THE JOURNAL FOR MEMBERS OF THE TAX INSTITUTE

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THE TAX INSTITUTE

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Tax News – at a glance

by TaxCounsel Pty Ltd

April – what happened in tax?

The following points highlight important federal tax developments that occurred during April 2020. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 539 (at the item number indicated).

Coronavirus measures

A package of amending legislation to give effect to the government's response to the coronavirus was introduced into, and passed by, parliament on 23 March 2020 and was assented to and became law on 24 March. **See item 1.**

Employee work expenses

The Commissioner has released a final ruling that sets out when an employee can deduct a work expense (that is, a loss or an outgoing incurred in producing salary or wages) under the general deduction provision (s 8-1 ITAA97) (TR 2020/1). **See item 2.**

FBT: cents per kilometre rates

The cents per kilometre rates for calculating the taxable value of a fringe benefit arising from the private use of a motor vehicle other than a car for the FBT year commencing on 1 April 2020 are set out in TD 2020/3. **See item 3.**

FBT: food and drink expenses

The Commissioner has released a determination that sets out the amounts that he considers reasonable (under s 31G of the *Fringe Benefits Tax Assessment Act 1986*) for food and drink expenses incurred by employees receiving a living-away-from-home allowance fringe benefit for the FBT year commencing on 1 April 2020 (TD 2020/4). **See item 4.**

SMSFs: property development

The Commissioner has issued an SMSF Regulator's bulletin in response to the increase in the number of SMSFs entering into arrangements, with related or unrelated parties, involving the purchase and development of real property for subsequent disposal or leasing (SMSFRB 2020/1). **See item 5.**

Salary sacrifice and super guarantee

The Commissioner has issued a guidance note that provides guidance for employers applying the super guarantee changes for salary sacrifice arrangements that commenced on 1 January 2020 (GN 2020/1). **See item 6.**

Associate: "sufficiently influenced"

The Full High Court has unanimously dismissed the taxpayer's appeal from the majority decision of the Full Federal Court in the BHP Billiton litigation which involved the construction of the definition of "associate" in s 318 ITAA36 and, in particular, the meaning of the expression "sufficiently influenced" (*BHP Billiton Ltd v FCT* [2020] HCA 5). **See item 7.**

Active asset test met

The AAT has held that a taxpayer who acquired a 343.95 hectare forestry property in 1992 and subsequently sold it in 2016 was carrying on a business (despite the lack of substantial activity on the land) and that the land was, therefore, an active asset for the purposes of the CGT small business reliefs (*SWPD and FCT* [2020] AATA 555). **See item 8.**

$11.85m share loss deductible

The Full Federal Court has by majority (Kenny and Steward JJ, Derrington J dissenting) allowed the taxpayer's appeal from a decision of Thawley J and held that the taxpayer was entitled to a general deduction for losses incurred on the disposal of shares in a public company that had been acquired over an approximately two-year period (*Greig v FCT* [2020] FCAFC 25). **See item 9.**

TPB cancellation decisions stayed

The AAT has stayed (subject to restrictions) decisions of the Tax Practitioners Board to cancel the tax agent registrations of an individual, and of a company of which he was the sole director and supervising agent, until the tribunal's review of the Board's cancellation decisions were finalised (*Norman and Tax Practitioners Board* [2020] AATA 640). **See item 10.**

TPB's non-reapplication period reduced

In another recent tax agent registration decision, the AAT has affirmed the decision of the Tax Practitioners Board to cancel the tax agent registration of the applicant (Mr Hill) but reduced the period within which the applicant may apply for re-registration from five years (as imposed by the Board) to two years (*Hill and Tax Practitioner Board* [2020] AATA 678). **See item 11.**

2020-21 Budget date

In a joint media release of 20 March 2020, the Treasurer and the Minister for Finance announced that the handing down of the 2020-21 Budget has been deferred until 6 October 2020.

President's Report

by Peter Godber, CTA

Operating in a COVID-19 world – together

How we're keeping members connected and informed in a disrupted, digital world.

All members are no doubt affected in some way now by the huge disruption of COVID-19.

At The Tax Institute, we have fortunately benefited from a preparedness with our technology that has enabled our people to operate effectively while being remote from the office. Like many organisations, we have probably surprised ourselves at how the current crisis has changed our mindsets about business and at how we have had to adapt. We all need to be creative and shift some paradigms in order to stabilise and keep our businesses going.

This is evident in our re-worked CPD offerings. Pretty much since The Tax Summit 2020 concluded, we have been denied the opportunity to hold our usual face-to-face events, and in lieu of that, we are planning to deliver our content digitally for the foreseeable future. Our volunteer presenters are continuing to offer their time and skills, and you will now see webcast offerings. We are coordinating these nationally to avoid repetition. However, and there is a positive twist to this, you can now enjoy events and presentations that you might have not otherwise considered attending. For example, you can register for the Barossa Online, although you may have to provide your own wine at the end of the event.

First to market has been our 10-part National Superannuation Webinar Series, delivered in a lunchtime slot. The technical content of all events will be maintained at its usual high level of quality.

So, there will continue to be a lot of learning offerings to choose from. They will be well-priced, and we will work to bring them to you in the best possible electronic format that we can reasonably deliver.

New horizons for The Tax Institute

In difficult times, providing service to members remains our priority. I hope that you read with pleasure the announcement of our online member portal, and that you have taken the time to access it for yourselves. The goal is to be as user-friendly as we can, and it certainly creates a new member user experience. It is the start of better things to come with our electronic member interface, which is so important for the Institute and its membership going forward.

In other very exciting news for members, you will have seen that we have welcomed on board one of Australia's leaders in tax learning and advocacy, Robyn Jacobson. Robyn is known to many of you, and she will now be at the forefront of helping members who are challenged with the difficulties of our law and practice, especially in the SME space. She is a real champion for the cause in making our tax system better for all. I enjoy my interaction with Robyn and have learned a lot from her passionate insights. You will see her at our future events and having her as a key part of our team is great for our members. Once again, welcome Robyn!

Tracking COVID-19 responses

The government responses to COVID-19 have given rise to new challenges for advisers, both in keeping up with the detail and then in communicating announced and legislated changes to clients.

Our tax policy and advocacy team have been understandably inundated. You will continue to be updated in *TaxVine* and on our website. Thanks to Bob Deutsch and Stephanie Caredes and our whole policy team. In the two weeks or so around the introduction of the stimulus package and the announcement of the JobKeeper legislation, we have discussed developments almost daily with other professional bodies, and with representatives of Treasury and the ATO.

I must say here that there has been overriding goodwill from all involved to implement government announcements for the betterment of all. In working with the new rules, and helping others to access financial relief, we are doing our part to act with integrity as advisers, but one of the great challenges we have had is just understanding how the new rules operate.

JobKeeper, in particular, has put great strain on the resources of the ATO. We offered to consult actively on the development of the underlying rules for the administration of these new measures. We also advocated for leniency in tax lodgment and payment deadlines and for taxpayers in these troubled times, and the genuine understanding from the administration is welcomed and very pleasing. Again, we are all in this together. Let's hope our collective efforts help us to get through the tough times ahead.

