrangements are:

- the de minimis reporting exemption for security, investigation or surveillance services and IT services has been provided in the same form that previously existed in the legislation for cleaning services and road freight and courier services, ie less than 10% of GST turnover;

Table 2. Elements before TPRS can apply

Element	Cleaning	Courier and road freight	Security, investigation, surveillance	Information technology
Entity makes a "supply" of the particular stated type of service	Yes	Yes	Yes	Yes
Entity has an ABN	Yes	Yes	Yes	Yes
Report any "consideration" provided by entity to another "wholly or partly" for supply by other entity of the particular stated type of service	Yes	Yes	Yes	Yes
Exclusion for members of same consolidated group or MEC group	Yes	Yes	Yes	Yes
Exclusion if Div 12 requires PAYG withholding	Yes	Yes	Yes	Yes
De minimis exemption per s 396-70(4) TAA in amending legislation[32]	Yes 10%	Yes 10%	Yes 10%	Yes 10%

- where a business entity is supplying multiple categories of services covered by the TPRS, a separate assessment of the exemption is required for each one;
- if an entity is exempt for one TPRS activity but not for another, the contractor payments must be reported for the latter activity only;
- when determining this, couriers and road freight services must be combined as they are covered together in the same item;
- the same applies for security, investigation and surveillance;
- when a business has only operated for part of a year, the projected GST turnover for the following year (ie annualised) should be used in the calculation; and
- prima facie, the ATO will use a business industry code that is included on a business entity's tax return as an initial indicator of potential obligations arising.

Requirements

The first obligation for these industries arose on 28 August 2019[33] when they need to submit the taxable payments annual report for the 2018-19 year. The information required to be reported for each affected contractor on the taxable payments annual report (TPAR) is:

- their ABN;
- their name and address; and
- the gross amount paid to them for the financial year (including GST).

To clarify, the amount included is what is paid during the year (ie cash basis) rather than what is accrued.

Practical issues

Identity of recipient contractors

Payments to recipient contractors are covered irrespective of the type of entity, which includes whether it is a non-resident or non-assessable entity — but noting that they need an ABN.

Definition of relevant TPRS service

Except for building and construction activities, the other TPRS activities are not defined. LCR 2018/8 provides some assistance for courier and cleaning services and LCR 2019/4 (previously issued in draft as LCR 2018/D8) provides assistance with the other new TPRS activities. To illustrate what is not covered, I have noted the following exclusions:

- road freight services[34] does not include:
  - passenger transport services;
  - the operation of road freight terminals;
  - providing crating and packing for road freight transport; or
  - leasing or hiring trucks without drivers;
- security, investigation and surveillance services[35] do not include:
  - police services;
  - the surveillance of country borders;
  - aerial surveying or mapping;
  - academic or market research;
  - the manufacture, retail, installation, maintenance or repair of fire alarm systems, security alarms or cameras or voice recorders; or
  - providing key cutting/duplication services; and
- information technology services[36] are very broad in scope but do not include:
  - the mass production of computer software;
  - leasing or hiring computers or other data processing equipment;
  - providing data processing services or computer data storage and retrieval services; or
  - installing computer cabling.

Nature of supply

Services provided need to be split into separately identifiable parts if possible. If at least one part is a relevant TPRS service, then the relevant part(s) needs to be reported on the TPAR.

As noted in GST rulings and determinations (eg GSTD 2002/3 which has specific relevance to delivery, ie courier services but can apply more broadly), a *mixed supply* is one which can be split into separately identifiable parts. However, if the particular TPRS service is merely incidental to another product or service provided, this is regarded as a *composite supply* and not relevant to the TPAR.

Consideration "wholly or partly"

Where consideration is partly related to a TPRS service, the full amount may still be reportable. For example, a payment for labour and materials combined may need to be reported in full unless the labour is incidental.

Transacting within client groups

Payments within consolidated groups and multiple entry consolidated (MEC) groups are excluded from reporting obligations. However, this exclusion does not apply where a member of a consolidated group makes supplies within the group while utilising contractors outside the group (whether they are related parties or third parties). In such cases, the group member will need to report all contractor payments being made except for payments to other group members. And each member will need to report in relation to their own activities.

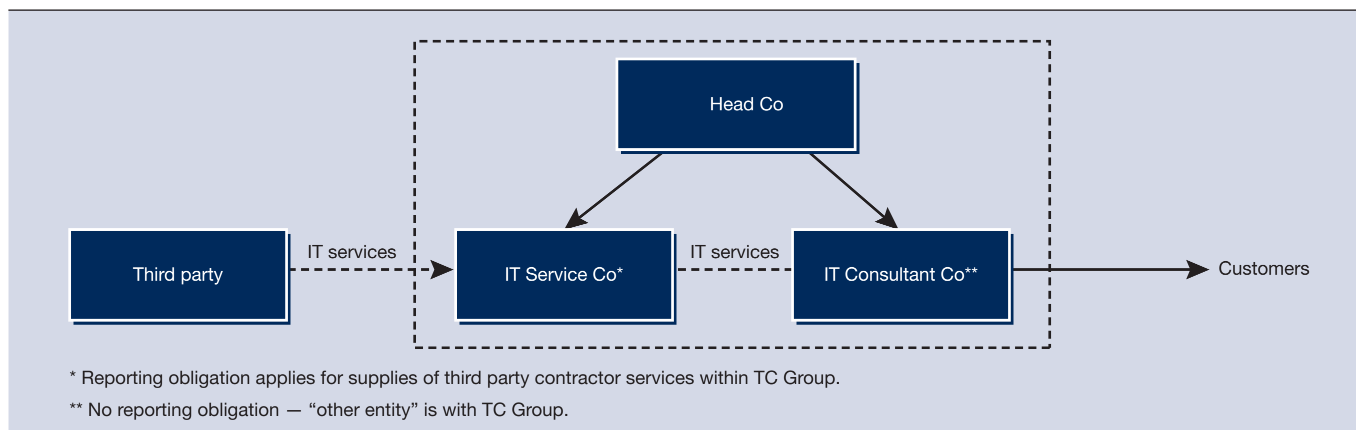
Consider the situation of a shared services entity within a client group. This entity will potentially be making supplies of TPRS services with associated parties. Given the potential extent of cost for IT services, these may be affected so should be closely watched. If contractors are engaged to assist, the payments may need to be reported.

The example in Diagram 1 considers a tax consolidated group where the customer-facing group company sources its labour from an associated group service company. Payments between these entities are not subject to TPRS reporting. However, if the service company obtains support from third-party contractors, the service company will have a reporting obligation.

IT providers, including professional firms

The prevalence of businesses supplying IT services will substantially expand the scope of the TPRS rules. This

Diagram 1. Applying TPRS to a tax consolidated group



* Reporting obligation applies for supplies of third party contractor services within TC Group.

** No reporting obligation — "other entity" is with TC Group.

includes those professional firms now offering a range of IT consulting services. Subject to the de minimis rule, payments to external contractors may need to be reported.

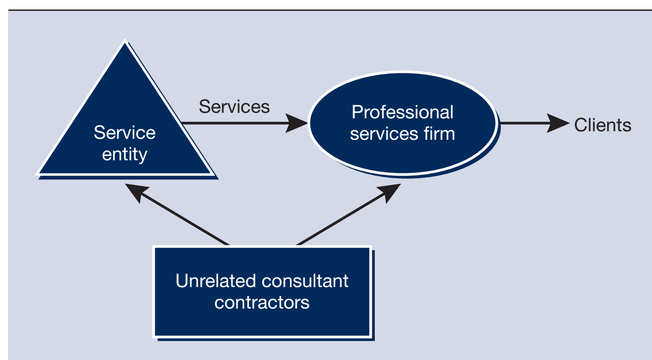
I make the following observations in relation to the example depicted in Diagram 2, subject to the de minimis rule:

- if the professional services firm engages contractors in support of supplying IT[37] services to its clients, it may have TPRS reporting obligations;
- if the service entity engages contractors in support of the professional services firm supplying IT services to its clients[38], it may have TPRS reporting obligations; and
- if the service entity's contractors are providing general support to the entity's obligations to serve the professional services firm, it is unlikely to be a distinct service meaning there is unlikely to be TPRS reporting obligation.

Significant global entity penalties

The penalties that may be imposed for a breach of a TPRS reporting obligation are affected by the substantial uplift that applies for significant global entities. Suffice to say that it will pay to prioritise assessment of the impact of these obligations for large businesses or those that are part of a larger global group.

Diagram 2. Applying TPRS to professional services firm entities



If it is any solace, the software that businesses are using to comply with STP ought to have the capability to assist compliance with TPRS.

Reinforcement of employer and other business-related responsibilities

While not all strictly related to the black economy and the work of the BET, there have been a number of developments that reinforce compliance responsibilities of employers and leverage other work already done. These are addressed below.

Treasury Laws Amendment (2018 Measures No. 4) Act 2019 received royal assent on 1 March 2019. Reforms that have now been legislated by this Act include:

- STP currently applying to employers having 20 or more employees will apply to all employers from 1 July 2019;
- the ATO now has stronger powers to issue directions and penalties in relation to SGC responsibilities, including to provide information to affected employees and to enforce employers to make payments and undertake further education; and
- to reinforce director responsibilities for PAYG withholding and SGC liabilities, a number of amendments have been made, especially for the purposes of the DPN provisions:
  - the responsibility for an estimate provided under Div 268 of Sch 1 TAA is taken to arise at the end of the relevant period rather than the day the estimate notice is provided;
  - the three-month period before DPNs regarding SGC liabilities are "locked down" has been removed;[39] and
  - the Commissioner can apply for a court order to compel entities to provide a security deposit in relation to an existing or future tax-related liability.

The Treasury Laws Amendment (Combating Illegal Phoenixing) Bill 2019[40] is currently before parliament. The Bill includes the following tax-related measures:

- estimates: the Commissioner's current power to make and collect estimates of PAYG withholding and SGC liabilities is to be extended to GST, luxury car tax (LCT) and wine equalisation tax (WET) liabilities;

- DPNs: the Commissioner's current powers, as enhanced by the above enacted amending legislation, to recover director penalties in relation to actual and estimated PAYG withholding and SGC liabilities is to be extended to outstanding GST, LCT and WET liabilities, as well as estimates of those liabilities; and
- refund retention: the Commissioner's current power to retain a tax refund owing to a taxpayer that has an outstanding notification under BAS or petroleum resource rent tax provisions is to be extended to other outstanding lodgments and information requirements.

If legislated, these measures will commence on the first day of the quarter following royal assent.

STP

The extension of STP to employers with one to 19 employees will involve limited relief. Micro-businesses (one to four employees) will have some alternative options, eg being able to lodge quarterly through an agent. And those businesses with no or unreliable internet connections will be exempt.

Businesses with closely held employees (eg those related to the directors/owners) will be provided with a one-year extension to 1 July 2020 in relation to salaries of those employees, given the more flexible cash drawing and remuneration arrangements that often apply for such employees.

The impact of expanding STP is a potential game-changer and will be a significant milestone for business. With STP requiring real-time payroll reporting, the only practical way for businesses to cope is to invest in software. And with real-time information, the ATO will possess data that will allow virtually immediate checking of payroll and superannuation contribution information.

The journey from things like SuperStream through to STP was an obvious one. What comes next will be interesting to watch:

- from a payroll perspective, implementing BET recommendation 3.2 to mandate electronic payment of salary and wages should be easy;
- there will only be political obstacles to extending STP to incorporate state-based payroll taxes; and
- beyond this, further enablement of the technological interfaces with regulators will underscore other initiatives including ABN reform.

STP transitional relief for small employers

With the introduction of STP for small employers (ie one to 19 employees) from 1 July 2019, they are subject to a number of exemptions and reliefs:

- they are deemed to be "on time" if they start reporting between 1 July and 30 September;
- there are no penalties for missed/late STP reporting in the first year;
- there is penalty/deferral relief for small employers in transition;
- registered agents can provide STP service for their clients;
- micro businesses (one to four employees) have some alternatives, eg they can lodge quarterly through an agent;
- exemption if there is no/unreliable internet connection; and
- closely held employees of small employers have a one-year extension to comply.

More details can be found on the ATO's website.[41]

It is noted that some practical and administrative confusion applies on a number of issues, for example:

- whether wages already reported via STP need to be reported on the IAS/BAS. While the ATO considers that an STP-advised amount should be re-reported on the IAS/BAS,[42] I do not interpret the provisions as requiring this, in particular, s 389-20 of Sch 1 TAA suggests otherwise; and
- the due date for the payment of PAYG withholding via STP when quarterly BASs are lodged electronically via a deferred due date via the tax agents concession.

Advisers and taxpayers will need to follow ATO announcements on these important practical points.

Other proposed measures and issues

The foregoing content of this article illustrates that there has been much progress in reforming the tax system in relation to recommendations by the BET. There is much more to come. A summary of tax-related recommendations is provided below, together with a comment on their progress:

- recommendation 3.1 – Economy-wide cash payment limit of $10,000: the initial Treasury consultation closed on 1 July 2018 and further consultation closed on 12 August 2019 (see below);
- recommendation 3.2 – Mandating payment of salary and wages into bank accounts: this measure will likely flow after STP has been implemented economy-wide;
- recommendation 3.7 – ABN verification for electronic payments (see below);
- recommendation 4.2 – ABN reforms (see below);
- recommendation 4.3 – Single business register for companies, ABN's and business names (see below);
- recommendation 6.2 – Sharing economy reporting regime: Treasury consultation closed on 22 February 2019 (see below);
- recommendation 7.4 – Examining the role of advisers and the TPB: an independent review of the effectiveness of the TPB and the *Tax Agent Services Act 2009* (Cth) was announced on 5 March 2019. Submissions were due by 12 April 2019 and further consultation is currently underway, with stage 2 submissions having closed on 30 August 2019;
- recommendation 7.6 – Examining/modernising tax record-keeping practices (see below);
- recommendation 8.5 – Transparency of beneficial ownership: an international transparency related measure that will have a wide impact if implemented;
- recommendation 9.1 – Integrity of government procurement: Treasury consultation closed on 21 December 2018 and the measure was adopted.[43] From 1 July 2019, businesses wanting to tender for Australian Government contracts over $4m (including

GST) now need a "statement of tax record" from the ATO. Details can be obtained from the ATO website;[44] and
- recommendation 12.3 – Enhancing/strengthening anti-money laundering requirements: this is inevitable if progress in other large markets is an indication.

Outside of this extensive program, some other specific aspects are worth noting:

- labour underpayments, as well as giving rise to industrial law implications and reputational issues, are regarded as indicators of black economy activity. Organisations actioning discovered labour underpayments need to manage redress carefully;
- personal services income rules: the effective operation of the personal services income rules will support the effective taxation of labour. As such, the Commissioner is active in this space, so advisers should support their clients accordingly, including to ensure that they consider recent case decisions;[45]
- ATO strike teams are in operation and active, especially with a focus on small business in selected areas; and
- common reporting standard (CRS): the ATO now has access to data from more than 65 countries through CRS. Clients may appreciate understanding that this means that the ATO receives regular information regarding their foreign bank transactions.