Finally, we understand the consequence of economic downturn. It affects us all, and it affects our clients and our practices. Stay in contact with us and good luck in the months ahead.

CEO's Report

by Giles Hurst

From strength to strength with our members

The Tax Institute is supporting members with advocacy, technology and teamwork.

It really does seem a long time since we were at the inaugural Tax Summit in Sydney. The celebration of our profession and the important contribution that it makes to Australian life was as exciting as it was memorable. Over 1,500 people came to share in the experience, and what a great event it was. Yet, who would have foreseen what was to come next?

Far from taking any kind of break after The Tax Summit, the past few weeks have seen The Tax Institute going up a few more gears again as we coordinate the response of our profession to the incredible changes taking place around us, pivot our operations to be able to continue delivering all-important CPD, shift our education offerings to ensure that our students can maintain their learning in an online environment, and safeguard the wellbeing of our staff during this difficult period of isolation.

I'm very proud of my team right now and I'm particularly heartened by the way in which they are dealing with members who are eager to find out how they can navigate their way through the choppy waters of COVID-19. The fact that 1,800 of you signed up for last week's webinar on the government's stimulus measures is a sign of just how important our work together is. The strong sense of community in the tax profession has been shining through as experts support one another to get to the answers. Clients require those answers from you, and you require that assistance from us.

In the months ahead, we will be intensifying the representation of our members through our Tax Policy and Advocacy team. Many of you have kindly acknowledged the heightened efforts of Bob Deutsch and Stephanie Caredes in representing our Institute and the membership that underpins it. You will see from Peter's President's Report that Robyn Jacobson is joining our organisation this month, and I am sure that her keen focus on all tax matters, relating to practitioners of all shapes and sizes, will begin an exciting period in the development of membership with this remarkable organisation. Welcome Robyn!

The pressures of operating in this challenging environment cannot be underestimated. I want our members to know that all Tax Institute staff wish to go the extra mile to assist you in any way they are able. While we cannot see you in person, we are still available on the other end of a phone so that businesses and life can go on regardless. Please do reach out to my team at any stage in support of that objective.

On a final note, I trust many of you have enjoyed the positive experience of our new online member portal which launched a few weeks ago. The culmination of nearly two years' planning and development work, the new portal is making the lives of our members easier by housing everything you need in one modern and customisable platform, easily accessible from any device. If you have not accessed it yet, I encourage you to do so. You'll be able to access all of your membership benefits, papers, presentations, journals, as well as current and past events. The ability to receive notifications and to tailor the portal to your specific needs is already proving very popular!

I wish to extend my personal thanks for the incredible support of all of the volunteers who made The Tax Summit 2020 a resounding success, and to many more volunteers who have continued to support our community as we respond to the complexities inherent within the government's COVID-19 stimulus measures.

Stay safe and stay sanitised everyone!

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Senior Adviser's Report

by Bruce Quigley, CTA

We're all in this together

The government measures taken to address the significant economic consequences of COVID-19 are welcomed, but a number of tax policy and administration issues also need to be addressed.

The Tax Institute, together with Chartered Accountants Australia and New Zealand, the Corporate Tax Association, CPA Australia, the Institute of Public Accountants and the Law Council of Australia (the joint bodies), made a number of submissions to the government, Treasury and the Australian Taxation Office recommending policy and administration initiatives that would further ease the burden on businesses, employees and tax practitioners during the COVID-19 crisis (the crisis).

Key tax policy measures

Many taxpayers affected by tax measures due to take effect from 1 July 2020 will, through no fault of their own, not be in a position to meet the requirements of these new measures. A non-exhaustive list of measures of concern, and the required outcomes, was presented to the government.

Division 7A. The following recommendations were made with respect to Div 7A of the *Income Tax Assessment Act 1936* (Cth):

- to alleviate the current uncertainty regarding if/when changes to Div 7A may be made, the start time for any new measures related to Div 7A should be deferred until 1 July 2022;
- to ease the cost of Div 7A loans during the crisis period, there should be a temporary reduction in the benchmark interest rate from 5.37% to the medium business variable lending rate or lower; and
- to alleviate the cost of Div 7A loans during the crisis period, there should be temporary relief from minimum yearly loan repayments.

Non-resident CGT main residence exemption. As real estate sales have been significantly impacted by the crisis, the transitional measure for the removal of the main resident exemption for non-resident disposals should be extended from 30 June 2020 to 30 June 2022.

Superannuation guarantee amnesty. The superannuation guarantee amnesty end-date should be extended until 30 June 2022. The review of records and tracing required to participate in the amnesty takes time. The 7 September 2020 deadline may not be met due to impacts of the crisis.

Superannuation guarantee charge. To help alleviate the burden that employers may be facing in meeting their superannuation guarantee charge obligations on time, the Commissioner should be provided with power to waive penalties for late superannuation charge payments and penalties during the crisis.

Research and development. Due to the cancellation of the public hearings on the Treasury Laws Amendment (Research and Development Tax Incentive) Bill 2019, the 2019-20 R&D tax claims should be made under the current legislation and the start date for the Bill should be deferred until 1 July 2021.

Economic recovery package. The following recommendations were made to Treasury with respect to the economic recovery package:

- the requirement that eligible assets need to be used, or installed ready for use, to be eligible for the instant asset write-off (IAWO) from 30 June 2020 should be delayed until 31 December 2020 or possibly later, given the difficulties with supply chains;
- the current year end date should be extended to 30 June 2021 (or the current year end date requirement should simply be deleted) to enable businesses with a substituted accounting period ending after 30 June 2020 to be eligible for the IAWO; and
- businesses that started up in December 2019 or January 2020 which meet all of the other requirements will not be eligible for the cash flow boost if they have not provided notice of the taxable supplies that they made in a period that ended before 12 March 2020. The Commissioner should have a discretion to extend the end period similar to the discretion that he has with respect to the notice period.

Administration recommendations

Deferrals and penalty waivers. The Commissioner should consider the following deferrals and penalty waivers:

- company, individual, trust and partnership 2019 income tax returns should be deferred to 15 June 2020 and SMSF returns to 30 June 2020, without the need for the tax agent to make a specific application regarding how the agent has been impacted by the crisis;
- there should be a 90-day waiver for all lodgment penalties for all compliance obligations, including the deferrals requested above;
- public advice should be provided indicating that those who do not meet the "85 per cent on-time lodgment requirement" for the lodgment program framework during the crisis will not be negatively impacted; and
- all non-critical (not related to fraud or evasion) ATO requests for information should be deferred for 90 days.

Division 7A loans: exercise of Commissioner's discretion. Irrespective of the outcome of the recommendation above that the government announce temporary relief from minimum yearly Div 7A loan repayments, the joint bodies considered that the Commissioner will need to exercise his discretion to ensure that, where the minimum yearly repayment is not met, an amalgamated loan will not be treated as a dividend.

Space does not allow for a discussion of other submissions made by the joint bodies, such as those providing input on the JobKeeper Stimulus Package and the Commissioner's remedial power regarding deceased estates.

Tax News – the details

by TaxCounsel Pty Ltd

April – what happened in tax?

The following points highlight important federal tax developments that occurred during April 2020.

2020-21 Budget date

In a joint media release of 20 March 2020, the Treasurer and the Minister for Finance announced that the handing down of the 2020-21 Budget has been deferred until 6 October 2020.

Government initiatives

1. Coronavirus measures

A package of amending legislation to give effect to the government's response to the coronavirus was introduced into, and passed by, parliament on 23 March 2020 and was assented to and became law on 24 March.

The taxation measures in the legislation are briefly noted below.

Instant asset write-off

The instant asset write-off threshold has been increased from $30,000 to $150,000 and access to the write-off expanded to include businesses with an aggregated annual turnover of less than $500m (up from $50m). These changes apply from and including 12 March 2020 until 30 June 2020, for new or second-hand assets first used, or installed ready for use, in that timeframe.

Accelerated depreciation

A time limited 15-month investment incentive has been introduced to support business investment and economic growth over the short-term by accelerating depreciation deductions. A deduction of 50% of the cost of an eligible asset on installation applies, with existing depreciation rules applying to the balance of the asset's cost.

To be eligible for the accelerated depreciation, a taxpayer must have an aggregated turnover of less than $500m.

Eligible assets are *new* assets that can be depreciated under Div 40 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) (that is, plant, equipment and specified intangible assets, such as patents) and that are first held, and first used or installed ready for use, for a taxable purpose in the period beginning on 12 March 2020 and ending on 30 June 2021 (inclusive). Assets acquired under a contract entered into, or which commenced to be constructed, before 12 March 2020 are not eligible.

Cash flow boost

The *Boosting Cash Flow for Employers (Coronavirus Economic Response Package) Act 2020*, which formed part of the legislative package referred to, provides for cash flow support to eligible small and medium businesses. This is being done through two cash flow boosts delivered from 28 April 2020.

Under the Act, eligible businesses will receive a tax-free cash flow boost of between $20,000 and $100,000 through credits in the activity statement system when they lodge their activity statements.

A taxpayer is eligible for the cash flow boost if (broadly) it:

- employs staff;
- held an ABN on 12 March 2020 and continues to be active;
- has an aggregated annual turnover under $50m; and
- made eligible payments that the taxpayer was required to withhold from (even if the amount that was required to be withheld was zero).

If a taxpayer lodged their 2018-19 income tax return or an activity statement before 12 March 2020, there is no need to apply for the cash flow boost. All that is necessary is for the upcoming activity statements to be lodged. The cash flow boost will be automatically credited to the taxpayer's activity statement account. It will not be received before 28 April 2020, even if the taxpayer lodges the activity statement early. A taxpayer who or which has not lodged their 2018-19 income tax return or activity statements may still be eligible.

If a taxpayer has an activity statement lodgment deferral, the taxpayer, if eligible, will still receive the cash flow boost at the time of lodgment. This ensures that eligible entities that have received deferrals (for example, due to recent natural disasters) still have the extended time to lodge and will not miss out on the cash flow boost.

The cash flow boost Act also provides for the Commissioner to make second cash flow boost payments, on lodgment of the activity statements for eligible periods from June to September 2020, to entities that were entitled to the first cash flow boost.

The cash flow boost payments may also be available to a charity or other not-for-profit entity of equivalent size to a small or medium business entity.

The Commissioner's perspective

2. Employee work expenses

The Commissioner has released a final ruling that sets out when an employee can deduct a work expense (that is, a loss or an outgoing incurred in producing salary or wages) under the general deduction provision (s 8-1 ITAA97) (TR 2020/1).

For expenses incurred by employees, the fundamental question is whether an expense is incurred in the course of earning employment income. This involves considering the proper scope of the particular taxpayer's work activities to determine if the circumstances of the expense have a sufficiently close connection to earning the employment income. This means that an expense deductible for a taxpayer in one job is not necessarily deductible for another taxpayer holding a similar job.

However, some expense types almost always have a relevant connection to employment activities. For example, union membership or relevant professional association subscriptions relating to employment usually have a sufficiently close connection to earning income as an employee.

The requirement that expenses be incurred in the course of producing assessable income means that it is not enough to show only that there is some general link or causal connection between expenditure and the production of income. The expenditure must have a sufficiently close connection to performance of the employment duties and activities through which the employee earns income.

Accordingly, in some cases, expenditure would be regarded as being too remote from the income-earning activities or incurred only as a prerequisite to earning income, and not incurred as being in the course of producing that income.

Relevance of employer requirements

TR 2020/1 notes that a common issue relating to the deductibility of employee expenses is the relevance of express or implied conditions of employment. In this regard, a question that frequently arises is whether an expense becomes deductible merely because an employer specifically requires the employee to incur the expense.

In these circumstances, the employer's requirements do not determine the question of deductibility. This question is always to be answered by reference to the statutory test which involves an objective determination of the connection between the expense and the employee's income-earning activities. For example, an expense that is private in nature or only a prerequisite to the earning of income does not become deductible only because of an employer's requirements.

Private or domestic expenditure

Even if the positive test of s 8-1 ITAA97 is satisfied, employees cannot claim deductions for outgoings that are private or domestic in nature. The terms "private" and "domestic" are not defined but have the ordinary meanings of "personal" and "relating to the home, household or household affairs", respectively.

Although the separate presence of a private test within s 8-1 implies that expenditure of this nature could otherwise qualify as a deduction under the positive test, it has been observed that it is a "rare case where an outgoing incurred in gaining assessable income is also an outgoing of a private nature". Characterisation of an expense as private typically supports a conclusion that the expense does not have a sufficiently close connection to the earning of assessable income by the employee.

Everyday clothing, personal grooming items, and food and drink are usually private expense items, even if an employer encourages or gives instructions to incur the expenditure. However, expenses that are typically of a private nature may be deductible when there is a sufficiently close and real connection to the employment activities that produce assessable income for the employee. An example is expenditure on food and drink incurred in the course of overnight travel away from home for work purposes.

The "domestic" exclusion from deductibility is the basis on which home-occupancy expenses, such as rent, mortgage interest, rates and insurance have been held to be not deductible even when a portion of a residence has been set aside for use only as a home office. However, there may be instances of home-occupancy expenses not having a domestic character, such as when a portion of a residence is properly characterised as a place of business. In such a case, a relevant portion of the expenses may be deductible.

Other ATO information

The ruling notes that the ATO has published a wide variety of other material that deals with more specific issues or expense types. This material includes legally binding taxation rulings and taxation determinations as well as products that are not legally binding, including ATO interpretative decisions and law administration practice statements. The ruling groups these materials topically.

Work-related car expense deductions

It may be noted that the Commissioner has released a draft legislative instrument that prescribes the rate at which work-related car expense deductions may be claimed under s 28-25 ITAA97 in respect of the 2020-21 income year when using the cents per kilometre method (MVE 2020/D1).

The Commissioner has determined that the rate of 72 cents per kilometre will apply for that income year.

3. FBT: cents per kilometre rates

The cents per kilometre rates for calculating the taxable value of a fringe benefit arising from the private use of a motor vehicle other than a car for the FBT year commencing on 1 April 2020 are set out in TD 2020/3.