$10,000 cash payment limit

After an initial review, Treasury conducted further consultation with exposure draft Bills that closed on 12 August 2019. Among the relevant points of the latest proposal[46] are:

- proposed offences are to apply if cash payments of $10,000 or more are made from 1 January 2020;
- measures are to apply where businesses "make or accept" cash payments or a series of payments, the latter being subject to similar rules as currently apply to Austrac reporting;
- despite this, wording of the Bill indicates that the measures will apply beyond a B2B and B2C setting, ie they may apply between two non-business individuals as well;
- fault elements are to include intent and strict liability. For strict liability offences, fines apply of up to 60 penalty units for individuals and 300 penalty units for corporations. Where the mental element offences are proven, the maximum increases to 120 penalty units, two years' imprisonment or both;
- "cash" is proposed to include any currency, both physical and digital. However, exemptions are expected which may include digital currency due to the way that this is used in Australia; and
- jurisdiction of the proposal is to be on a "category B extended jurisdiction" basis. That is, the proposal will also apply to Australian entities undertaking transactions outside Australia.

The Currency (Restrictions on the Use of Cash) Bill 2019 was introduced into parliament on 19 September 2019.

ABN reform

After the government's response in May 2018 to the BET final report, Treasury conducted consultation regarding "designing a modern Australian business number system" which closed on 31 August 2018.

With sophisticated technology now being accessible at reasonable prices for virtually all businesses, and acknowledging that many will be utilising this technology to comply with STP obligations within the next year or so, business seems well positioned to accommodate reforms to the way that ABNs are utilised, whether that is from a supply chain/B2B perspective or in regulatory data reporting.

There were some aspects of the consultation that caused controversy, in particular, surrounding whether a renewal process and renewal fee should be introduced. From my perspective, I don't see the latter as being a welcome reform as constantly changing business laws and regulations already impose enough cost on business. However, I am in little doubt that having a unique identifier like the ABN can be a powerful tool in a well-designed system and, as such, possessing an ABN should not be an automatic entitlement and a "set and forget" process. It has been an underutilised tool since the ABN/GST system was implemented as at 1 July 2000.

Now that wide adoption of technology to support better business and regulatory integration is with us, the future will involve mutual business identity verification, regulatory reporting and record-keeping.

The importance of the ABN system may be further reinforced after the consultation regarding the sharing/gig economy.

The role of tax agents and BAS agents in this process will be critical. We are ideally placed to identify and help resolve transitional problems, including coaching business operators through change, helping new businesses as they start up and grow, and identifying and suggesting future improvements as any adverse supply chain impacts become evident.

Sharing/gig economy

Treasury conducted a consultation into the sharing/gig economy as recommended by BET recommendation 6.2. This consultation[47] closed on 22 February 2019. Some features of the sharing/gig economy were highlighted in the discussion paper released with the consultation:

- there are a wide range of activities that comprise the sharing/gig economy, eg ride-sharing, accommodation, odd jobs, delivery;
- the estimated value of the sharing economy was $15.1b in February 2017;
- administering the sharing economy, especially introducing a new reporting regime, involves inherent problems, including:
  - the uncertainty of taxpayer obligations, for example: whether activities are a hobby or part of a business; categorising activities for tax purposes (the confusion regarding whether ride-sharing includes taxis or not and for what purpose, eg FBT and GST highlight this); whether payments are for employment or contractors and, if the latter, whether they are labour payments;
  - visibility: whether there is a platform or marketplace that can be readily administered; and
  - the location/jurisdiction of the platform provider: whether the platform provider can be made subject to the Australian jurisdiction and, if so, how effectively;

– the ATO's success was noted with GST registrations for ride-sharing drivers: up from 54% to 77%;
– compulsory reporting was the apparent desire and whether tax withholding should occur was outside scope of the review; and
– the consultation posed the question of what role the banking/financial system could play.

There has been no further progress on these matters as at 19 September 2019.

E-invoicing framework and other digital business initiatives

The ATO and Australia's Digital Business Council have been working to develop a framework of standards and guidelines for e-invoicing. The Australian and New Zealand Governments signed an agreement on 25 October 2018 to formalise a common framework for e-invoicing in our markets.

With 1.2 billion invoices being exchanged in Australia annually, e-invoicing provides an opportunity to create digital interactivity within the economy and thus substantially improve B2B commerce and defray business administration costs.[48]

If well integrated with ABN reform, many businesses will find adoption of the voluntary e-invoicing compelling.

Legislation to enable the e-invoicing framework was passed by the House of Representatives and was introduced into the Senate on 1 August 2019.[49]

Contractor issues

The impact of the TPRS changes are covered earlier in this article, but even a relatively brief review of the potential reform list above highlights that businesses that engage contractors are potentially in for significant future change, including systems upgrades to accommodate ABN verification and reforms, the introduction of cash payment limits, and meeting further compliance requirements when tendering for federal government work.

From a commercial perspective, many existing businesses are already needing to cope with significant changes surrounding rules affecting contractors under various guises:

– the ATO head contractor project which, among other things, provides head contractors with some visibility of the tax status and behaviour of the people in their supply chains;
– Australian Building and Construction Commission compliance;
– whistleblower and anti-corruption legislation;
– contractor payment/project bank account reforms, which involve different rules with different compliance requirements, cut-offs and lodgment deadlines in each state; and
– tendering reform (both state and federal).

Disclosure of business tax debts to credit reporting agencies

A Bill to permit disclosure by the ATO of business tax debts to credit reporting agencies is currently before the Senate.[49]

Along with this, Treasury has conducted consultation[50] (which closed on 21 August 2019) in relation to the class of business whose tax debt information can be disclosed. The legislative instrument only allows the ATO to disclose this information when certain conditions and safeguards are met, including ensuring the entity has not entered into a payment arrangement with the ATO, does not have a complaint with the Inspector-General of Taxation about the disclosure of debt information and has total tax debts of at least $100,000 which has been payable for more than 90 days.

Conclusion

The extensive work of the BET gained an enormous amount of traction with government, and this is reflected in the significant volume and impact of subsequent legislative reform.

It seems that measures designed to bring others into the tax and regulatory system have been well targeted, but they have a much wider impact which affects, perhaps even penalises, us all. From a tax system perspective, this seems to be a price that those of us operating within the system already should be willing to pay so that the future tax system can stand up to the unknown impact of future business disruption.

The strength of our tax and regulatory system will be supported by validated participants supplying real-time information with data integrity. It seems that we are making progress towards this "nirvana", but there's a long way to go. However, we have made rapid progress from the early days of the electronic gateway through SuperStream to now nearing full adoption of STP. So, things may happen sooner than we think.

In the meantime, it's a question of how our clients and us as advisers survive through inevitable change and address the risks that go along with that, such as:

– surviving and thriving: the key to both will be adopting and adapting to technology;
– STP: many are not sure whether it will be a help or a hindrance, and question whether the incorporation of state payroll taxes is too much to wish for;
– whether the denial of deductions for non-compliant payments will be more costly than expected, or whether this will shine a light on issues already requiring attention (the non-quotation of the ABN rule perhaps?); and
– the ever-increasing pressure on businesses and their advisers, both coping with rapid change generally and the stresses arising from additional consequences for compliance breaches, especially if the business is a significant global entity.

It remains to be seen what problems will be stubborn enough to survive reform, and whether we can come up with a reasonable solution to the employee versus contractor distinction.

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An earlier version of this article was presented at The Tax Institute's 52nd WA State Convention held in Perth on 22 to 23 August 2019.

Appendix 1. Summary of key amending legislation and Bills

Instrument	Key topics	Introduced into House of Representatives	Introduced into Senate	Passed by both Houses	Royal assent
Treasury Laws Amendment (Black Economy Taskforce Measures No. 1) Act 2018	Ban the manufacture, distribution, possession, sale and use of electronic sales suppression tools. Courier and cleaning industries added to TPRS from 1 July 18.	7 Feb 18	18 Jun 18	18 Sept 18	3 Oct 18
Treasury Laws Amendment (Black Economy Taskforce Measures No. 2) Act 2018	Deny tax deduction for failure to comply with withholding/reporting obligations. Road freight, security and IT services added to TPRS from 1 July 19. Moves taxing point of domestically manufactured tobacco to point of manufacture rather than when it enters home consumption (along with Excise Tariff Amendment (Collecting Tobacco Duties at Manufacture) Bill 2018 and legislation affecting the Department of Home Affairs. This measure is designed to stop tobacco leakage from warehouses, which is alleged to be the primary cause of illicit tobacco trade – a major funding source for organised crime according to the BET.	20 Sept 18	18 Oct 18	15 Nov 18	29 Nov 18
Treasury Laws Amendment (2018 Measures No. 4) Act 2019	Single touch payroll extended to all employers from 1 July 2019. Reforms to boost protection of workers' superannuation entitlements including: – court order penalties where employers defy directions to pay SG liabilities; – earlier detection ability, eg STP combined with real-time contrib reporting; – strengthened DPN and security deposits regime; – employees ability to check super information through myGov account; and – the ATO can pre-fill new employees' TFN declaration and super choice forms. Welfare system data-matching incl improved TFN verification powers.	28 Mar 18	25 June 18	12 Feb 19	1 Mar 19
Treasury Laws Amendment (Combating Illegal Phoenixing) Bill 2019	Provide regulators with additional enforcement and regulatory tools to better detect and address illegal phoenix activity, including to prosecute/penalise directors and facilitators (eg "unscrupulous" pre-insolvency advisers), limit ability to resign/remove directors and create new voidable transaction (creditor defeating disposition) rules. Extend DPN regime to GST, LCT and WET estimates and liabilities. Expand the ATO power to retain refunds. Minor clarifying amendments to insolvency reform (part of National Innovation and Science Agenda).	13 Feb 19 – lapsed. Re-introduced 4 July 19	N/A	N/A	N/A
Treasury Laws Amendment (2019 Tax Integrity and Other Measures No. 1) Bill 2019	Includes proposal to disclose business tax debts to credit reporting agencies as well as terms to support the e-invoicing framework	24 July 19	1 Aug 19	N/A	N/A
Currency (Restrictions on the Use of Cash) Bill 2019	Restricts use of cash payments of $10,000 or more	19 Sept 19	N/A	N/A	N/A

Appendix 2. Summary of black economy related measures and their current status

Measure	From when?	Current status
TPRS: – building and construction – cleaning and couriers – road freight, security, investigation, surveillance, IT	 2012-13 2018-19 2019-20	 Law Law Law
Foreign resident CGT withholding	2016-17	Law
GST withholding on residential sales	2018-19	Law
Single touch payroll: – 20 or more employees – < 20 employees	 2018-19 2019-20	 Law Law
Annual tax transparency reporting incl MAAL/CbC	Various	Law
Common reporting standard (foreign bank account information exchange)	2017-18	Law
ATO permitted to estimate GST liabilities	2018-19	Law
Expand ATO power to retain refunds	Royal assent	Bill
Denial of tax deduction for not withholding and reporting PAYG	2019-20	Law
Extend DPN regime to GST, LCT and WET estimates and liabilities	Royal assent	Bill
Salary and wages: compulsory payment to bank account	Unknown	Awaiting
New regulatory framework for ABN system	Unknown	Awaiting
Economy wide B2B $10,000 cash limit	1/1/20	Bill
Director identification number system	Unknown	Awaiting
Limit ability to resign/remove directors	Royal assent	Bill
New voidable transaction (creditor defeating disposition) rules	Royal assent	Bill
Integrity measures for government procurement: “STR” > $4m incl GST	1/7/19	In place
Criminal penalties for failure to follow ATO direction to pay superannuation	SGC 1/7/18	Law
Power of ATO to issue directions to pay unpaid superannuation (incl to non-directors)	1/4/19 for SGC arising from 1/7/18	Law
Power of ATO to make education directions and orders (including to non-directors) Power to inform employees regarding unpaid superannuation	1/4/19 for SGC owing as at/from 1/7/18	Law
Funding for targeted initiatives: – new “mobile strike teams” – data analytics/matching initiatives – a black economy hotline	Under way	In place
Prohibit supply/use/etc of electronic sales suppression tools	Royal assent unless held pre-9/5/17	Law

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6 Measures affecting tobacco excise will not be considered.

7 Page 3 of the explanatory memorandum to the Bill that became the *Treasury Laws Amendment (Black Economy Taskforce Measures No. 2) Act 2018*.

8 Many of these payments would be made by a not-for-profit entity, for which there ought to be no inconvenience for denial of a tax deduction. As such, there must be concern about non-NFP entities’ activities for this to be incorporated in this reform.

9 This is not a withholding obligation; it is an additional imposition on the provider of the non-cash benefit in relation to the value provided. To balance this, pursuant to s 14-15 TAA, the payer may recover the amount from the recipient of the benefit as a debt.

10 S 26-105(1) and (3) ITAA97.

11 This is in addition to the “failure to withhold” offence that applies pursuant to s 16-25(1) TAA.

12 Given that STP has now commenced for all employers from 1 July 2019 (subject to some deferral reliefs and exemptions), s 389-5 will apply in most employer situations instead of s 16-150. Among other things, s 389-5 mandates same day reporting which has applied for employers with 20 or more employees from 1 July 2018.

13 S 26-105(1)(b)(i) ITAA97.

14 This aspect explained further below.
15 S 26-105(1)(b)(ii) ITAA97.
16 S 26-105(2) and (3) ITAA97.
17 Again, this is in addition to the offence in s 16-25 TAA. In this case, the "fail to pay" offence in s 16-25(2).
18 S 26-105(4).
19 S 26-105(5) and (6).
20 S 26-105(7) in the payment case and s 26-105(8) in the non-cash benefit case.
21 *Treasury Laws Amendment (Black Economy Taskforce Measures No. 2) Act 2018*.
22 Page 7 of the government response to the BET final report claims that $2.3b was raised in tax liabilities in the first year of the TPRS alone (2012-13). Until 1 July 2018, the TPRS only applied to the building and construction industry.
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28 Figures previously reported by the ATO in May 2015 in a report entitled *Taxable payments reporting – effectiveness measurement*.
29 Previously reg 64 in the now repealed *Taxation Administration Regulations 1976*.
30 Building and construction activities are defined whereas the new activities are not.
31 Comments on feedback on the draft law companion ruling are found at LCR 2019/4EC.
32 The ATO has issued TPRS 2019/1 to confirm this.
33 For cleaning and courier industries; the others have their first obligation a year later.
34 Para 15 of LCR 2019/4.
35 Para 31 of LCR 2019/4.
36 Para 38 of LCR 2019/4.
37 The same may apply for other TPRS-reportable services in theory, but they are unlikely to be of the extent to exceed the de minimis level.
38 This is probably outside normal service entity guidelines, but it may arise if the IT contractor is supporting both the business and the services provided.
39 The three-month rule has been retained for PAYG withholding liabilities and estimates.
40 Originally introduced into House of Representatives on 13 February 2019; reintroduced on 4 July 2019.
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ATO perspective on large super funds

by Nadia Alfonsi, Client Engagement Director, and Chris Thomson, Law Interpretation Director, Australian Taxation Office

With the ever-expanding level of investment and subsequent oversight by regulators, we recognise that large superannuation funds operate in a complex and challenging environment as they seek to act in the best interests of members and meet their tax, reporting and other regulatory obligations. Through our engagement with large superannuation funds, we have seen the different ways funds are responding to these challenges and how they are continually evolving in the way they do business and interact with their members and regulators, including the ATO. In response, our responsibilities and services have also expanded to support funds and their advisers in meeting their tax and reporting obligations and in undertaking assurance activities that build community and government confidence in the sector. This article provides valuable insights from our engagement with large superannuation funds over the last 12 months and notes key areas of future focus.