The rates to be applied are:

Engine capacity	Rate per kilometre
0 – 2500cc	56 cents
Over 2500cc	67 cents
Motorcycles	17 cents

4. FBT: food and drink expenses

The Commissioner has released a determination that sets out the amounts that he considers reasonable (under s 31G of the *Fringe Benefits Tax Assessment Act 1986* (Cth) (FBTAA86)) for food and drink expenses incurred by employees receiving a living-away-from-home allowance (LAFHA) fringe benefit for the FBT year commencing on 1 April 2020 (TD 2020/4).

Where the total of food and drink expenses for an employee (including eligible family members) does not exceed the amount that the Commissioner considers reasonable, those expenses do not have to be substantiated under s 31G FBTAA86. Where an employee receives a LAFHA fringe benefit, for the employer to reduce the taxable value of the fringe benefit by the exempt food component, the expenses must be either:

– equal to or less than the amount that the Commissioner considers reasonable under s 31G(1)(b) FBTAA86; or

– substantiated in accordance with the requirements in s 31G(2) FBTAA86.

If the total of an employee's food or drink expenses exceeds the amount that the Commissioner considers reasonable, the substantiation provisions under s 31G FBTAA86 apply.

The determination sets out the weekly amounts that the Commissioner considers reasonable amounts for food and drink within Australia and overseas.

5. SMSFs: property development

The Commissioner has issued an SMSF regulator's bulletin in response to the increase in the number of self-managed superannuation funds (SMSFs) entering into arrangements, with related or unrelated parties, involving the purchase and development of real property for subsequent disposal or leasing (SMSFRB 2020/1).

The bulletin states that, in particular, a number of arrangements have been seen in which the investment activity is undertaken utilising joint venture arrangements, partnerships or investments through an ungeared related unit trust or company.

While the bulletin recognises that property development can be a legitimate investment for SMSFs, these types of investments can cause concerns where they are used to inappropriately divert income into the superannuation environment, or if SMSF assets are used to fund property development ventures in a manner that is inappropriate for and sometimes detrimental to retirement purposes.

Property development ventures may also involve complex structures and the manner in which they are implemented can lead to inadvertent but serious contraventions of the regulatory rules.

Although there are no specific prohibitions preventing an SMSF from investing directly or indirectly in property development, where an SMSF seeks to undertake investments of this nature, care needs to be taken to ensure that there are no breaches of the *Superannuation Industry (Supervision) Act 1993* (Cth) and the *Superannuation Industry (Supervision) Regulations 1994* (Cth). Regulatory concerns that can arise in some arrangements include:

– whether the arrangement amounts to the SMSF being maintained for a purpose outside those permitted by the sole purpose test;
– whether the SMSF continues to meet the relevant operating standards, including record-keeping requirements, ensuring that assets are appropriately valued and recorded at market value, and keeping SMSF assets separate from members' assets;
– whether the arrangement includes the provisions of a loan or financial assistance (directly or indirectly) to a member or their relative;
– whether the arrangement includes the SMSF acquiring assets from a related party;
– if the arrangement features the SMSF borrowing money, whether that borrowing fails to meet the requirements to be exempted from the prohibition on borrowing for a limited recourse borrowing arrangement;
– whether the SMSF has contravened the in-house assets rules by exceeding the level of in-house assets allowed;
– whether payments out of the SMSF under the arrangement are in fact payments of benefits contravening the relevant payment standards (commonly known as "illegal early release of superannuation"); and
– whether the SMSF's investments are made and maintained on an arm's length basis and, if they are not, whether the terms and conditions of the transaction are not more favourable to the other party than would be expected in an arm's length dealing.

The bulletin also points out that SMSFs need to be conscious of income tax matters (such as the non-arm's length income provisions and the general anti-avoidance rules) and GST matters.

6. Salary sacrifice and superannuation guarantee

The Commissioner has issued a guidance note that provides guidance for employers applying the superannuation guarantee changes for salary sacrifice arrangements that commenced on 1 January 2020 (GN 2020/1).

Until 31 December 2019, if an employer entered into an effective salary sacrifice arrangement with an employee, the minimum superannuation guarantee payments were calculated only on the employee's ordinary time earnings (OTE). As salary sacrifice arrangements reduced the OTE, these arrangements may have reduced the amount of superannuation guarantee payable.

In addition, superannuation contributions to an employee's fund under an effective salary sacrifice arrangement were previously considered employer contributions under superannuation guarantee law and counted towards the employer's superannuation guarantee obligations.

From 1 January 2020, the minimum amount of superannuation guarantee is calculated on the employee's OTE base. This is the sum of the employee's OTE and any OTE amounts that they sacrifice in return for superannuation contributions.

Additionally, superannuation contributions to an employee's fund under an effective salary sacrifice arrangement no longer count towards the employer's superannuation guarantee obligations.

Calculation of superannuation guarantee relating to other sacrificed amounts (such as salary sacrifice arrangements for cars, property or expense payments) are not affected by the changes.

Recent case decisions

7. Associate: "sufficiently influenced"

The Full High Court has unanimously dismissed the taxpayer's appeal from the majority decision of the Full Federal Court in the BHP Billiton litigation which involved the construction of the definition of "associate" in s 318 of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) and, in particular, the meaning of the expression "sufficiently influenced" (*BHP Billiton Ltd v FCT*[1]).

The High Court held that, under Pt X ITAA36, income derived by BHP Billiton Marketing AG (BMAG) from the sale of commodities purchased by BMAG from BHP Billiton Plc's (Plc) Australian entities was to be included in the assessable income of BHP Billiton Ltd (Ltd), because Plc's Australian entities were "associates" of BMAG.

Part X ITAA36 applies to an Australian resident taxpayer who has a sufficiently substantial interest in a controlled foreign company (CFC). Part X "attributes" a share of the CFC's income to the Australian resident taxpayer. One circumstance where income is attributable is where it is from the sale of goods by a company, if the goods were sold to the company by another entity and that entity (the seller) was an "associate" of the company and a Pt X Australian resident.

A company is an "associate" of another entity where, among other situations, the company is sufficiently influenced by the other entity. Section 318(6)(b) ITAA36 relevantly provides that:

> "… a company is sufficiently influenced by an entity or entities if the company, or its directors, are accustomed or under an obligation (whether formal or informal), or might reasonably be expected, to act in accordance with the directions, instructions or wishes of the entity or entities …"

The appellant, Ltd, an Australian resident taxpayer, was part of a dual-listed company arrangement with Plc. Under this arrangement, Ltd and Plc were required to operate "as if they were a single unified economic entity" through common boards of directors and "a unified senior executive management". BMAG was a Swiss company which was a CFC of Ltd. BMAG purchased commodities from Ltd's Australian subsidiaries and Plc's Australian entities for sale. The question was whether BMAG's income from the sale of commodities that it purchased from Plc's Australian entities was to be included in the assessable income of Ltd under Pt X. That depended on whether Plc's Australian entities were "associates" of BMAG.