Background

When compulsory superannuation was introduced about 25 years ago, it would have been difficult to anticipate the significant contribution this sector now makes to the Australian economy. As at March 2019, the value of assets held within superannuation totalled approximately $2.8tr, with over two-thirds held within large superannuation funds.[1]

Current government policy settings including mandated contributions and concessional tax rates will continue to promote growth in this sector. With this level of investment and subsequent oversight by regulators, we recognise that funds operate in a complex and challenging environment as they seek to act in the best interests of members and meet their tax, reporting and other regulatory obligations.

Through our engagement with the sector, we have seen the different ways funds are responding to these challenges and continually evolving in the way they do their business and interact with their members and regulators, including the ATO.

We have observed the investment behaviours of funds changing as they seek alternative investment structures, moving away from concentrated domestic markets to seek exposure offshore. We see funds adopting new technology directly or through service providers to process the significant number of daily investment and service-related transactions. We also note that the service offerings of funds continue to evolve as they seek to remain competitive in this growing market.

In response, our responsibilities and services have expanded to support funds and their advisers to meet their obligations and undertake assurance activities that build community and government confidence in this sector.

We welcome the opportunity to provide an update on our engagement with large superannuation funds over the last 12 months. This article will provide insights into some of our important initiatives, such as the "justified trust" program and a snapshot of our key areas of focus.

Engagement with the ATO

Large superannuation funds interact with the ATO in a number of ways. Interactions include supporting funds to meet their tax obligations as well as member reporting obligations, which are fundamental to the administration of the broader superannuation system.

Over the last 12 months, we have extended our engagement with funds through the justified trust program where we seek an understanding of a fund's operations and economic activity to obtain a level of confidence that their tax obligations are being met.

In undertaking this work, we interact directly with funds, their advisers and, increasingly, their service providers employed by funds to undertake investment activities, process data and report to the ATO either through the fund's income tax return or event-based reporting.

Event-based reporting

As we move away from an annual member contributions statement reporting system, we recognise that the transition to event-based reporting and bedding down of systems has been a significant development for the industry over the last 12 months. Event-based reporting brings greater insight into a fund's reporting systems and processes, as well as providing a more timely view of members' attributes and contributions.

Transactions now reported to us have been in the order of over 32 million reports of member accounts or changes and 183 million reports of account contributions or transactions. This information now allows us to share this account and transactional information back to fund members though ATO online services.[2]

Successor fund transfers

Last financial year, we supported funds through 16 successor fund transfers that involved approximately 1.2 million members, all or some of whom had the potential to be impacted in some way.

Looking ahead, we will continue to support funds going through a merger or successor fund transfer. With the likely increase in this activity, we are updating our successor

fund transfer protocol document following input from funds. Further updates will be provided as these changes are finalised.[3]

Justified trust

As part of the Tax Avoidance Taskforce, the ATO has been engaging with some of Australia's largest taxpayers through the justified trust program. Justified trust is an OECD concept that intends to build and maintain community confidence that taxpayers are paying the right amount of tax. The way that justified trust is achieved is by seeking objective evidence that would lead a reasonable person to conclude that a particular taxpayer paid the right amount of tax.

This is quite different to the risk-based approach of engaging with funds through compliance activities undertaken in the past. Justified trust requires a holistic understanding of the taxpayer and their business. It also requires obtaining a higher level of assurance than only confirming that a certain risk does not arise.[4]

The justified trust approach was initially applied to funds in the top 100 population. The top 100 population consists of public and multinational businesses and large superannuation funds that have substantial economic activity related to Australia. As these entities have a significant impact on the health of our tax system, we engage with them one-to-one to manage their compliance and obtain a level of assurance over their economic and tax affairs.[5]

Top 1,000 reviews

The justified trust approach is also applied to funds in the top 1,000 population. The top 1,000 population consists of public and multinational businesses and large superannuation funds with an annual turnover above $250m. It does not cover taxpayers that continuously engage with us through our top 100 program.[6]

Reviews of large superannuation funds in the top 1,000 population commenced in February 2019 and we expect to review approximately 82 funds through this program.

Our assurance team engage with each fund through streamlined assurance reviews (reviews) that typically cover the last four income years. We seek to apply a consistent, structured approach that has been tailored having regard to the unique business profile of large superannuation funds and their reliance on automated systems and third-party service providers. This includes:

- data driven assurance: we seek to assure aspects of the income tax paid by funds using data. Data sources used included income tax return and member contribution data, as well as audited publicly available data such as data reported by funds to APRA. Where we have been able to assure aspects prior to engaging with a fund, our questions will be limited to confirming our assumptions or requesting explanations of outliers or variances;
- governance over third-party data: due to the necessity of outsourcing in the institutional investment environment, large superannuation funds rely on data from third-party providers. Tax governance for superannuation funds therefore requires an assessment of the controls and processes in place to reduce the risks of reliance on third-party data (see below); and
- tailored questionnaire: our tailored questionnaire focuses inquiries to areas that cannot be assured through data and to specific tax risks such as propagation, investments in offshore limited partnerships and structured arrangements that provide additional imputation benefits (see below).

Following a review, we share our findings with each fund, including:

- identifying areas where we have assurance that a fund has reported the right amount of income tax; and
- any identified concerns or tax risks.

We may recommend specific actions to obtain greater assurance in particular areas and may follow up on these recommendations. If we identify concerns or areas of tax risk, we will engage with funds through a variety of tailored approaches. We will seek to work collaboratively with funds to obtain greater assurance or address identified concerns or tax risks. There will be circumstances where we will move to more intensive approaches, such as audits.

The outcomes of these reviews will help inform our engagement with funds over the next 12 months and include:

- working collaboratively with industry on areas such as tax governance to obtain higher levels of assurance; and
- engaging with funds on aspects where concerns or specific tax risks have been identified.

We will also consider whether some of these aspects require further public guidance to provide greater certainty and make it easier for funds to comply with their tax obligations.

Managing tax risks

Tax governance and third-party data

Tax risk is the risk that funds may be paying or accounting for an incorrect amount of tax, or that the tax positions that a fund adopts are out of step with the tax risk appetite that the trustee board has authorised or believe is prudent. Because tax will ultimately impact on member balances, funds have an obligation to ensure that they manage tax risk through a strong tax governance framework.

The ATO published an updated *Tax risk management and governance review guide* on 27 January 2017. The guide sets out principles for board-level and managerial-level responsibilities, with examples of evidence that demonstrates the design and operational effectiveness of tax control frameworks.

In addition to the controls set out in the ATO guide, we have broadened our focus on tax governance for large superannuation funds to include controls relating to the quality and integrity of third-party data which is key to the accurate reporting by funds in their income tax return.

For most funds, this starts with their custodian and obtaining a level of confidence that the data flowing through to and from a custodian is accurate. This also extends to the direct receipt of investment information from both domestic and foreign sources.

The appropriateness of the controls and processes will vary depending on the size of the fund and the complexity of the investments held. However, some fundamental controls that trustees should consider include:

- whether tax policies are prepared in accordance with the tax law. For example:
  - a review of the custodian's tax policy and processes to review and update in the event of law change; and
  - a process to ensure that instructions accord with the tax law where there is an override to a default position in the custodian's tax policy, eg external advice or a private binding ruling is sought; and
- what steps a fund undertakes to be sufficiently satisfied that the returns and tax outcomes of investments are properly reflected in their tax return. For example:
  - a review and testing of the information in trust distribution statements;
  - a tax due diligence process for new investments;
  - processes and controls to identify and manage the Australian tax consequences of foreign investments; and
  - what assurance the fund seeks in relation to the accuracy of the data received and processed by service providers. For example, the employment of independent assurance providers (internal or external) on the effectiveness of the tax controls of service providers and the accuracy of the data they receive and process, eg trust distribution statements.

Given the reliance that funds have on the data provided by third parties in completing their income tax return, strong governance over this data is an important factor taken into account in determining the level of assurance obtained over particular aspects of the fund's economic activity in our reviews.

This includes whether the amount of investment income derived from investments such as offshore limited partnerships or managed investment trusts has been correctly reported as well as the claiming of associated offsets and deductions. In circumstances where a fund cannot demonstrate good governance over third-party data, we are unable to gain high assurance for these aspects.

Useful insights on findings on tax governance and ratings provided to date through the general top 1,000 program can be found in the latest findings report.[7]

We seek to apply a consistent rating system when reviewing and assessing tax governance of funds.[8] However, in recognition of the broadened scope of governance to include controls over third-party data, we have assessed some funds as provisional stage 2. This provisional rating acknowledges that some funds have reached stage 2 for their overall tax governance framework when assessed against the ATO guide, but they were assessed as stage 1 for governance over third-party data.

From our limited engagement with funds to date, common reasons for funds achieving stage 1 rating for their tax governance include:

- a narrative description of the tax control framework is not evidence that can be relied on. Processes should be documented rather than a narrative being provided;
- no gap analysis was provided, or a gap analysis was provided with no document references to support how controls are aligned with the ATO guide; and
- limited evidence of controls and processes over third-party data.

We will continue to engage with funds through the justified trust program to gain insights on the necessary controls and processes over third-party data. We will use this intelligence and consult further with industry to provide guidance on what is considered to be best practice for funds in this area.

Taxation of investments

As the funds under management continue to grow in this sector, we see funds seeking alternative investments through more complex arrangements, often to seek exposure to offshore investments. Funds are reminded that they need to have processes in place to manage the tax consequences of these arrangements to reduce the risk of non-compliance with their Australian tax obligations.

Through our engagement with funds over the last 12 months, we have expressed concerns over a number of domestic and offshore investment arrangements where we have identified specific tax risks. We are therefore likely to continue our engagement with funds on the following arrangements.

Structured arrangements and equity derivatives that provide imputation benefits

In February 2018, TA 2018/1 was published on structured arrangements that provide imputation benefits on shares acquired on a limited risk basis around ex-dividend dates after becoming aware of certain arrangements being entered into by entities, including superannuation funds.

We have also become aware of similar arrangements not covered by TA 2018/1, including those involving the use of derivative instruments, where it is clear that additional imputation benefits are being sought.

We are not concerned with the use of derivative instruments as part of a fund's investment strategy recognising that there may be clear commercial reasons why funds seek to utilise such instruments. However, where funds utilise such arrangements to obtain additional imputation credits, we will consider the following:

- whether a participant is a qualified person as per Div 1A of former Pt III of the *Income Tax Assessment Act 1936* (Cth) (ITAA36), particularly where arrangements are put in place to substantially reduce their risk of loss or economic benefit of the underlying Australian equities;
- whether it is appropriate to make a determination under s 276-90 of the *Income Tax Assessment Act 1997* (Cth) where a participant invests in Australian equities via an attribution managed investment trust (AMIT) and enters into an arrangement that directly or indirectly reduces the economic exposure to changes in the value of the membership interests held in the AMIT; and
- where a fund has put in place a structured arrangement seeking a franking credit benefit, whether s 177EA ITAA36 should apply.

We will continue to engage with funds to gain a better understanding of arrangements that involve holding an additional long position in Australian equities, whether directly or indirectly, and entering into related derivative instruments that reduce economic exposure to the returns and capital performance of those equities. These derivative instruments can include, but are not limited to, total return swaps and short positions on futures contracts.

In our top 1,000 reviews, we will query funds on whether they have entered into these types of arrangements. Where we observe that a fund has entered into these or similar arrangements, we are likely to undertake more intensive engagement.

We will also consider whether further public guidance is warranted. Funds or advisers contemplating these arrangements are encouraged to speak to us prior to implementing the arrangement.

Foreign income tax offsets and foreign exchange gains and losses

The ATO has previously engaged with funds on compliance matters associated with the Commissioner's view contained in TR 2014/7 and how funds treat foreign exchange (FX) hedging gains and losses in respect of the calculation of the foreign income tax offsets (FITO) limit.

We have also issued PCG 2016/6 that sets out the ATO's compliance approach to taxpayers determining the source of certain hedging gains for the purposes of calculating the FITO limit.

In our engagement with funds through our justified trust program, we continue to seek assurance that funds are complying with the views in TR 2014/7 and, in particular, determining which FX gains are foreign sourced, which portfolios those FX gains relate to and which reasonably related deductions relate to those FX gains.

We also seek to gain an understanding as to whether funds have opted to apply PCG 2016/6, which is based on applying a reasonable approach to determining source of FX gains taking into account relevant matters. Early observations include that the following relevant matters have not been taken into account by funds:

- either a single branch or multi-branch ISDA did not include an Australian branch;
- the branches identified in the SWIFT 300 confirmations were offshore;
- the presence of an Australian branch for a foreign bank counterparty is not enough to classify a FX hedging gain as being domestic sourced even if is undertaken in Australian business hours if that branch does not actually conduct its FX trades in Australia. Further information may be required from the hedge manager and/or foreign banks to confirm whether they actually trade in Australia;
- initial contact may occur with a dealer in Australia, but the forward points for a forward FX contract are agreed later, meaning that the contract is formed in another jurisdiction (may be foreign or domestic); and
- multiple trades with identical time stamps which cause concern as to the reliability of the information provided by the hedge manager to the superannuation fund.

It is anticipated that large superannuation funds are likely to incur net FX losses in the 2019 income year which may have a significant impact on the FITOs claimed for this year. We are therefore likely to continue our engagement with funds to ensure compliance with the views contained in TR 2014/7 and PCG 2016/6.

Corporate limited partnerships

Given the investments by funds through corporate limited partnerships (CLPs) has increased over recent years, we are seeking to understand the characterisation of the distributions from these investments. We have observed some instances where information provided to the fund (and custodian) report that distributions received from CLPs are treated for Australian tax purposes as either 100% return of capital or 100% assessable dividends.

We are concerned that this does not accurately reflect the economic substance of the fund's investment in the CLP or the economic activities of the CLP. Where the characterisation of the distributions is not accurately reflected, this will most likely result in incorrect tax treatment being applied by the fund.

We acknowledge industry feedback on this issue to date regarding the limitations funds may face in obtaining relevant tax information. However, we expect funds to have sufficient controls and processes in place to review these distributions and ensure they are accurately brought to account for Australian tax purposes. This may include requesting further information from the CLP or utilising other sources of information relating to the performance, or the underlying transactions, of the CLP.

We will continue to work with industry and individual funds to gain insights on industry practice with respect to these investments and consider whether further engagement or public advice is warranted.

Other foreign investments

As previously noted, with more funds seeking exposure to foreign investments as part of their investment strategies, we are paying particular attention to the characteristics of these investments and returns for Australian tax purposes, including:

- the treatment of gains as revenue or capital from disposals of investments by a foreign hybrid limited partnership in which a fund holds an interest;
- whether the fund employs adequate controls to identify relevant interests in a controlled foreign company and ensure the correct calculation of attributable income; and
- the appropriateness of "bed and breakfast" arrangements particularly where the practice is undertaken because of an inability to accurately calculate the attributable income.