The Commissioner submitted that Plc's Australian entities were "associates" of BMAG for three independently sufficient reasons: Ltd was "sufficiently influenced" by Plc; Plc was "sufficiently influenced" by Ltd; and BMAG was "sufficiently influenced" by Plc and Ltd. Ltd submitted that the entities were not "associates" of BMAG because for a company to be "sufficiently influenced" by another requires "effective control" by the other entity.

The High Court held that Plc's Australian entities were "associates" of BMAG, and that "effective control" was not required to establish that a company was "sufficiently influenced" by an entity. Ltd and Plc "sufficiently influenced" each other because they were required to operate as "combined businesses" and a "single unified economic entity". Further, Ltd and Plc's shareholding in BMAG, the dual-listing structure, and group level documents that were issued by Ltd and Plc which applied to BMAG compelled the conclusion that Ltd and Plc "sufficiently influenced" BMAG.

It should be noted that the definition of associate in s 318 ITAA36 is adopted for the purposes of the operation of a number of provisions of the ITAA36 and the ITAA97.

8. Active asset test met

The AAT has held that a taxpayer who acquired a 343.95 hectare forestry property in 1992 and subsequently sold it in 2016 was carrying on a business (despite the lack of substantial activity on the land) and that the land was, therefore, an active asset for the purposes of the CGT small business reliefs (*SWPD and FCT*[2]).

The taxpayer, in partnership with his then wife, bought (with the assistance of borrowed funds) the property from a forestry operation for $180,000. The property was predominantly covered by native forest.

It was common ground that, prior to the purchase, the native forest on the land had been selectively logged and a plantation of approximately five hectares of native trees planted. On 5 January 1996, the taxpayer became the sole owner of the property. On 15 April 2016, the taxpayer sold the property for $2.75m.

During the period that the taxpayer owned the property, no harvesting activities took place on it. The activities that were carried out at the property, either by the taxpayer or at his direction, included maintaining the roads and fences on the property, clearing fallen logs, eradicating gorse weed, and establishing a new access road as the previous road (across a neighbour's property) was in the wrong place.

In concluding that the taxpayer was carrying on a business, the AAT held that the taxpayer's intention was always to make a profit from the forestry business. The expert evidence for both the taxpayer and the Commissioner was that the taxpayer's property was very much in the "sit back and watch it grow" stage. The experts agreed that there was no need for watering, pruning or fertilising the trees on the property during this period. It followed that the notions of "repetition and regularity" were of considerably less importance in a forestry operation such as that carried on by the taxpayer.

The AAT also did not accept that there were no other activities taking place on the property. Throughout the period of the taxpayer's ownership, the forest was growing, albeit slowly, and edging closer to becoming a commercial crop. This was an activity which was fundamental to a forestry business. It just happens that, in the case of a forest such as the one purchased by the taxpayer, it occurred with little or no human intervention after it was planted and thinned (to the extent that it is planted and thinned at all as opposed to being native).

It was apparent from the expert evidence that few transactions were to be expected during the growth phase of a forestry business. After all, there was nothing to sell and little to buy, apart from materials necessary for repairs and maintenance.

Other points made by the AAT were:

- the purchase of the property was a commercial transaction carried out by an entrepreneur after some limited research into the industry;
- while there were no records in respect of the loan, the taxpayer's evidence was that he arranged the loan through a business banker as opposed to a personal banker, which suggested that that the loan was a business loan and therefore commercial in nature; and
- it was the evidence of the experts retained by both parties that there were no activities that the taxpayer should have been carrying out but did not. Likewise, the activities that

he did carry out were consistent with the activities carried out by others who run forestry businesses.

While the taxpayer did not have a budget or a business plan, the evidence of his accountant was that this was to be expected and it would have been quite unusual if he had had them. The tribunal accepted this evidence, particularly in light of the lack of expenditure required on the property over the years that the taxpayer owned it.

9. $11.85m share loss deductible

The Full Federal Court has by majority (Kenny and Steward JJ, Derrington J dissenting) allowed the taxpayer's appeal from a decision of Thawley J and held that the taxpayer was entitled to a general deduction for losses incurred on the disposal of shares in a public company that had been acquired over an approximately two-year period (*Greig v FCT*[3]).

The taxpayer purchased shares in Nexus Energy Ltd (Nexus) on 64 occasions over a 25-month period at a cost of $11.85m. He also spent $507,198 on legal expenses in relation to court proceedings in which, along with others, he sought to contest a "deed of company arrangement" which provided for the transfer of all Nexus shares to a third party for nil consideration. The taxpayer lost that case. On the transfer of his shares in the 2015 financial year, the taxpayer incurred a loss of $11.85m. The character of that share loss and the legal expenses for income tax purposes were the issues to be decided. The Full Federal Court held that the amounts were of a revenue character and deductible under s 8-1 ITAA97.

Steward J (who delivered the principal judgment of the majority) said that he could not agree with the view of Thawley J that the Nexus shares were not acquired in a "business operation or commercial transaction". The shares were acquired with a view that they be sold at a profit in the short term; while no profit in fact was made, if the taxpayer had realised a gain, that gain would not have been characterised as windfall in nature or as the product of a game of chance or the pursuit of a hobby. Nor would the gain have been characterised as merely a realisation of a capital asset. That was so for a number of reasons:

– first, it was because the profit would have been the result of the implementation of an intention or purpose, existing at the time of the acquisition of each Nexus share, of profit-making from their sale;
– second, it was because the realisation of profit formed part of the taxpayer's overall sophisticated plan to generate cash profits prior to his retirement within four to five years;
– third, it was because the shares were acquired in a systematic fashion on 64 occasions;
– fourth, it was because of the taxpayer's participation, either personally or through the agency of a Mr Foot, a stockbroker, in a plan to crystallise indirectly what the taxpayer perceived was the true value of a particular asset which was owned by Nexus. It was true that the taxpayer's level of activity increased over time and that one should not use hindsight to characterise all of the acquisitions of Nexus shares;
– fifth, it was because the taxpayer used his business knowledge and experience. That knowledge and experience was applied each time the taxpayer decided to buy shares in Nexus; and
– sixth, it was because the taxpayer relevantly acted as a "business person" would.

10. TPB cancellation decisions stayed

The AAT has stayed (subject to restrictions) decisions of the Tax Practitioners Board to cancel the tax agent registrations of an individual, and of a company of which he was the sole director and supervising agent, until the tribunal's review of the Board's cancellation decisions were finalised (*Norman and Tax Practitioners Board*[4]).

In the stay hearing, the applicants relied on the observations of Davies J in *Re Josip Dekanic and Tax Agents' Board of New South Wales*[5] that it is the ordinary practice of the tribunal in the review of a cancellation of a tax agent's registration to grant a stay until the hearing and the determination of the review. The AAT rejected a submission by the respondent Board that *Dekanic* was no longer the current state of the law in terms of how the tribunal approaches the assessment of stay applications.

One of the considerations in *Dekanic* that was outlined by Davies J was that it is undesirable that there be a dislocation of the practice unless that dislocation will be permanent. In the present case before the AAT, the company had some 1,317 clients who would need to find another tax agent unless a stay was granted. It was appropriate to grant a stay to prevent any premature dislocation of the practice of the company. The stay would enable the clients to remain with the practice if they desired.