Advice and guidance

Where appropriate, we will continue to provide industry with certainty on how the tax law applies to their circumstances through advice and guidance. While we provide a tailored advice and guidance service on a one-on-one basis such as our early engagement process, we have continued to provide industry with certainty through public advice and guidance on the following aspects.

Pension tax bonus

On 17 July 2019, we published PCG 2019/D2 that outlines our compliance approach for large superannuation funds in respect of pension tax bonuses. It provides our transitional compliance approach where funds are having practical

difficulties in complying with certain legislative requirements, specifically where IT systems may not correctly reflect the pension tax bonus in the members' opening account balances.

The practical compliance guideline outlines conditions where we would not allocate compliance resources to review the calculation of exempt current pension income as a result of a fund not incorporating the value of the pension tax bonus for the purpose of calculating required minimum pension payment amounts.

We therefore expect that our compliance approach will only impact the calculation of required minimum pension payments made in the year that the relevant superannuation income stream commences. This is dependent on all of the conditions outlined in PCG 2019/D2 being met, including the requirement for funds to update their IT systems by 30 June 2020.

Consultation closed on 14 August 2019. We are now considering feedback and will issue a final practical compliance guideline shortly. Funds that do not meet the conditions in PCG 2019/D2 are encouraged to speak to us prior to implementing the arrangement.

Royal Commission – web guidance

The Royal Commission into misconduct in the banking, superannuation and financial services industry has now concluded. With attention turning to the tax consequences of remediation and compensation payments, we have been working to provide certainty to a range of stakeholders.

In October 2018, we published advice on the tax consequences for compensation paid directly to individuals.[9]

If a superannuation fund receives compensation, the trustee will need to be aware of possible super, income tax and GST consequences. These consequences will depend on the specific facts and circumstances the compensation amounts relate to, and how they are received.

Compensation received by superannuation funds

In July 2019, we published web guidance on the income tax, GST and superannuation consequences for compensation payments by financial service providers to superannuation funds.[10]

This latest guidance provides our views on payments that have been made as compensation for:

- fees where no service is provided;
- deficient financial advice; and
- overcharged insurance premiums.

Several aspects of the guidance, and the process of its development, are considered below.

Relationship to past advice

While the guidance is new in that it sets out broad principles to be applied by funds and other relevant entities in some particular scenarios, those principles reflect our existing published views, including TR 95/35, TR 2010/1 and GSTR 2001/4. These documents remain a central point of reference for the Commissioner's views on those particular topics and the web guidance should be read within that context.

Scope of web guidance

In order to determine what we believe to be an appropriate scope for the published material, we consulted with key stakeholders, including industry representatives, advisers, funds, regulators, and the Australian Financial Complaints Authority.

We structured the advice on principles because we acknowledge that the guidance will not exhaustively cover all possible permutations, but expect that reading the guidance together with our other published advice will cover the majority of scenarios.

While our guidance does not comment on the suitability or appropriateness of compensation that may be agreed between parties (being a matter for the co-regulators ASIC and APRA), it does highlight the potential tax and super consequences of remediation programs that may take place.

Contributions

A key concern for all stakeholders is certainty on the Commissioner's views as to when compensation payments will be contributions. This is a notable concern given the potential for members to unintentionally exceed their contribution caps.

Characterisation of an amount as a contribution will depend on:

- the nature of the payment;
- who may have the legal right to the compensation;
- whether the payment made to a fund increases or augments the capital of the fund; and
- whether special rules concerning payments made out of reserves held by the fund apply.

When a payment is not a contribution. We identified that when a payment is paid to a fund trustee that has a right to that compensation, the payment would be in satisfaction of a right held by the fund trustee that already forms part of the capital of the fund, and therefore not a contribution. This basic principle is also reflected throughout the guidance.

Whether a fund trustee has a right to compensation will depend on:

- the terms of the arrangement for the original transaction;
- the specifics of the claim and settlement; and
- the form of compensation being proposed.

When a payment is a contribution. Where a fund trustee does not have the right to compensation, any compensation paid will generally be an increase in the capital of the fund and therefore a contribution. For example, where:

- the right to compensation belongs to the member personally rather than to the fund trustee, a payment to the fund would result in the payment being a contribution; and
- a payment is made to the fund for which the fund does not have a right to (for example, in respect of members who may have received advice), the amount allocated to that member would be also treated as a contribution for that member.

Income tax considerations

The income tax consequences of funds receiving compensation payments are also explained in detail in the

guidance, and are separately detailed for payments that have been received as compensation for:

- fees where no service is provided;
- deficient financial advice; and
- overcharged insurance premiums.

Broadly speaking, in the scenarios considered, compensation amounts in relation to lost value, or lost earnings or interest, are subject to the CGT provisions. This is because the receipt of compensation involves a CGT event happening to a CGT asset of the fund. The exact treatment under the CGT provisions depends on a range of factors outlined in the guidance, including whether the relevant asset is an investment or the right to compensation itself.

GST considerations

There are some practical issues to be considered regarding the GST implications of compensation payments referred to in the guidance. A superannuation fund trustee will need to consider whether it is required to repay the GST credits claimed where it receives a compensation amount that reflects a refund of fees paid to a financial service provider, and the superannuation fund had previously claimed GST credits or reduced GST credits on the fees.

The financial services provider will also need to consider their situation in respect of making the compensation payment to the superannuation fund.

Law reform and implementation

Law reform and implementation continues to be a focus for the ATO and large superannuation funds. Included in the 2019-20 Budget was the measure to make permanent the current tax relief for merging superannuation funds that is due to expire on 1 July 2020. Other measures affecting large superannuation funds include:

- protecting your superannuation package: this package of reforms announced in the 2018-19 Budget has now been passed by parliament. The law introduces a number of initiatives to protect individuals' retirement savings. Among other measures, we will now be able to proactively consolidate certain types of unclaimed super money to an eligible active super account via an ATO-initiated transfer;[11] and
- non-arm's length income: the recently introduced Treasury Laws Amendment (2018 Superannuation Measures No. 1) Bill 2019 contains amendments to remove any ambiguity about how the non-arm's length income provisions apply to income derived from schemes where the superannuation entity has incurred non-arm's length expenditure. We do not expect these amendments to have any significant effects on large superannuation funds. We are working to publish a new law companion ruling. The new law companion ruling will incorporate the feedback received in relation to the withdrawn LCR 2018/D10.

To keep up to date on these and other anticipated measures, funds are encouraged to:

- see the ATO's current news for APRA-regulated funds and current superannuation client relationship team alerts;
- subscribe to email updates to see when news pages are updated; and
- subscribe to *Super news* for a monthly wrap-up of news and updates.

Conclusion

Over the next 12 months, the ATO will continue to build on the strong and collaborative relationship with industry.

We will continue to provide assurance to the community and government that funds are meeting their obligations through our justified trust program, affording us the opportunity to gain a holistic understanding of the industry and its operation. As we continue to progress through the program, we will share our findings and insights to help funds make improvements and focus their activities over the next 12 months.

We expect the outcomes of these reviews to shape the design of our future engagement with the industry and individual funds to target high risk areas, as well as providing support and certainty to industry on aspects of their operation that will continue to evolve, such as tax governance.

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An earlier version of this article was presented at The Tax Institute's 2019 National Superannuation Conference held in Sydney on 29 to 30 August 2019.

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Are all dwellings "substantial and permanent structures"?

by David Krunic, CTA, Principal – Taxation Advisory, DKP & Co

Some interesting changes are about to apply to a broad range of individual, family trust and self-managed superannuation fund taxpayers when dealing with holding costs for residential property investments. New measures have been introduced which effectively deem land to be vacant until the land contains a substantial and permanent structure which is available for use. When these measures apply, holding costs will generally form part of the cost base of the property and cease to be deductible expenditure. There are exemptions for property used in business and for listed and corporate taxpayers. As the measures are slated to apply from 1 July 2019, taxpayers would be well served in familiarising themselves with these proposals. This article provides several examples to explain how the measures will apply. There are also minor twists to the examples to highlight some interesting issues for consideration.

Introduction

The August 2019 issue of *Taxation in Australia* included an article on an earlier version of proposed legislation regarding limiting deductions for holding costs in relation to "vacant" land.[1] The proposed legislation has since changed and is now found in Sch 3 of the Treasury Laws Amendment (2019 Tax Integrity and Other Measures No. 1) Bill 2019.

Following these changes, this article seeks to provide further analysis of the new measures and attempts to explain them by considering various examples and the associated explanatory memorandum (EM). It also contemplates what happens when there are slight variations to those basic examples.

This article starts with:

– Why were the measures introduced?
– When do the measures apply?
– Who is affected?

It then discusses new concepts, how the measures will apply in a range of common scenarios, and then details what happens with subtle variants to the same scenarios.

Throughout the article, issues are raised, together with suggestions regarding the operation of the proposed measures.

Why were the measures introduced?

Paragraphs 3.4 and 3.5 of the EM provide some background as to why these measures were introduced:

> "3.4 … some taxpayers have been claiming deductions for costs associated with holding vacant land when it is not genuinely held for the purpose of gaining or producing assessable income.
>
> 3.5 As the land is vacant, there is often limited evidence about the taxpayer's intent other than statements by the taxpayer. The reliance on a taxpayer's assertion about their current intention leads to compliance and administrative difficulties."

So, the stated concerns are with:

– not genuinely holding land to generate assessable income;
– often limited evidence about the taxpayer's intent; and
– compliance and administrative difficulties.

When do the measures apply?

The proposed measures are intended to apply to losses and outgoings incurred on or after 1 July 2019, regardless of whether the land was first held prior to this date. This will come as a shock to many non-business taxpayers who are building rental properties.

Who is affected?

The proposed measures specifically target non-business taxpayers, including individuals, family/discretionary trusts, closely held unit trusts and self-managed superannuation funds not in business.

Unlike many state-based tax measures and recent reforms to CGT on the sale of a former main residence which targeted non-residents, proposed s 26-102 does not specifically target non-residents.

The measures apply to all taxpayers, but exclude the following:

> "*Exception — kind of entity*
>
> (5) Subsection (1) does not stop you deducting a loss or outgoing if, at any time during the income year in which the loss or outgoing is incurred, you are:
>
> (a) a corporate tax entity; or
>
> (b) a superannuation plan that is not a self managed superannuation fund; or
>
> (c) a managed investment trust; or
>
> (d) a public unit trust (within the meaning of section 102P of the *Income Tax Assessment Act 1936*); or
>
> (e) a unit trust or partnership, if each member of the trust or partnership is covered by a paragraph of this subsection at that time during the income year."

Let us consider the s 26-102(5)(a) corporate tax entity exclusion. A "corporate tax entity" is given the following meaning by s 960-115 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97):

"An entity is a ***corporate tax entity*** at a particular time if:

(a) the entity is a company at that time; or

(b) the entity is a corporate limited partnership in relation to the income year in which that time occurs; or

(d) the entity is a public trading trust in relation to the income year in which that time occurs."

To the extent that a corporate tax entity (or their nominee) can acquire land, it appears that all foreign tax haven company entities are specifically excluded from these integrity measures (not explained anywhere in Sch 3), yet ordinary Australian residents who are subject to the domestic legal system are denied this because of the behaviour of "some taxpayers". This is an interesting approach to deal with integrity concerns.

It is suggested that s 26-102(5)(a) should be narrowed to an "Australian corporate tax entity".

There are further exemptions where the land is used in business.

What holding costs do taxpayers need to consider, and what are the associated timing or apportionment issues?

The Bill and the EM refer to costs such as interest, maintenance, land tax and council rates. However, the CGT cost base provisions in the ITAA97 provide more information about the costs of owning (rather than holding) land.

Are the holding costs referred to in the EM the same as those costs contemplated in s 110-25(4)?

"110-25(4) The third element is the costs of owning the CGT asset you incurred (but only if you acquired the asset after 20 August 1991). These costs include:

(a) interest on money you borrowed to acquire the asset; and

(b) costs of maintaining, repairing or insuring it; and

(c) rates or land tax, if the asset is land; and

(d) interest on money you borrowed to refinance the money you borrowed to acquire the asset; and

(e) interest on money you borrowed to finance the capital expenditure you incurred to increase the asset's value."

Based on the proposed s 26-102, taxpayers will need to focus on the timing rules that apply when these types of costs are incurred, including:

- When is interest incurred? (Typically, when liable to pay interest.)
- When are maintenance and repair costs incurred? (Typically, when an obligation to pay arises.)
- When are insurance costs incurred? (Typically, when the contract is organised.)
- When are rates or land taxes incurred? (Typically, at the start of the year, or the date of issue of council rates.)

Consider the first year after a dwelling has been constructed. Insurance is normally obtained well before the dwelling is made available for lease — are these costs non-deductible for the entire first year of coverage? Is an apportionment of costs required?

With respect to rates, there is typically a site value (land) and a capital improved value. Do we apportion the rates cost, ie does the site value form part of the cost base and the capital improved portion continue to be deductible?

Do we deny land tax deductions for a full year if the lawful occupation test is not satisfied on 31 December, even though the asset has been used as a rental property for decades and will become available for most of the subsequent year?

Many timing and administrative matters will arise when undertaking this type of analysis, which will cause a significant compliance burden for taxpayers.

The meaning of "holding costs" needs to be clearly defined, either separately within s 26-102, or by reference to s 110-25(4) ITAA97.

What is the "substantial and permanent structure" test and how does this differ from a "dwelling" in s 118-115(1)(a)? Is there a non-financial component to the test?

The EM provides insufficient explanation of "substantial and permanent structure" and it is unclear whether this differs from the well-understood and defined term "dwelling" in s 118-115(1)(a) ITAA97:

"3.18 To be substantial, a building or other structure needs to be significant in size, value or some other criteria of importance in the context of the relevant property. [Schedule 3, item 3, subsection 26-102(1)]

3.19 Whatever makes the structure substantial must be a feature of that particular structure — a structure is not substantial if it only has value as an adjunct to another structure. For example, a letterbox would not be substantial and a residential garage would be unlikely to be substantial."

What does this all mean?

Is a building or structure which costs $250,000 on land worth $25,000,000 considered to be "significant in size, value or some other criteria of importance in the context of the relevant property"?

Is a one-bedroom prefabricated dwelling installed on a 2-acre property significant in size, value or some other criteria?

It is difficult to argue that these two situations would satisfy this test — very difficult to argue that they are "significant in size, value or some other criteria of importance in the context of the relevant property".

On a separate matter, is the reference to "value" only a monetary concept? Does it contemplate an aesthetic or heritage value, ie is a one-bedroom childhood/inherited house on 2 acres with a land value of $10,000,000 of sufficient value?

Does a unique building which has significant historical or architectural features meet the value test or the "some other criteria" test? What is the "some other criteria" test? (Where a taxpayer was born?)

Future reforms to s 26-102 should use the s 118-115(1)(a) definition of a "dwelling" rather than introduce a new concept, ie a "substantial and permanent structure".

The legislation needs clearer thresholds, legislative guidance, and a detailed explanation of "some other criteria".

This measure is far too important to wait for the courts to decide, for the ATO to interpret, or to be left totally unexplained, practically unusable and not capable of reasonable interpretation.

Building exclusion issues and whether a building is different to a dwelling

What is the importance of the concept of a "building" in Sch 3 of the Bill? First, let us consider s 26-102(4) and the use of the term "building":

> "For the purposes of paragraph (1)(b), treat a building as not being a substantial and permanent structure if it is residential premises constructed, or substantially renovated, while you hold the land unless:
>
> (a) the residential premises are lawfully able to be occupied; and
>
> (b) the residential premises are:
>
> (i) leased, hired or licensed; or
>
> (ii) available for lease, hire or licence."

The *Macquarie Dictionary* defines a building to be a "substantial structure with a roof and walls". Does this in turn mean that this exclusion section does not apply to an apartment or part of a unit complex that does not have a roof?

It is suggested that s 26-102(4) should refer to a "dwelling" (s 118-115(1)(a)) rather than a "building"?

Vacancy due to involuntary evacuation/ significant damage

Consider a situation involving vacancy due to involuntary evacuation or significant damage. For the purposes of satisfying s 26-102(1)(b), the taxpayer must have a "substantial and permanent structure in use or available for use on the land". Section 26-102(4) then goes on to tell taxpayers to:

> "… treat a building as not being a substantial and permanent structure if it is residential premises constructed, or substantially renovated, while you hold the land unless:
>
> (a) *the residential premises are lawfully able to be occupied*; and
>
> (b) the residential premises are:
>
> (i) leased, hired or licensed; or
>
> (ii) available for lease, hire or licence." (emphasis added)

As the property cannot lawfully be occupied (because the tenants have been evacuated), the holding costs would not be allowable income tax deductions and would form part of the cost base. This can happen due to cracks in an apartment complex or a serious industrial chemical leak forcing permanent evacuation of the building.

There is no need to consider sub-para (b), as sub-para (a) has been triggered. Failure of *either* sub-para (a) or (b) is sufficient to trigger these measures. The EM includes the following example:

> "**Example 3.5: New residential premises available for rent**
>
> Anna purchased a block of vacant land and built new residential premises on it. Occupancy permits are issued for the residential premises once the building is considered suitable for occupation and the building is actively made available for rent.
>
> Anna can deduct the costs of holding this block of land to the extent expenses are incurred once the property is legally available for occupation and is leased, hired or licensed or otherwise available for lease, hire or licence."

These measures apply even where the vacancy was not caused by the taxpayer. This clearly needs legislative rectification.

Vacancy during significant renovation/ expansion phase

Consider vacancy during a significant renovation or expansion phase. For the purposes of satisfying s 26-102(1)(b), the taxpayer must have a "substantial and permanent structure in use or available for use on the land". Section 26-102(4) then goes on to tell taxpayers to:

> "… treat a building as not being a substantial and permanent structure if it is residential premises constructed, or substantially renovated, while you hold the land unless:
>
> (a) *the residential premises are lawfully able to be occupied*; and
>
> (b) the residential premises are:
>
> (i) leased, hired or licensed; or
>
> (ii) available for lease, hire or licence."

While the property is not available for lease during significant renovations (for example, building a second story to increase residential rental capacity), the holding costs appear not to be allowable income tax deductions, and would form part of the cost base.

There is no need to consider sub-para (b), as sub-para (a) has been triggered. Failure of *either* sub-para (a) or (b) is sufficient to trigger these measures (see example 3.5 of the EM (set out above)). However, what if the significant renovations to the property (for example, an extension) were to be used by a related business (for example, a home extension for business purposes, such as a yoga studio or an art class studio)? Are the holding costs deductible?

Paragraphs 3.32 and 3.34 of the EM provide interesting commentary:

> "3.32 Accordingly, it is sufficient that land is held in the course of carrying on a business for future use or made available to a related entity that is carrying on a business for future use.
>
> …
>
> 3.34 The extent to which a property is used or held available for use in carrying on a business must be determined on an apportionment basis that is fair and reasonable in the context of the particular property.
>
> **Example 3.2: Expenditure for mixed use land**
>
> Howard owns one hectare of land in Queensland. He uses one third of the land for carrying on his firewood sales business. He stores all his firewood in the open and there are no structures on the land. Howard has set aside the remainder of the land to construct a rental property. The remaining part of the land is separately fenced off and has been subject to site work including earthworks to clear the land ready for construction.
>
> Howard is eligible to claim losses and outgoings relating to holding the part of the land that he uses for carrying on his firewood business, to the extent that the loss or outgoing is necessarily incurred for the purpose of gaining or producing the assessable income.
>
> The remainder of his land is not used or held available for use in carrying on his firewood business. Further, as there are no structures

on Howard's land, it cannot contain a building or other structure that meets the requirements of these amendments. As a result, Howard is not entitled to claim any deductions relating to the costs of holding this part of the land even though he intended to derive income from it in the future as a rental property."

Based on the comments in para 3.32, it seems arguable that these holding costs would be deductible.

It is promising to see that the EM refers to the requirement to be "fair and reasonable" in the context of the particular property.

How much land do we need to have?

How are these proposed measures intended to apply, even if there is a miniscule land component and a significant building component funded by a single loan facility?

Does the land need to exceed a certain dollar amount, even where the construction costs considerably exceed the land value? When the rules apply, does the test apply to exclude all holding costs or only the holding costs as they relate to the land component of the purchase price?

Section 26-102(1)(a) requires that the taxpayer "incur a loss or outgoing *relating to holding land* (including interest or any other ongoing costs of borrowing to acquire the land" (emphasis added).

Consider where the land has minimal value (for example, $100 in remote rural settings), but it has a large building cost (for example, $300,000). It is considered that the measures apply even where the land is worth $100. The measures appear to deny the holding costs relating to the entire amount (for example, $300,100). There does not appear to be any apportionment mentioned in the provisions or in the EM, and this requires urgent clarification and explanation.

Clearly, the holding costs relate to the building rather than the land, but the provisions do not accommodate for such situations. Examples 3.1 and 3.5 do not contemplate any apportionment of costs in this regard.

The draftsperson to Sch 3 should consider the introduction of a land threshold test similar to that found in ss 108-70(2) and 108-75(3) ITAA97 to avoid inadvertent application when the land component is relatively minor, thus avoiding disproportionate compliance difficulties.

Deposits on house and land packages built by third parties

Consider deposits on house and land packages built by third parties. For the purposes of satisfying s 26-102(1)(b), the taxpayer must have a "substantial and permanent structure in use or available for use on the land". Section 26-102(4) then goes on to tell taxpayers to:

"… treat a building as not being a substantial and permanent structure if it is residential premises constructed, or substantially renovated, while you hold the land unless:

(a) the residential premises are lawfully able to be occupied; and

(b) the residential premises are:

(i) leased, hired or licensed; or

(ii) available for lease, hire or licence."

Prior to the time when the property is not lawfully able to be occupied, these measures would apply.

There is no need to consider sub-para (b), as sub-para (a) has been triggered. Failure of *either* sub-para (a) or (b) is sufficient to trigger these measures (see example 3.1 of the EM (below) and example 3.5 of the EM (set out above)):

"**3.1: Vacant land**

Chelsy owns a block of land. She intends to eventually build a rental property on the land. However, while the block of land is fenced and has a retaining wall, it currently does not contain any substantial and permanent building or other structure with an independent purpose that is not incidental to the purpose of another building or structure. As the block of land does not have a substantial and permanent structure on it, it is vacant land and Chelsy cannot deduct any holding costs she may incur in relation to the land."

As discussed earlier, what if the purchase price of the house and land component were dissected into separate land and construction components?

What happens if a finance arrangement provides a much lower interest rate for the land component (as there is less risk) and a much higher interest rate for the construction component?

Does s 26-102 require apportionment of holding costs?

Land purchased with savings, but renovation/building funded via borrowings

What if the land is purchased with savings but the renovation or building is funded via borrowings? This is a slight twist to the relatively straightforward cases discussed earlier. In the first instance, s 26-102(1)(a) requires that "you incur a loss or outgoing relating to holding land (including interest or any other ongoing costs of borrowing to acquire the land)".

Where the borrowing only relates to construction and not "holding land", it is difficult to see how s 26-102(1) would apply, as the borrowed funds have a specific economic purpose of construction and not of holding land.

If this analysis is correct, it would be entirely preferable to organise two sources of borrowing under two different contracts rather than one, that is, the first to purchase the land and the second to organise construction of a rental property without offending the provisions.

Examples 3.1 and 3.5 of the EM do not clearly address this issue and do not discuss any apportionment of costs. Confirmation that this approach will not offend the proposed measures is required.

Vacancy pre-sale

In many cases involving the sale of a property, real estate agents advise that the property should be vacant to enable a smoother and higher-value sale process, and to allow for immediate entry for the new buyer.

Accordingly, when we consider the wording of s 26-102(1) that "there is no substantial and permanent structure in use or available for use on the land", it seems we immediately fail the test even though the taxpayer is attempting to generate higher taxable profits.

Would it be reasonable to include a "historical use of asset" test in s 26-102, and perhaps consider something like s 152-35 ITAA97?

Property development, rental and subdivision as a business or investment

The EM provides an interesting insight for property developers:

> "3.29 Even where land is vacant (i.e. does not contain any structures) these amendments do not deny deductions to the holder of the land for the costs of holding that land to the extent that they are incurred in:
>
> – carrying on a business by the taxpayer (for example a property development or primary production business); or
>
> – holding land that is used or made available for use in carrying on such a business by certain entities related to the taxpayer."

So, for property developers, the answer is quite clear: property development is not captured by these measures.

What happens when the asset ceases to be held as trading stock and becomes a rental property in response to changes to market conditions?

It seems quite clear from para 3.29 and examples 3.1 and 3.5 of the EM, and from the use of the term "business" rather than "enterprise", that holding costs for rental property construction seem to be the target of the measures and therefore holding costs would be denied. As such, taxpayers could have situations where the holding costs are treated differently if the subdivided property moves from being trading stock to becoming a future rental property. This is an enormous compliance and administrative process caused by these new measures.

Note that one of the objectives of these measures was to remove compliance and administrative difficulties!

Alternate integrity measures

If Sch 3 is a response to integrity concerns only, it could be argued that a better approach would be to simply broaden Div 35 rather than introduce a blanket ban to holding costs. Schedule 3 should also provide the Commissioner with the discretion to override s 26-102 and allow judicial overview of the facts.

Unlike the measures dealing with integrity problems regarding non-commercial losses (s 35-55 ITAA97), Sch 3 of the Bill does not provide for any Commissioner discretion. There is also no scope for a review of the facts or verification of the taxpayer's intention, and no scope for judicial overview or analysis of the same facts or taxpayer intention.

It is not explained why non-commercial losses allow for the use of "evidence from independent sources" (s 35-55(1)(b)(ii) ITAA97) to help override the denial mechanisms, whereas no such scope exists within Sch 3 of the Bill for similar integrity concerns for losses relating to residential rental property investments.

It is suggested that Div 35 ITAA97 should be expanded to allow the use of "evidence from independent sources" in the context of applying the measures in Sch 3 of the Bill. For example, the following could be included:

- evidence of rental assessments;
- contracts with real estate agents;
- financial plans;
- statements of intention by the taxpayer; and
- other relevant evidence proving intent to produce assessable income.

Consistency within the ITAA97 would require Sch 3 to consider objective tests and evidence from independent sources.

It is believed that the introduction of time-based rules like those found in CGT event J5 or J6 could be considered where a requisite level of activity is necessary within a certain time frame.

Alternatively, another item could be included in s 20-30 ITAA97 to bring to revenue any holding costs previously claimed where the requisite level of income has not been generated without adequate explanation.

Schedule 3 of the Bill provides no flexibility, it is absolute, and it applies from 1 July 2019 without any transitional or grandfathered mechanisms.

At the moment, Sch 3 lacks:

- consideration of objective and verifiable evidence;
- phase-in/phase-out threshold-type tests;
- exemptions for unexpected outcomes (for example, a health event, death or divorce);
- transitional application/grandfathering;
- a general scope for Commissioner discretion with objective evidence; and
- scope for judicial overview.

Enterprise rather than business

There is an exemption from the proposed measures where the land is used in "business" (s 26-102(1)). Importantly, the requirement to have a "business" is a much higher threshold than having to operate an "enterprise", so just because a related party has an ABN does not automatically mean that the taxpayer is exempt from Sch 3.

Note that a "business" is subjective and involves an element of intent (which was one of the reasons why these measures were introduced in the first instance).

As the EM to Sch 3 refers to aspects of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GSTA), it is unclear why the taxpayer must have a business rather than an enterprise.

Technically, we can have an enterprise, and still fail this test. Why should the measures deny holding costs where the land is used in an enterprise rather than a business? Accordingly, s 26-102 should be broadened to include taxpayers that are an enterprise rather than a business.

Why timing issues caused by third parties have nothing to do with intent

As mentioned, to deduct holding costs, the residential premises need to be lawfully able to be occupied. This is a decision that should be made by a local council or a tribunal.

It seems unfair that a taxpayer would be disadvantaged merely because of delays by third parties, as this has nothing to do with the taxpayer's intent or actions. Anecdotally, taxpayers often remark that they "cannot wait for council approval".

Accordingly, the measures need to be refined in this regard.

Lack of ability to establish intention and judicial oversight

As the purpose of the measures in the Bill is to address an integrity concern, it seems unusual that a taxpayer cannot

either submit any facts to the Commissioner or have the facts reviewed by a court or tribunal. The measures need to be reformed and these legitimate facts should be capable of reasonable assessment and consideration by a court and the Commissioner, as is the case with so many other parts of the ITAA97.

Related entities – unnecessary complication and unintended exclusions?

A "related entities" definition is provided in s 26-102(2):

> "A business is covered by this subsection if the business is carried on for the purpose of gaining or producing the assessable income of one or more of the following entities:
>
> (a) you;
>
> (b) your affiliate, or an entity of which you are an affiliate;
>
> (c) if you are an individual — your spouse, or any of your children who is under 18 years of age;
>
> (d) an entity connected with you."

This seems rather complex and may exclude certain related parties. It may be more easily understood if a s 318 of the *Income Tax Assessment Act 1936* definition of "associate" was also included. This is well understood and used in many other aspects of the GSTA and the ITAA97.

Consider also that taxpayers who cease to be related parties/associates (for example, as a result of a relationship breakdown) may also fail these measures. This appears to be an unfair outcome and is unrelated to the income-generating features of the property or the intention of the taxpayers.

De minimus threshold

In order to avoid unnecessary and disproportionate compliance costs, the proposed measures should include a de minimus threshold (as exists in many other areas of tax legislation).

It is suggested that there should be a general threshold whereby s 26-102 only applies if the holding costs exceed $10,000 per income year, combined with a short application to the Commissioner as per s 35-55 ITAA97, resulting in small and minor taxpayers being excluded from these burdensome measures.

Conclusion

Schedule 3 of the Bill provides many interesting twists and it seems there are numerous unintended or unforeseen consequences. Therefore, clarification and detail are required regarding many parts of the proposed measures.

Taxpayers and their advisers would benefit by understanding the new landscape for "vacant land" (no pun intended)!

David Krunic, CTA
Principal – Taxation Advisory
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Reference

1 D Krunic, "No restrictions to negative gearing? Think again!", (2019) 54(2) *Taxation in Australia* 73.

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A Matter of Trusts

by Melissa Colaluca, Sladen Legal

Reg 13.22C unit trusts – opportunity or burden?