Further, if there were no stay, the company would effectively cease to exist and any hearing of the applications for review of the Board's decisions would be nugatory.

The AAT ordered the applicants to inform each of the clients of the stay decision.

11. TPB's non-reapplication period reduced

In another recent tax agent registration decision, the AAT has affirmed the decision of the Tax Practitioners Board to cancel the tax agent registration of the applicant (Mr Hill) but reduced the period within which he may apply for re-registration from five years (as imposed by the Board) to two years (*Hill and Tax Practitioner Board*[6]).

Following an investigation that it had initiated in September 2018, the Tax Practitioners Board (the Board) decided on 10 January 2019 to terminate Mr Hill's tax agent registration. The principal reason for the Board's decision was its view that Mr Hill was not a "fit and proper" person. That view was itself primarily based on findings that Mr Hill had failed to comply with the Code of Professional Conduct obligations imposed by the *Tax Agent Services Act 2009* (Cth) to act honestly and had failed to comply with taxation laws in the conduct of his personal affairs. The result of the Board's view was that Mr Hill no longer met one of the statutory registration eligibility requirements, and that result enlivened the termination power conferred by s 40-5(1)(b) of the *Tax Agent Services Act 2009*.

The Board notified Mr Hill of its decision on 24 January 2019 and informed him that the termination decision would take effect on 22 February 2019. The Board also determined that Mr Hill could not apply for re-registration within five years.

In relation to the imposition of a non-reapplication period, the AAT said that, given the variability of the circumstances likely to exist, and prevent informed comparison with decisions made in other matters, the determination period discretion should be exercised with particular attention to the circumstances of the agent under consideration. In the present matter, the tribunal had found Mr Hill not to be a fit and proper person because of his misleading responses to the Board in the disclosure documents. The tribunal also found that he had failed to comply with the Code of Professional Conduct in relation to the conduct of his personal taxation affairs. However, Mr Hill had largely remedied or regularised his taxation affairs.

There was also no complaint or criticism about his past competence when dealing with clients' affairs. That was a significant consideration, given the length of time over which he had been engaged in providing tax agent services. Finally, there was the assertion that his circumstances had changed, and the likelihood of future contravention had been removed both by that change and the effect of the present proceedings.

The AAT went on:

> "Given the seriousness of Mr Hill's misleading responses to the Board, and the nature and extent of his taxation defaults, and my current lack of confidence in the asserted unlikelihood of future misconduct, I am of the view that it is appropriate to impose a determination period … The appropriate period I have determined is two years from the date of the Board's 10 January 2019 decision."

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References

1 [2020] HCA 5.
2 [2020] AATA 555.
3 [2020] FCAFC 25.
4 [2020] AATA 640.
5 [1982] AATA 195.
6 [2020] AATA 678.

Tax Tips

by TaxCounsel Pty Ltd

Declaration of trust

A recent High Court decision has considered the nature of a partner's interest in a partnership in the context of whether there had been a dutiable declaration of trust.

Background

The recent decision of the High Court in *Commissioner of State Revenue v Rojoda Pty Ltd*[1] is important for two reasons. First, because of the analysis in the decision of the nature of the interest of partners in partnership property. Second, because it considers whether deeds entered into after the dissolution of two partnerships by the partner (in whose name the title to certain real property was held) constituted declarations of trust for the purposes of the *Duties Act 2008* (WA).

Although the case involved the application of the Western Australian *Duties Act 2008*, the decision has a wider relevance, including in relation to capital gains tax.

The facts

The appeal to the High Court concerned the business affairs of the Scolaro family which ran a business of property ownership and investment. The business was conducted through two partnerships, these being:

– the Scolaro Investment Company Partnership (the SIC Partnership) which was established by a deed of partnership in 1972 with five equal partners, Anthony and Maria Scolaro and their three children (Rosana, John and David); and

– the A&MMR Scolaro Partnership (the AMS Partnership) which was established by a deed of partnership in 1986 with two equal partners, Anthony and Maria.

Anthony died on 12 February 2011, leaving his estate to be divided equally between three testamentary trusts for his children: (1) the JASCO Testamentary Trust (with John as the primary beneficiary); (2) the RASCO Testamentary Trust (with Rosana as the primary beneficiary); and (3) the DASCO Testamentary Trust (with David as the primary beneficiary).

On Anthony's death, each of the partnerships dissolved. The partnership deeds had provided a mechanism for this dissolution to be "technical" or "notional", with the other partners to continue the business of the partnership. But this did not occur. Instead, on 12 May 2011 and 15 March 2012, respectively, each of the AMS Partnership and the SIC Partnership was subject to a general dissolution in accordance with the respective partnership deeds. The combined value of the properties of the AMS Partnership at dissolution was $14.2m and, in relation to the SIC Partnership, $11.65m. For each partnership, the value of cash and other current assets exceeded the value of the liabilities.

Anthony and Maria had been registered as joint tenants of six freehold titles (four of which as to a half-share) which were partnership property of the SIC Partnership. They were also registered as joint tenants of five freehold titles (one of which as to a half-share) which were partnership property of the AMS Partnership. Following Anthony's death, Maria, as the surviving joint tenant, became registered as the proprietor of the freehold titles. None of the properties was sold.

John died intestate on 7 August 2012. By operation of s 14 of the *Administration Act 1903* (WA), one-third of his estate passed to his wife and two-thirds passed to his children. John's wife, Bianca, and his daughter, Diana, became the trustees of the JASCO Testamentary Trust. Diana became the administrator of John's estate.

Until December 2013, the partnership freehold titles were accounted for as assets in the balance sheets of the partnerships. None of the partnership freehold titles had been sold and the present litigation proceeded on the basis that the partnership liabilities had not been discharged.

On 1 December 2013, Maria, her two surviving children (Rosana and David), Diana and Bianca, and Rojoda Pty Ltd (Rojoda) entered into two deeds concerning, respectively, the SIC Partnership (the SIC Deed) and the AMS Partnership (the AMS Deed) (together "the 2013 deeds"). Each of the 2013 deeds took the same approach in relation to the freehold titles of each partnership. The relevant recitals to the SIC Deed were replicated in the AMS Deed with relevant changes to reflect the different freehold titles of each partnership and the half-shares of each of Anthony and Maria in that partnership.

The 2013 deeds each recited (in recital C) the detail of the freehold titles that were held by "Anthony Scolaro and Maria Scolaro … jointly as joint trustees for the Partnership". Those freehold titles were referred to as "the properties" in each deed. In recital E, the 2013 deeds each recited that:

> "… [o]n the passing away of Anthony Scolaro, Maria Scolaro became the sole surviving trustee of the Properties. The Properties continued to be held on trust for the Partnership as before."

Recital F described the properties as to which the legal title was transferred "into the sole name of Maria Scolaro as the sole surviving trustee" and stated that the "beneficial ownership … remained unchanged".