Regulation 13.22C unit trusts are an important structuring option for self-managed superannuation fund investments. However, is the administrative burden worth it?

The ability for self-managed superannuation funds (SMSFs) to make investments via private unit trusts and companies has always been somewhat of a minefield. Amidst the ever-changing superannuation laws and the ATO's recent interpretation of the non-arm's length income rules, it has become more and more difficult to be able to make investments via the use of an SMSF. This may act as a deterrent for some, however the tax advantage of investing via an SMSF has to be weighed up against the administrative costs and complexity.

The use of a unit trust that satisfies reg 13.22C of the *Superannuation Industry (Supervision) Regulations 1994* (Cth) (SISR) is a case in point. While such structures have always been a useful investment vehicle for SMSFs, they come with a high level of complexity and administration. This article will examine the requirements that a unit trust must satisfy under reg 13.22C (in this article, such a unit trust is referred to as a reg 13.22C unit trust).

The use of a reg 13.22C unit trust

Before delving into the legislation requirements of a reg 13.22C unit trust, it is necessary to discuss, at a high level, the in-house asset rules which affect an SMSF's ability to invest in certain assets. Relevantly, in simplified terms, an in-house asset includes an asset of a superannuation fund that is an investment in a "related trust". The trustee of a regulated superannuation fund is prohibited from holding in-house assets that exceed 5% of the market value of the fund's total assets.[1]

When considering whether the investment by an SMSF in a unit trust would be treated as an in-house asset, it must be determined whether that unit trust is a related trust of the SMSF and, if it is, whether any exceptions apply to such an investment.

Determining whether a trust is a related trust of an SMSF is a complicated task (a discussion of the related party provisions would require an article in itself). However, as a simple rule of thumb, if the SMSF and its "group" of related parties and entities hold no more than 50% of the units in the unit trust, hold no more than 50% of the shares in the corporate trustee, hold no more than 50% of the director roles in the corporate trustee, do not otherwise control the corporate trustee and do not have the unilateral power to remove the unit trust's trustee, then the unit trust will not be a related trust.

As a result, where an SMSF controls a unit trust (for example, it holds 100% of the units) then, unless an exemption applies, the investment by the SMSF in the unit trust would be classified as an in-house asset.

One such exemption is a reg 13.22C unit trust. Where a unit trust satisfies the requirements of reg 13.22C, even where that unit trust is a related trust of the SMSF, the investment in that unit trust by the SMSF will not be an in-house asset.

The requirements of reg 13.22C

The strict criteria of reg 13.22C are set out as follows:[2]

- the SMSF has fewer than five members;
- the trustee of the unit trust is not a party to a lease with a related party of the SMSF unless it is legally binding and relates to business real property;
- the trustee of the unit trust does not have any outstanding borrowings; and
- the assets of the unit trust do not include:
  - an interest in another entity;
  - a loan to another entity;
  - an asset over which there is a charge;
  - an asset that was acquired from a related party after 11 August 1999 (unless it is business real property acquired at market value); or
  - an asset that has been an asset of a related party of an SMSF at any time during the three years prior to that SMSF acquiring its interest in the unit trust (unless it is business real property acquired at market value).

The requirements of reg 13.22D

Once an investment is made in a reg 13.22C unit trust, that unit trust must continue to operate in a manner that does not breach reg 13.22D SISR.

Under reg 13.22D, a unit trust will cease to be a reg 13.22C unit trust if any of the requirements set out in that regulation are breached. Those requirements basically mirror reg 13.22C. However, there are two additional requirements, that is, the trustee of the unit trust cannot carry on a business and must not conduct any of its transactions on a non-arm's length basis.

Things to look out for with a reg 13.22C unit trust

As can be seen with the requirements of regs 13.22C and 13.22D, the operation of a reg 13.22C unit trust is very restricted. Effectively, reg 13.22C unit trusts are best used as vehicles for holding real estate.

It is easy enough to overlook, or not fully comprehend, some of the requirements of reg 13.22D. Things to look out for with a reg 13.22C unit trust include:

- a reg 13.22C unit trust can be used to hold business real property that is leased to a related party. In such a situation, it is important that the property is at all times business real property. This means that the property must be wholly and exclusively used for business purposes at all times and that there is no non-business use of the property (whether that is by related parties or unrelated parties of the SMSF). This would exclude any property which is used for business purposes as well as residential purposes, for example, a doctor's surgery which also doubles as the doctor's residence;
- the unit trust must not have any borrowings. For example, the unit trust cannot borrow funds or have an overdraft;
- it is important that any amounts paid by the unitholders to the unit trust are paid as the subscription price for the issue of units. Commonly, unitholders loan amounts to a unit trust and convert them into units at a later date. That cannot occur with a reg 13.22C unit trust. Therefore, it is important that the correct documentation (for the issue of units) be prepared each time cash is transferred from the unitholders to the unit trust;
- the unit trust must not have an interest in another entity. That is, it cannot hold shares in another company or have an interest in another trust;
- the unit trust must not allow a charge to be made over any of its assets. For example, the unit trust cannot use any real property it holds as security or grant a mortgage over any property at any time;
- the unit trust must pay out its distributions within a reasonable time after the end of each financial year to ensure the distributions are not financial accommodation;[3] and
- the unit trust must conduct all its transactions on an arm's length basis. This is particularly important for leases over real property. It is important that the terms of the lease be arm's length and, in particular, that the rent is on arm's length value. In this regard, it is generally recommended that the rent should be determined on the basis of an expert opinion or valuation.

The consequence of breaching reg 13.22D

If any of the requirements of reg 13.22D are breached, the unit trust ceases to be a reg 13.22C unit trust. Such a breach can never be rectified. The consequence of this is that the unit trust would then form part of the in-house assets of the SMSF. In that case:

- if the value of those in-house asset units do breach the 5% limit, ultimately, the fund would need to dispose of its interest in the unit trust (at least up to the 5% limit). This could trigger significant taxation and duty consequences; or
- if the value does not breach the 5% limit, the SMSF has the option to retain its investment in the unit trust and, in which case, it would need to continue to monitor the 5% limit.

Conclusion

As discussed above, the requirements relating to the establishment and ongoing administration of a reg 13.22C unit trust are quite stringent. As a result of such strict requirements and the significant consequences of breaching them, an investment in a reg 13.22C unit trust may not be the right investment vehicle for every scenario.

Where this type of unit trust is being used, it is prudent to monitor the activities of the unit trust to ensure that it does not breach any requirements as set out by reg 13.22D. While this can be an administrative burden, when used correctly, the reg 13.22C unit trust can be an important investment option for SMSFs.

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References

1 Ss 82 and 83 of the *Superannuation Industry (Supervision) Act 1993* (Cth).

2 Reg 13.22C of the *Superannuation Industry (Supervision) Regulations 1994* (Cth).

3 SMSFR 2009/3.

Superannuation

by Daniel Butler, CTA, DBA Lawyers

Downsizer contributions: basics, tips and traps

Downsizer contributions were introduced to allow those aged 65 or over to sell their main residence and make up to a $300,000 contribution to superannuation, or $600,000 for a couple.

As one of a number of "housing affordability" measures where superannuation is seeking to encourage housing affordability, downsizer contributions were introduced from 1 July 2018 to allow those aged 65 or over to sell their main residence and make up to a $300,000 contribution to superannuation, or $600,000 for a couple, provided the relevant legislative criteria is satisfied.

Indeed, Michael Sukkar, Minister for Housing and Assistant Treasurer, in his 28 June 2019 press release, confirmed that:

> "Older Australians downsizing from their family homes have contributed $1 billion to their superannuation funds, building up retirement incomes and freeing up housing for younger families, Minister for Housing and Assistant Treasurer, Michael Sukkar announced today.
>
> – 4,246 individuals have utilised the Downsizer measure;
> – 55% of contributions have been made by females and 45% from males;
> – Individuals from every state and territory have made Downsizer contribution with the top three states being, NSW (31%), VIC (26%) and QLD (24%)."

This article examines two key questions:

1. How do downsizer contributions work?
2. What are some tips and traps for SMSFs in utilising downsizer contributions?

Although this is an important strategy (especially for tax advisers and accountants), there has not been much education on downsizer contributions. In particular, a sound understanding of the tax provisions driving the downsizer contributions is beneficial.

How do downsizer contributions work?

There are three broad steps, as outlined below, that need to be followed for a member to be eligible to make downsizer contributions.

Step 1. Eligibility

The first step that the member needs to take is to confirm that the amount they wish to contribute will constitute eligible downsizer contributions. Broadly, an eligible downsizer contribution is where:

- the contribution is made to a complying superannuation fund by a member aged 65 years or older;
- the amount is equal to all or part of the "capital proceeds" received from the disposal of an ownership interest in a dwelling that qualifies as a main residence in Australia, under the downsizer provisions;
- the member or the member's spouse had an interest in the main residence before the disposal;
- the interest in the main residence was held by:
  - the member;
  - the member's spouse;
  - the member's former spouse; or
  - a trustee of the estate of the member's deceased spouse,

  during the 10 years prior to the disposal; and
- the member has not previously made downsizer contributions in relation to an earlier disposal of a main residence.

A member's ownership interest in a dwelling must be held by an individual or their spouse. The ownership interest in the dwelling being sold (ie broadly, a legal or an equitable interest, or a right or licence to occupy the dwelling) must be held by the individual (in respect of whom a downsizer contribution is being made) and/or their spouse, just before the disposal.

The member should determine whether they are eligible to make downsizer contributions and whether their main residence satisfies the above criteria prior to the disposing of their main residence in order to make a downsizer contribution.

Note that a caravan, houseboat or other mobile home does not qualify as a main residence for these purposes. Thus, the grey nomads travelling around Australia in their luxury motor homes, caravans or yachts will not be eligible.

Step 2. Contributions

On the sale or disposal of a main residence, a member can make up to a maximum of $300,000 in contributions to their superannuation fund above their usual concessional and non-concessional contribution caps in the relevant financial year. A downsizer contribution must not exceed the lesser of $300,000 and the total capital proceeds that the individual, their spouse, or they both receive from disposing of their ownership interests in the dwelling.

Further, there is no age limit or gainful employment test that needs to be satisfied (however, many SMSF deeds prepared prior to 30 June 2018 preclude such contributions and an SMSF deed update may be required).

Moreover, downsizer contributions are not counted towards the relevant member's contributions caps or total superannuation balance (TSB) in the financial year a downsizer contribution is made. The $1.6m (indexed) total superannuation balance restriction (which applies to, among other things, determine an individual's eligibility for non-concessional contributions) does not apply in respect of

downsizer contributions in the financial year the downsizer contribution is made. Thus, a member could have, say, $2m in superannuation and still make a downsizer contribution.

Once the member sells their main residence, they are required to make downsizer contributions to their superannuation fund within 90 days after the day the ownership changed (typically, 90 days from settlement).

Given this 90-day time frame, a member cannot make downsizer contributions if settlement is, for instance, on vendor terms or a settlement date that goes beyond the 90-day period unless they have been granted an extension from the ATO.

While multiple downsizer contributions in respect of the sale of the same residence can be made, as noted above, the total amount of downsizer contributions made by each member cannot exceed the lesser of the total capital proceed and $300,000. This total amount includes the amount of all downsizer contributions a member makes in respect of all of their superannuation funds.

It is important to note that the maximum $300,000 downsizer contribution cap is for only one member and therefore this allows for a couple to contribute up to $600,000 (ie 2 × $300,000).

Step 3. Reporting and verification

On the superannuation fund's receipt of the downsizer contribution form, the superannuation fund must inform the ATO during the fund's annual reporting. The ATO will then run verification checks on the amount and may contact the member for further information.

An approved form should be completed by the contributing member(s) and given to the trustee of the superannuation fund detailing the amount that is to be attributed to downsizer contributions.

If the ATO has verified that the member has made eligible downsizer contributions, no further action is taken. However, if the contribution does not qualify as a downsizer contribution, the ATO notifies the superannuation provider. The amount will then either be allocated as a non-concessional contribution — if permitted by superannuation law and may result in the member exceeding their cap — or refunded to the member in due course.

Expert advice should be obtained if the contribution fails to satisfy the downsizer criteria as there are special rules for dealing with excess contributions and a hasty withdrawal of the contribution may give rise to further consequences.

Tips and traps for SMSFs and their members

Age pension

Members should note that disposing of their main residence (which is exempt from Centrelink's asset test) and contributing downsizer contributions to their superannuation fund (which counts towards Centrelink's asset test) may adversely impact on their Centrelink entitlements. This is because the Commonwealth Government's age pension provided via Centrelink is assessed against, among other things, an assets and incomes test, and those who exceed the applicable thresholds will be denied an old age pension in whole or in part.

A person's family home is generally not included in that person's assets test. However, superannuation savings are included once a member reaches pension age. This means that, if a member disposes of their main residence and makes a downsizer contribution, the member may either have:

- a reduced age pension; or
- no entitlement to any age pension.

The current asset test thresholds for the Centrelink age pension at the time of writing are as follows:

	Home owner	
	Full pension	No pension above this limit
Single	$263,250	$572,000
Couple	$394,500	$860,000
	Non-home owner	
Single	$473,750	$782,500
Couple	$605,000	$1,070,500
Reduction rate	Pension is reduced by $78 pa for each $1,000 of assets over the full pension threshold	
Indexing	Full pension thresholds are indexed each 1 July in line with CPI	

This aspect significantly reduces the attractiveness of the downsizer provisions for those who would be worse off as a result of a loss to their age pension entitlements. For example, a couple disposing of a dwelling valued at $600,000 to contribute to superannuation when they have $471,000 of assets and then deciding to rent for a period of time would be denied an age pension as their assessable assets for Centrelink purposes would exceed the maximum $1,070,500 threshold set out above.

The main residence exemption

An understanding of how the CGT main residence exemption operates is fundamental for advisers to provide strategic advice on downsizer contributions. As noted above, the dwelling must have been the main residence of the person that satisfied the main residence exemption criteria (in Subdiv 118-B of the *Income Tax Assessment Act 1997* (Cth) (ITAA97)). In this regard, the ATO notes in LCR 2018/9:

> "44. To make a downsizer contribution the dwelling must have been the individual's main residence, at some point during the period of ownership, for the purposes of the main residence exemption. Specifically, the capital gain or loss relating to the disposal of the old interest must be wholly or partially disregarded because the property has been treated as their main residence."

It is also important to note that s 292-102 ITAA97 provides that a downsizer contribution can also be made if the dwelling was a pre-CGT asset (ie it was acquired prior to 7.30 pm on 19 September 1985, when CGT was first introduced via press release by the then Treasurer, Mr Paul Keating). The ATO confirm this in LCR 2018/9 as follows:

> "46. If the interest was acquired prior to 20 September 1985, an individual is able to make a downsizer contribution only if they would have been able to claim this main residence exemption had the dwelling been acquired after this date."