Recital J of the SIC Deed and recital I of the AMS Deed reiterated that, on dissolution of the partnerships, the "beneficial interest in the assets" was held by the former partners or their estates. Recital W of the SIC Deed and recital Q of the AMS Deed recited that the parties "consider it prudent to appoint a new trustee … to replace Maria Scolaro as trustee of the Properties". That new trustee was Rojoda which was assessed by the Commissioner and was the respondent in the appeals to the High Court.

The operative clauses of the 2013 deeds were as follows:

- cl 1: the parties "acknowledge and agree" various matters, including that, on dissolution of the partnerships, the "Properties and other assets that were previously held by the Partnership were beneficially owned" as to shares of 20% for each of the partners (in the SIC Deed) and 50% for each of the partners (in the AMS Deed);
- cl 2 and cl 3 in the SIC Deed and cl 2 in the AMS Deed: the executors of Anthony's estate and the administrator of John's estate, and in the case of the AMS Deed Anthony's estate, "hereby transmit" the deceased's beneficial shares of "the Properties" according to the terms of Anthony's will (with respect to Anthony) and the *Administration Act 1903* (with respect to John); and
- by two final clauses: (1) Maria "confirms" that she held the properties on trust for the partners and the legatees of Anthony and John in their respective shares; and (2) Maria resigned as trustee of the properties and the parties agreed that Rojoda be appointed as the new trustee, with transfers of the legal title to the properties to be made to Rojoda.

The assessments

The Commissioner assessed duty on the declarations of trust in each of the 2013 deeds. Objections were lodged against the assessments on two bases. First, it was submitted that no duty was payable because the 2013 deeds had not created new trusts. The partnership freehold titles had always been held on trust and the 2013 deeds had merely confirmed this trust. Second, it was submitted that only nominal duty should have been payable to the extent to which the 2013 deeds gave effect to distributions of both Anthony's estate and John's estate. The first submission was rejected by the Commissioner but the second was accepted. Duty was re-assessed in the total amount of $707,285.

The legislation

The *Duties Act 2008* imposes duty on dutiable transactions (s 10), with the duty to be charged "by reference to the dutiable value of a dutiable transaction" (s 26(1)(a)). One type of dutiable transaction is "a declaration of trust over dutiable property" (s 11(1)(c)). Dutiable property includes "land in Western Australia" (s 15(a)) and "a right" (s 15(b)). A "declaration of trust" is defined as (s 9):

> "… any declaration (other than by a will) that any identified property vested or to be vested in the person making the declaration is or is to be held in trust for the person or persons, or the purpose or purposes, mentioned in the declaration although the beneficial owner of the property, or the person entitled to appoint the property, may not have joined in or assented to the declaration."

The contentions

The Commissioner's contention was that both before and after the dissolution of each partnership, but before the winding-up, the partners had only a non-specific, fluctuating interest in all of the partnership freehold titles so that the 2013 deeds created new trusts of those titles by a transaction that was liable for duty under s 11(1)(c) of the *Duties Act 2008*.

Rojoda's consistent primary position was that the 2013 deeds did not involve a declaration of trust, and hence they were not a dutiable transaction on that basis, because they merely confirmed the existence of the trust on which partners held the partnership property.

The decision

The majority of the High Court[2] said[3] that the Western Australian *Partnership Act 1895*, like its 1890 United Kingdom counterpart, reflected the equitable principle that, subject to the terms of the partnership deed, partners hold legal rights to the partnership property on trust for all of the partners. Section 30(1)[4] requires partnership property to be held and applied by the partners "exclusively for the purposes of the partnership, and in accordance with the partnership agreement" so that, if property is acquired as partnership property in the name only of one partner, it will be held "upon trust for the partnership". Section 30(2) provides that the legal estate or interest in land which is partnership property devolves according to the general rules of law but "in trust so far as necessary for the persons beneficially interested in the land under this section".

The majority then said:[5]

> "Section 30(2) does not create any new trust in relation to land. It gives 'statutory recognition' to the equitable principle that legal title to partnership property is held on trust for all partners. The reason for the specific provision that estates in land devolve on trust is to ensure that 'no distinction can be drawn between the nature of a partner's interest in real estate and his interest in personal estate'. Whatever the nature of the partnership property and 'wherever the legal estate may be', it is held on trust for the partners, whose interests are as tenants in common. As Deane J said in *Chan v Zacharia*, 'there is neither metaphor nor inaccuracy' in the description of a partner as a trustee for the partnership."

The majority then said that the *Partnership Act 1895* also preserved equity's unique treatment of the interest of partners under the trust. The partner's unascertained interest in relation to all of the partnership property is an equitable interest, not a mere equity, but the "partner's share" is defined in s 33[6] as being only "the proportion of the then existing partnership assets to which he would be entitled if the whole were realised and converted into money, and after all the then existing debts and liabilities of the firm had been discharged".

Hence, as Lindley MR explained, a "deceased partner could only dispose of his interest in the surplus which would remain after payment of the joint debts out of the joint assets".[7] Until then, a partner's interest under the trust is unascertained and, although it is a non-specific interest that concerns all partnership assets, it is not a right to any particular partnership asset. Indeed, in order that "all doubt upon the point [be] removed", s 32[8] makes certain that, in the absence of agreement, partners will lack a vested interest in any land that is partnership property. It provides that, unless the contrary intention appears, where land has become partnership property, it is treated between partners, and the heirs, executors or administrators of partners, as personal and not real estate.

Position before the 2013 deeds

The majority said[9] that, prior to the 2013 deeds, the legal position of the partners of each of the AMS Partnership and the SIC Partnership was as follows. Since there was no provision to the contrary in either of the partnership deeds, Maria held the freehold titles of each partnership on trust for the partners. The rights of the partners under that trust were unique. Each partner had a non-specific interest in relation to all of the partnership freehold titles (as well as all of the current assets of each partnership) with a right, on dissolution, to compel the sale of the freehold titles in order to realise a fund from which, at the conclusion of the winding-up, a vested share could then be claimed.

Position after the 2013 deeds

The majority went on:[10]

> "Although the relevant operative clause of each of the 2013 Deeds provided that Maria 'confirms' that she held the freehold titles of each partnership on trust in the relevant proportions for each former partner or their successors, those 'confirmations' of fixed trust had a substantive effect. They extinguished the unique equitable rights of the partners under the partnership trusts and created new fixed trusts. The 2013 Deeds effectively removed all the freehold titles from the property of each partnership available to create a fund for the payment of partnership debts, including for payment to external creditors. The fund for each partnership became limited to the current assets of the partnership. No partner could individually compel the sale of any of the freehold titles in the process of winding up the partnership. And each partner had new ascertained equitable rights in relation to the freehold titles held on fixed trust."

Rojoda submitted that the lack of a new trust was supported by a distinction between the internal and the external perspectives of partnership property. However, the majority said[11] that the distinction between these perspectives did not change the nature of the rights held by partners. The distinction merely contrasted the contractual restrictions within the partnership deed with the partners' rights in relation to partnership assets. The contractual restrictions applied only between the partners, but the legal rights to, or equitable rights of partners in relation to, partnership property can be the basis for a claim against third parties such as those who receive partnership property as volunteers. As Hoffmann LJ said in *Inland Revenue Commissioners v Gray*,[12] it is the "outside view which identifies the nature of the property falling to be valued for the purpose of capital transfer tax". So too, the nature of the equitable rights is the basis for the assessment of duty under the *Duties Act 2008*.