We examine below an example of Peter who acquired his main residence around 20 years ago for $600,000 (on 1 July 1999). He disposes of it on 30 June 2019 for $1,800,000. During the final 10 years of his ownership interest, it was rented to a third party tenant. The following CGT implications would broadly apply:

- assuming Peter does not have any capital losses and cannot rely on any other exemption under the main residence provisions such as s 118-145 ITAA97, 50% of the capital gain will be exposed to tax given the ownership period that the property was used as his main residence is 10 years and 50% of the time it was used to produce assessable income;
- s 118-195 ITAA97 broadly pro-rates the main residence exemption based on the extent to which the residence was used as the person's main residence during the entire ownership period (ie capital gain x [non-main residence days/days in your ownership period]); and
- since Peter held the asset for more than 12 months, the 50% CGT discount under Div 115 ITAA97 is then applied to the capital gain in accordance with step 3 of the method statement in s 102-5 ITAA97. Since the asset was acquired prior to 21 September 1999, the indexed cost base method under Div 114 ITAA97 could also apply, but Peter has elected for the general CGT discount under Div 115 to apply instead. It is also, naturally, assumed here that the gain is not on revenue account as, broadly, the CGT provisions apply on a secondary basis with a reduction to any capital gain to the extent that it is otherwise assessable on revenue account in accordance with s 118-20 ITAA97.

This results in a net capital gain on disposal of the asset and CGT to Peter as follows:

Example of disposal by Peter		
Sale proceeds		1,800,000
Cost base		600,000
Capital gain		1,200,000
Less: partial main residence exemption (s 118-185)	50%	600,000
Capital gain (reduced by MRE)		600,000
Less: Div 115 50% discount	50%	300,000
Net capital gain		**300,000**
Tax at 47% assuming top marginal rate + Medicare	47%	**141,000**

As can be seen from the above example, Peter will pay CGT of $141,000 if he disposes of his residence to make a downsizer contribution — and this has to be factored into each client's particular strategy unless the residence was the person(s) main residence for their entire holding period.

Related party transfers/transactions

If a dwelling is transferred from a "transferor" spouse to a "transferee" spouse for no consideration, the transferor is still, for CGT purposes, deemed to have received the market value of that asset under the market substitution rule in s 116-20 ITAA97. The following is an extract from this provision:

> "(1) The capital proceeds from a CGT event are the total of:
>
> (a) the money you have received, or are entitled to receive, in respect of the event happening; and
>
> (b) the market value of any other property you have received, or are entitled to receive, in respect of the event happening (worked out as at the time of the event)."

Conversely, the "transferee" spouse obtains a cost base equivalent to the market value deemed to have been paid under s 112-20 ITAA97. The following is an extract from this provision:

> "(1) The first element of your cost base and reduced cost base of a *CGT asset you acquire from another entity is its market value (at the time of acquisition) if:
>
> (a) …;
>
> (b) …; or
>
> (c) you did not deal at arm's length with the other entity in connection with the acquisition."

In some jurisdictions, such as Victoria, a duty concession may be available for the transfer of a person's principal place of residence where there is, among other things, no consideration provided in relation to that spouse-to-spouse transfer. Thus, where, say, a husband transfers his main residence which is valued at $1m (which qualifies for the main residence exemption and has been held for more than 10 years) to his wife, the husband is deemed to have received $1m in capital proceeds under s 116-20 and the wife is deemed to have a cost base of $1m under s 112-20 for CGT purposes.

The question might therefore be asked, can the husband who is over 65 years make a downsizer contribution?

The ATO has responded to this scenario in LCR 2018/9 as follows:

> "62. Capital proceeds are defined in the ITAA 1997, and for most cases are the money received, or entitled to be received, from the sale of the interest in the dwelling. The policy intent for the downsizer measure is that an individual source their downsizer contribution from the total proceeds received from the disposal of the ownership interest in the dwelling. *It is not intended that an individual be eligible to make a downsizer contribution by entering into a non–arm's length arrangement to dispose of their ownership interest in the dwelling for less than market value and applying the CGT market value substitution rules* so as to be taken to have received the market value of the ownership interest.
>
> 63. On that basis, where an individual disposes of their ownership interest in a dwelling to a related party on a non-arm's length basis for less than market value, and the individual or their spouse make downsizer contributions the total value of which exceeds the amount of the sale price specified in the contract, *the Commissioner will consider whether Part IVA* of the Income Tax Assessment Act 1936 (Part IVA) applies to the arrangement. Part IVA applies to a scheme if a tax benefit has been obtained in connection with the scheme and the main purpose of a person who participated in the scheme, or a part of it, was to enable a taxpayer to obtain that tax benefit." (emphasis added)

Note that a proposed amendment to s 292-102(3) is included in the exposure draft of the Treasury Laws Amendment (Measures for a later sitting) Bill 2019 that will disregard the market value substitution rule in s 116-30 ITAA97 to the extent that it would increase the capital proceeds for the

purposes of the downsizer provisions. Broadly, if enacted, this amendment will result in the actual consideration constituting the capital proceeds. This change is proposed to take effect from the date of royal assent of this Bill and is therefore not retrospective.

In kind or in specie contributions

Downsizer contributions may be able to be made as an in specie contribution, for example, if the capital proceeds have been used to purchase an asset (such as listed securities and business real property acquired at market value), that asset can be contributed.

Naturally, the prohibition against related party acquisitions in s 66 of the *Superannuation Industry (Supervision) Act 1993* (Cth) must be complied with. As noted, listed securities and business real property acquired at market value are the key exceptions to this prohibition.

Proceeds and borrowings

It is important to note that the downsizer contributions cap is the lesser of $300,000 and the sum of the capital proceeds. Any debt outstanding on a mortgage over the relevant property is not considered for the purpose of determining the capital proceeds.

For example, Peter bought his main residence 14 years ago for $1m. He then sells it for $1.25m when his outstanding borrowings are $1m.

Peter received capital proceeds of $1.25m. Thus, he can make downsizer contributions of up to $300,000.

Members should also be aware that downsizer contributions are not deductible.

SMSF deed provisions

As the downsizer contribution is a relatively new type of contribution, the SMSF's deed should have express wording that allows members to make these contributions to the fund, especially as a member over 65 years may not be gainfully employed and, in many cases, a member may be over 75 years (and prior to 1 July 2018, contributions could not generally be made for members over 75 years under reg 7.04 of the *Superannuation Industry (Supervision) Regulations 1994* (Cth)). Additionally, the SMSF deed should provide appropriate mechanisms to resolve what happens when a downsizer contribution is deemed ineligible by the ATO.

Financial product advice

Naturally, since superannuation advice can readily fall within financial product advice unless you fall within a relevant exemption, non-licensed advisers need to ensure that they comply with the relevant Australian financial services licence (AFSL) requirements of the *Corporations Act 2001* (Cth). One method of minimising risk here is to recommend that your client in writing obtain advice from an adviser with an AFSL before proceeding with your advice with an appropriate disclaimer.

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Tax Cases

by Michael Norbury, CTA, Norbury Lawyers

Fortunatow and personal services income

Were personal services provided as a result of a taxpayer making offers of personal service to the public? Did it matter that the provider of the services was the taxpayer's company?

Fortunatow v FCT[1] considers the personal services income provisions in Pt 2-42 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97). In particular, it considers the "unrelated clients test".

The court explained the basic rule was that an individual was required to include in his or her assessable income any income that another entity gains for the individual's personal services notwithstanding that the income may have been alienated to another interposed company. The rule does not apply to personal services income which was income from conducting a "personal services business" as defined in s 87-15 ITAA97, which required the relevant person or entity to satisfy one of four personal services business tests as set out in s 87-15(2). One of those tests was the "unrelated clients test" which was set out in s 87-20 ITAA97.[2]

Facts

The taxpayer was a business analyst and was at all relevant times the sole director of Fortunatow Pty Ltd (the company). Through contracts between the company and various recruitment or similar agencies, the taxpayer was engaged to provide services to organisations such as government departments, utilities, defence contractors, universities, banks and large corporations. In the taxation years 2012 and 2013, income of approximately $166,000 and $121,000 respectively was returned in the company's income tax returns. The income related to the provision of the taxpayer's personal services to eight different end clients during those two taxation years. No remuneration was paid by the company to the taxpayer and he returned no income in his personal income tax returns for the relevant years.[3]

The company transferred income generated by the taxpayer's personal services to the Fortunatow Family Trust (the trust). The transferred income was characterised as "management fees" payable to the trust. These fees were claimed as deductions and had the effect of reducing the company's taxable income to nil. The trust income was offset against the trust's rental losses. The end result of this structure was that none of the taxpayer, the company or the trust paid tax on the income generated by the supply of the taxpayer's personal services as a business analyst in the two relevant taxation years.[4]

The question of law

The matter came first before the AAT, where the Commissioner was successful. The taxpayer appealed to the Federal Court.

The question of law before the court related to the proper construction and application of s 87-20(2) and its interaction with s 87-20(1)(b) in the context of the unrelated clients test for a personal services business. The taxpayer submitted that it provided "a complete answer" and that the other two questions of law fall away (which related to the AAT's findings on the "results test" and penalties, respectively). The taxpayer contended that the AAT misconstrued s 87-20(2) and gave that provision too wide a meaning in its interaction with s 87-20(1)(b).[5]

Section 87-20 provided:

> "**87–20 The unrelated clients test for a personal services business**
>
> (1) An individual or a personal services entity meets the unrelated clients test in an income year if:
>
> (a) during the year, the individual or personal services entity gains or produces income from providing services to 2 or more entities that are not associates of each other, and are not associates of the individual or of the personal services entity; and
>
> (b) the services are provided as a direct result of the individual or personal services entity making offers or invitations (for example, by advertising), to the public at large or to a section of the public, to provide the services.
>
> Note: Sections 87- 35 and 87-40 affect the operation of paragraph (1)(a) in relation to Australian government agencies and certain agents.
>
> (2) The individual or personal services entity is *not* treated, for the purposes of paragraph (1)(b), as having made offers or invitations to provide services merely by being available to provide the services through an entity that conducts a business of arranging for persons to provide services directly for clients of the entity."

The AAT decision

The AAT cited the Full Federal Court's decision in *Cameron v FCT*[6] as identifying the following five elements of the unrelated clients test:

- an identification of each income year;
- an identification of the income in question;
- whether that income was gained or produced from providing services to two or more unrelated entities and the identification of those unrelated entities;
- whether the individual or personal services entity made any offers or invitations to the public at large or to a section of the public to provide those services (here, the offers were made through the taxpayer's LinkedIn profile); and

– if so, whether the services provided to the unrelated entities were so provided as a direct result of the individual or personal services entity making those offers or invitations.

The AAT construed the last of these against the taxpayer.

The taxpayer's position

The taxpayer contended that, having found in his favour for the purposes of s 87-20(1)(b) the exclusion in s 87-20(2) no longer had a valid role to play, it was wrong of the AAT to undo its favourable finding for the purposes of s 87-20(1)(b) by resorting to and applying s 87-20(2).[7]

The taxpayer contended that the AAT's approach revealed the following five errors:

1. there was no basis to construe s 87-20(2) as fundamentally modifying s 87-20(1)(b) such that if an intermediary is involved in the engagement, the advertising is ineffective, with the consequence that even where the advertising is broader, the exclusion is triggered merely because the taxpayer's services are available through an agency;
2. it was erroneous of the AAT to apply the legislation in a way which treated LinkedIn as constituting "merely by being available to provide the services through an [agency]";
3. the AAT adopted an unduly complex analysis of how s 87-20(2) operated;
4. there were inconsistencies in the AAT's reasons; and
5. on a proper construction of s 87-20, the exclusion in s 87-20(2) did not radically alter s 87-20(1)(b), but rather informed that provision.[8]

The taxpayer submitted that the AAT's reasoning was in error because:

– s 87-20(2) only concerned itself with the offers or invitations to provide services and was not concerned with the provision of services or any causal connection between the offers/invitations and the provision of services;
– s 87-20(2) was not engaged to modify the prima facie result under s 87-20(1)(b) where an individual or personal services entity made offers or invitations which go "beyond intermediaries";
– s 87-20(2) was engaged where the individual or personal services entity was only available to provide services by being "registered" with an intermediary and did not advertise more broadly; and
– there was no requirement to address causal connection under s 87-20(2) itself because that issue arose under s 87-20(1)(b).[9]

Both parties accepted that the advertising described by the taxpayer was made to both the intermediaries and end clients.[10]

The Commissioner's position

The Commissioner did not dispute the five elements of s 87-20 as identified in *Cameron.* He accepted that the first three elements were not controversial here and that the fourth element (the existence of advertising) was determined by the AAT in the taxpayer's favour. The Commissioner emphasised, however, that the fifth element was found by the AAT not to have been established on the evidence before it, in circumstances where the taxpayer failed to call as witnesses any representative of the clients to support his claim that his roles with them came about as a direct result of his LinkedIn advertising.[11]

The Commissioner supported the AAT's construction of s 87-20(1)(b), such that if the taxpayer's advertising is directed at recruitment agencies/labour hire/personnel firms, the advertising did not count for the purposes of satisfying s 87-20(1)(b). Similarly, the Commissioner said that s 87-20(2) informed both the fourth and the fifth elements of *Cameron*.[12]

But even if the AAT erred in its construction of the relevant provisions, the Commissioner submitted that the end result would remain the same because the AAT found that the requisite "direct result" was not established because of the absence of a causal connection between the LinkedIn profile and the taxpayer securing the eight contracts. Could a direct result be established by the court in circumstances where the advertising attracted a recruitment or labour hire firm, but did not attract the end client?[13]

The Commissioner submitted that the taxpayer was chosen by the end client because he had been put forward by the intermediary. The Commissioner relied on the AAT's reasoning where the AAT found that the evidence did not establish that the end clients relied on any form of advertising by the taxpayer in relation to any of the services provided under the eight contracts, with the consequence that there was no direct link between the advertising and the end clients. The Commissioner contended that, to establish the unrelated clients test, a causal connection had to be shown between the advertising and the provision of the personal services to the end client. To satisfy the "direct result" requirement, it was insufficient to show that the advertising merely attracted the intermediary. The Commissioner submitted that the AAT finding should be read that there was a connection between the advertising and the intermediary, but that the AAT never found any causal connection between the advertising and the end clients.[14]

The Commissioner accepted that there was evidence that some of the end clients may have looked at the taxpayer's LinkedIn profile by way of confirmation that they should progress his engagement to provide services through the intermediary company. But it was submitted that this did not establish the relevant causal connection. The Commissioner submitted that while the taxpayer's intention in maintaining his LinkedIn profile may have been to advertise beyond recruitment agencies, the evidence did not establish that any of the personal services he provided under any of the eight contracts resulted from a causal connection between the advertising and the end clients' decisions to retain his personal services. The Commissioner accepted that the position would be different if, for example, an end client was influenced by the taxpayer's advertising to engage his services but then was told that the only way that this could occur would be via an intermediary or recruitment agency.[15]

Accordingly, the Commissioner submitted that if the court found that the AAT had misconstrued s 87-20(2) and its interaction with s 87-20(1)(b), the matter should not be remitted to the AAT for rehearing as sought by the taxpayer.[16]

Analysis

The court accepted the taxpayer's submission that s 87-20(2) only concerned itself with the issue arising under s 87-20(1)(b) as to whether "offers or invitations to provide services" had been made. It was not concerned with the separate issue of the provision of services or any causal connection or link between the offers or invitations and the provision of services. The court rejected the Commissioner's submission that s 87-20(2) informed the whole of s 87-20(1)(b) and not just the advertising component of it.[17]

The court held that the exclusion or exception in s 87-20(2) had no application where, in a case such as this, there was evidence that the taxpayer advertised his services to the public or a segment thereof through a forum such as LinkedIn, and also obtained work through the involvement of a recruitment or other similar intermediary. The AAT accepted that the LinkedIn advertising constituted an offer or invitation to the public to provide the taxpayer's personal services, but it viewed as fatal to the taxpayer's case that the taxpayer's work came through a recruitment or similar intermediary agency. The court found this gave too broad a meaning to the term "merely" in s 87-20(2). That provision was not engaged in circumstances where there was evidence that the taxpayer or personal services entity advertises to the public or a part thereof (including via LinkedIn), and was also available to provide personal services through a recruitment or other similar intermediary agency.[18]

The court concluded that the proper construction of s 87-20(2) was that an individual or personal services entity was not treated for the purposes of s 87-20(1)(b) as having made offers or invitations to provide services simply and only because the person or entity was available to provide the services through some association or connection with an intermediary, such as a recruitment agency. To put it another way, simply because an individual or personal services entity was able to provide services through an intermediary, such as a recruitment or similar agency, did not constitute the making of an offer or invitation for the purposes of s 87-20(1)(b). More than that was required for the purposes of the unrelated clients test. But that did not mean that the exclusion in s 87-20(2) necessarily applied, as found by the AAT, where an individual or personal services entity was in fact available to provide personal services through such an intermediary and there was evidence that, in addition to that fact, the individual or personal services entity had taken other steps to make offers or invitations to the public at large or a section thereof to provide the services.[19]

Comment

Fortunatow is a case which dealt with a narrow issue in a fairly narrow area of the law.

Perhaps greater interest lies in the court's ready acceptance of the use of LinkedIn being an advertisement to the public or a part thereof.

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Principal
Norbury Lawyers

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Alternative Assets Insights

by Edwin Baghdasarayan, ATI,
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PCG 2019/D3: a way forward on the ALDT

The latest ATO guidance suggests that a detailed robust analysis, along with corresponding evidence, is key to satisfying the arm's length debt test.

On 28 August 2019, the ATO released PCG 2019/D3 (the draft practical compliance guideline), which sets out the ATO's views on practical aspects of the arm's length debt test (ALDT) which is relevant for thin capitalisation purposes. The release of PCG 2019/D3 follows the release of TR 2019/D2 (the draft ruling) which provided the Commissioner of Taxation's views on key technical aspects of the ALDT. It is intended that, once finalised, the draft ruling accompanied by the draft practical compliance guideline will replace the only other earlier guidance on the ALDT issued by the ATO in 2003 (see TR 2003/1).

The draft practical compliance guideline and draft ruling together replace the six-step methodology suggested in TR 2003/1, which has formed the basis for the ALDT analysis undertaken by many taxpayers to date. PCG 2019/D3 emphases the clear distinction between the independent lender test (what could you borrow) and the independent borrower test (what would you borrow). It provides guidance on how to have regard to the factual assumptions and relevant factors of the "notional standalone Australian business" in order to calculate the maximum allowable debt (read: commercially supportable debt quantum). The "notional Australian standalone business" is a hypothetical construct which comprises the taxpayer's Australian commercial activities, disregarding any foreign interests, associate entity debt and the provision of credit support.

PCG 2019/D3 sets out what the Commissioner considers to be a reasonable approach to undertaking the ALDT and establishes a series of considerations which taxpayers should avail themselves of in performing self-assessment. The draft practical compliance guideline sets out a level of analysis that represents the "minimum standard expected of a comprehensive and robust ALDT analysis".[1] The ATO is of the view that Australian businesses are not commonly geared in excess of the safe harbour debt amount, and therefore the "choice" to apply the ALDT carries the weight of undertaking a more robust analysis to demonstrate the commerciality of the quantum of debt capital in the entity as the maximum allowable debt under Australia's thin capitalisation provisions.

Risk zones

Similar to earlier practical compliance guidelines on other matters, the ATO expects taxpayers to self-assess their risk zone with respect to the ALDT. There are essentially two risk zones contained in PCG 2019/D3, being low risk (green) and medium to high risk (yellow). The criteria for being in each zone varies depending on whether the business is regulated or non-regulated, inbound or outbound, and whether the actual debt comes from related parties or third parties. It is likely that the majority of the taxpayers will fall in the medium to high risk zone, which means that the ATO may apply compliance resources to review the debt capital supported under the ALDT.

There is also a white zone for arrangements where the ATO has already undertaken a review (where the review commenced after 1 July 2019) and concluded on the outcome. For white zone arrangements, the ATO will not review these arrangements further, other than to confirm ongoing consistency with the agreed/determined approach.

Key practical aspects

PCG 2019/D3 is extensive and includes commentary on many of the practical aspects of the arm's length debt analysis. This article does not deal with all aspects of PCG 2019/D3. However, some of the notable points are set out below:

- **financial data:** in defining the financial position of the Australian business, accounting information used in preparation of the tax return is seen as the starting point. The ATO expects to see a reconciliation of financial information to statutory accounts. However, the relevant value of assets used in the analysis can depart from accounting values provided appropriate evidence is maintained. For example, in the case of regulated entities, regulated asset base might be considered appropriate;
- **comparables:** selection and use of comparables are important in both the borrower and lender tests. The comparables used in the analysis need to reflect independent companies and should ideally be in the Australian market, and the process of selection needs to be supported with a detailed analysis. Where it can be demonstrated that no suitable comparable exists in the Australian market, other geographic markets can be considered. However, the ATO has observed that for regulated industries, overseas regulated markets are not considered comparable. The ATO has also provided guidance on how it expects the comparable analysis to be used in assuming an arm's length debt amount;
- **relevance of transfer pricing analysis:** when considering the requirement to ensure that the debt is on terms and conditions that would reasonably be expected at arm's length, it is not acceptable to assume that an analysis undertaken for transfer pricing purposes is sufficient. The ATO observes that taxpayers may adopt a "conservative" position for transfer pricing purposes (ie a lower

interest rate). Where this is the case, an adjustment needs to be made for the interest that might be expected at arm's length (having regard to the statutory assumptions);

- **use of credit rating approaches:** using the published guidance of rating agencies can be useful provided they are applied in an appropriate way. For example, credit ratings can be useful to identify a consistent set of limits or covenants ranges. Credit ratings or agency rating reports can be useful in weightings applied to the relevant factors (from a lender test perspective);
- **covenants:** any covenants should reflect those that the notional Australian business would reasonably be expected to agree to. Where actual covenants exist in third-party debt that provide a basis to test debt serviceability, these need to be considered. The existence of actual covenants cannot be ignored — adjustments must be made if departing from actual covenants due to consideration of the statutory assumptions. When applying the covenants, the ATO expects that consideration is given to the headroom that would be expected, ie the covenant limits do not define the amount that the borrower would be expected to have;
- **consideration of relevant factors:** all of the statutory relevant factors must be considered in applying the test. It is acknowledged, though, that some factors will have greater or lesser significance on the outcome than others. For qualitative factors, the ATO has proposed a structure which weights each factor as "supportive", "neutral" or "adverse". It is noted that consideration of how these assessments impact on the quantitative measures requires an exercise of judgment;
- **weighting of metrics:** when applying quantitative metrics (ratios such as interest cover ratio, return on capital employed etc) to the analysis, the ATO suggests that, in circumstances where multiple metrics are being considered, a weighting should be determined (with appropriate support and evidence). For administrative ease, the ATO accepts that taxpayers may adopt equal weightings;
- **return on capital:** an important factor in the borrower amount is the return on capital. The "return" can be in the relevant year or at any other time. Where negative equity exists, it is acceptable to explain by way of undervaluation of Australian assets and to use revalued amounts for comparison purposes. After-tax profit and cash-flow measures need to be considered. Return on equity capital should exceed the required rate of return (hurdle rate). The ATO suggests using a capital asset pricing model approach as a way of testing this aspect; and
- **management's financial risk appetite:** the ATO's view is that the functional analysis should have no regard to the financial risk preferences of the entity. Note this view will have particular significance from the borrower perspective in circumstances where the leverage of the entity is high relative to others in the industry that might have a more conservative financial risk preference (for example, listed companies as opposed to private companies).

The ATO postulates that "there are limited circumstances in which an entity would gear in excess of 60% of its net assets" and "in most circumstances … do not consider the ALDT will enable an entity to achieve maximum allowable debt in excess of the safe harbour debt amount".[2] However, the ATO does recognise that the ALDT is "more likely to be relied upon in an industry where it is common practice to operate with higher debt to equity ratios".[3] The application of the thin capitalisation rules does not prevent the Australian business from assuming higher levels of debt. However, the debt deductions will be denied where the statutory limits are exceeded. On this basis, the evidence required to satisfy the non-statutory framework contained within PCG 2019/D3 to support a commercially supportable level of debt if a taxpayer does not fall into the limited "low risk" outcomes is increasingly onerous.

The date of effect of PCG 2019/D3 is 1 July 2019 and will apply where the ALDT has been used to establish an entity's maximum allowable debt from this date. The date of effect of TR 2019/D2 is when the final ruling is issued, and is proposed to apply both before and after its date of issue.

Consultation on PCG 2019/D3 is open until 9 October 2019, with the final version anticipated to be delivered in early 2020.

The takeaway

The picture that emerges from TR 2019/D2 and PCG 2019/D3 is that, in the Commissioner's view, while Australia's thin capitalisation legislation itself has not changed, the evidence and analysis required to discharge the onus of proof for the taxpayer that it has satisfied the key legislative requirements of the ALDT has significantly increased.

While PCG 2019/D3 provides further clarity as to the Commissioner's recommended approach for undertaking an ALDT analysis that was not provided in TR 2019/D2, given that any analysis is based on the facts and circumstances of each case, there will inherently remain various issues and considerations which would need to be addressed given the circumstances of the taxpayer. Nevertheless, the practical compliance guideline product does provide a broad framework around how to consider these specific issues and considerations, which is positive.

Following release of PCG 2019/D3's practical framework, taxpayers should evaluate their go-forward ALDT positions against Australia's thin capitalisation legislation and the ATO's compliance approach to consider whether achieving a "low risk" outcome is feasible. In the absence of achieving a "low risk" outcome, taxpayers are encouraged to assess the overall commerciality of the capital structure of their Australian business having regard to the relevant factors contained in Australia's thin capitalisation legislation against PCG 2019/D3.

Irrespective of the views of taxpayers and advisers on TR 2019/D2 and PCG 2019/D3, it remains imperative for taxpayers to robustly document technical positions adopted in respect of their capital structure, and to overlay those positions with detailed consideration of the commerciality thereof — even for the simplest ALDT exercise. The flavour

of the draft practical compliance guideline is that commercial lending practices observable in your industry take centre stage, which will likely necessitate a closer relationship between taxpayers' tax and finance/treasury teams and their financiers.

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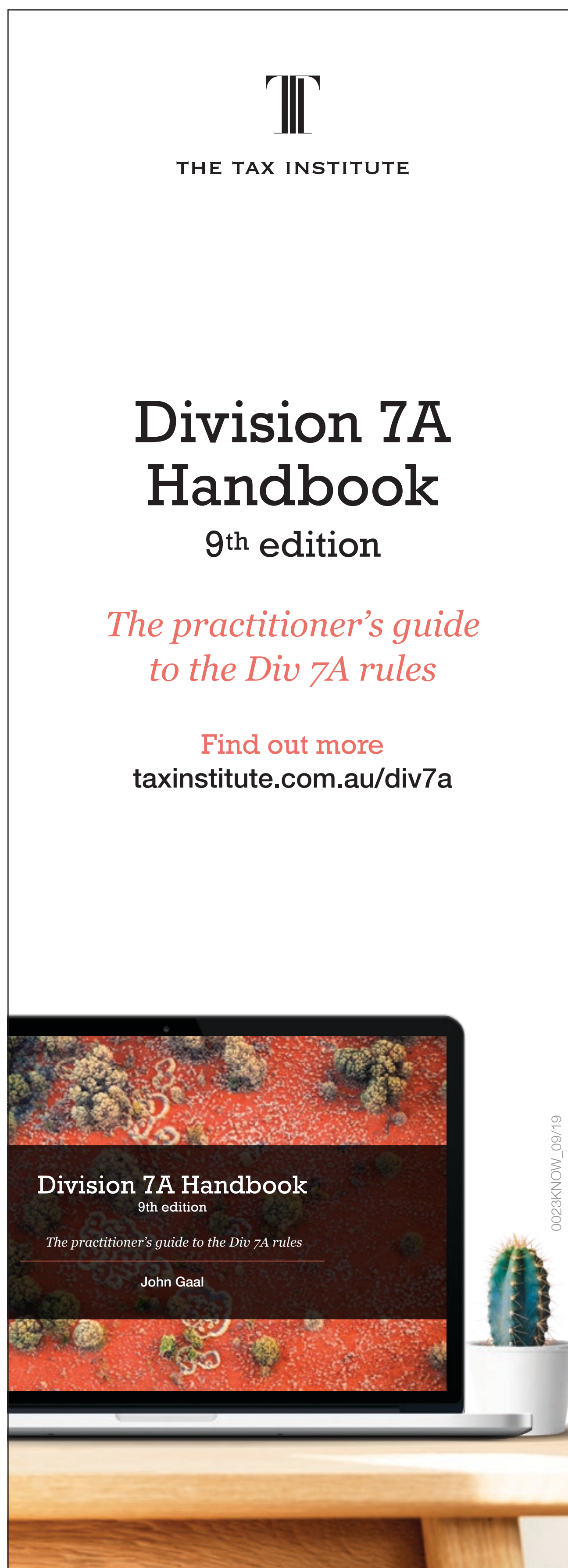

Events Calendar

October 2019

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National		
Monthly Tax Update	30/10/19	1
New South Wales		
Morning Tax Club — Sydney	1/10/19	1.5
Morning Tax Club — Parramatta	3/10/19	1.5
Women in Tax Lunch	23/10/19	1
NSW 16th Annual Estate & Succession Planning Conference	24/10/19	7
Queensland		
Women in Tax Lunch	14/10/19	2
Tax Discussion Group	16/10/19	2
Trusts for SMEs	22/10/19	7
Leading with Purpose	25/10/19	6
Young Tax Professionals	30/10/19	1.5
South Australia		
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SA Tax Roundtable — Goodwill	16/10/19	2
SA Essential Business Session	23/10/19	1
SA Tax Intensive	24/10/19	9
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Tasmanian State Convention	17/10/19	9.5
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Young Tax Professionals	11/10/19	1
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Breakfast Club — Geelong	25/10/19	1.5
Western Australia		
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Young Tax Professionals	30/10/19	1.5
WA Tax Intensive	31/10/19	12

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TAXATION *in Australia*®
ISSN 0494-8343

Publishing House
The Tax Institute
ABN 45 008 392 372

50 Miller Street
North Sydney, NSW 2060

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Graphic Designers
Mei Lam
Nicole Welch

Typesetter
Midland Typesetters, Australia

Advertising
Wayne Flekser 02 8223 0071

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The Tax Institute would like to thank the following presenters from our September 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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