Submission: no dutiable property "moved"

Another submission of Rojoda was that the 2013 deeds created no new trust within s 11(1)(c) of the *Duties Act 2008* because no dutiable property "moved".

The majority said that this submission was contrary to equitable principle and contrary to the operation of the *Duties Act 2008*. As to equitable principle, it is fundamental that the creation of a trust involves the creation of new equitable obligations, which are "annexed to the trust property" or "engrafted" or "impressed upon it". The creation of a trust never involves "movement" of property in the sense of a conveyance of title from one person to another.

The majority went on:[13]

> "The *Duties Act* does not presuppose any different principle in its reference to a 'declaration of trust over dutiable property' in s 11(1)(c) as a dutiable transaction. Indeed, as Rojoda accepted, there may be duty payable if a discretionary trust were extinguished and replaced by a trust for the same persons in fixed shares. No property would have 'moved' but the creation of new equitable rights under a fixed trust is sufficient to attract duty. The *Duties Act* does not contemplate any different operation where the equitable rights extinguished are those sui generis rights of partners in relation to partnership property."

Submission: equity regards as done that which ought to be done

The Western Australian Court of Appeal avoided the conclusion that the 2013 deeds had created new trusts by reasoning that, as a consequence of the general dissolution of each of the AMS Partnership and the SIC Partnership, in circumstances in which the "practical certainty" was that liabilities would be discharged from current assets, equity would regard as done that which ought to be done and would treat the freehold titles as held on fixed trusts according to the shares of each partner.

The majority of the High Court said that, for several reasons, this reasoning involved a misapplication of the equitable maxim.

Section 78 of the Duties Act 2008

The final contention of Rojoda was that the 2013 deeds involved agreements to transfer partnership property to the former partners and their successors, and the 2013 deeds were not dutiable due to the operation of s 78 of the *Duties Act 2008* which applies if, on a person (the retiring partner) ceasing to be a partner in a partnership because of the retiring partner's retirement from the partnership or its dissolution, dutiable property of the partnership is transferred or agreed to be transferred to the retiring partner.

The majority said that:[14]

> "The purpose of s 78 of the *Duties Act* is to ensure that duty is not levied on both a conveyance or agreement to convey property to a partnership and, upon dissolution, a conveyance or agreement to convey the same property to partners in their partnership share. It treats the conveyance of property out of a partnership according to the partner's share upon dissolution as not being a separate dutiable event from the conveyance into a partnership. For instance, if land is acquired by a partnership of A, B and C, the acquisition will be a dutiable transaction. The value of the partnership interest of A, B and C will be reduced by the incidence of that duty. Section 78 ensures that A, B and C are not again subjected to duty if the property is conveyed to them after dissolution according to their same partnership shares. The example in the Duties Act at the conclusion of s 78 illustrates this[96]:
>
> > 'A, B and C are in partnership in equal shares. B had a one-third partnership interest immediately before retiring. On B ceasing to be a partner, A and C transfer land to B. The dutiable value of the land acquired by B will be reduced by one-third.'"

Rojoda accepted that, if the 2013 deeds did not embody agreements to transfer rights to the partners on dissolution, it would not be entitled to rely on s 78 of the *Duties Act 2008*. However, Rojoda submitted that s 78 of the *Duties Act 2008* used the concept of "transfer" in a loose sense that extended to the creation of new rights. The majority, in rejecting this submission, said that "transfer" was not used in a sense that could capture the creation of new equitable rights. The definition of "transfer" in s 9 includes an "assignment" or "exchange". It did not include a "declaration of trust", which is separately defined in the same section. Further, s 11(1) recognised the distinction between a transfer and the creation of new rights by providing separately for, on the one hand, a "transfer of dutiable property" and an "agreement for the transfer of dutiable property" (s 11(1)(a) and (b)), and, on the other hand, "a declaration of trust over dutiable property" (s 11(1)(c)).

Comment

The decision of the majority of the High Court in the *Rojoda* case is important in that it clearly states what the principles are that govern the interests of partners in the partnership and its assets.

The facts considered in the case also would raise CGT issues. There are CGT provisions that particularly relate to partners and partnership assets and other provisions that particularly relate to trusts.

In the case of a partnership, the partners and the assets of the partnership, there are CGT provisions) that are to the effect that:

– an interest in an asset of a partnership and an interest in a partnership that is not an interest in a partnership asset are, to avoid doubt, CGT assets (s 108-5(2)(c) and (d) of the *Income Tax Assessment Act 1997* (Cth) (ITAA97)); and
– any capital gain or capital loss from a CGT event happening in relation to a partnership, or one of its CGT assets, is made by the partners individually (s 106-5(1) ITAA97).

Where there is a change in the identity of the partners by, say, a retirement, then if there are no other relevant facts, a continuing partner will, for CGT purposes, acquire a further interest in each CGT asset of the partnership which interest is treated as a separate CGT asset (s 106-5(4) ITAA97).

In addition, there are special cost base rules in relation to a partner's interest in a partnership asset (ss 110-43 and 110-50 ITAA97) and the so-called CGT anti-overlap provisions contain a mechanism for meshing the ordinary partnership provisions with the CGT provisions (s 118-20 ITAA97).

Although it may be thought that the CGT partnership provisions do not accurately reflect partnership law principles, the CGT partnership provisions are clear in their intent and must be applied accordingly.

Further, CGT event E1 happens "if you create a trust over a CGT asset by declaration or settlement".

In the context of the facts of the *Rojoda* case, each parcel of land in question was in fact a partnership asset before the 2013 deeds were entered into. It was the 2013 deeds that altered this.

It would seem to follow from the reasoning in the *Rojoda* case that, from a CGT perspective, the 2013 deeds would each, within the meaning of s 104-55(1) ITAA97, have created a trust over CGT assets. It is suggested that CGT event E1 would happen "in relation to" the CGT assets of the partnerships, so that, by virtue of s 106-5(1) ITAA97, each relevant partner would make a capital gain or capital loss (unless the CGT asset were a pre-CGT asset).

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References

1 [2020] HCA 7. The High Court's decision reversed a decision of the Court of Appeal of the WA Supreme Court ([2018] WASCA 224) which had reversed a decision of the WA State Administrative Tribunal ([2017] WASAT 35).

2 Bell, Keane, Nettle and Edelman JJ; Gageler J dissenting. This article does not consider the dissenting view as the authority of the decision is clearly contained in the majority's views which would have prevailed even had the court been constituted by all seven justices, regardless of the views of the justices who did not sit on the appeal.

3 [2020] HCA 7 at [36].

4 For other jurisdictions, see for example s 20(1) of the *Partnership Act 1892* (NSW), and s 24(1) of the *Partnership Act 1958* (Vic).

5 [2020] HCA 7 at [37] (footnotes omitted).

6 For other jurisdictions, see for example s 22 of the *Partnership Act 1892* (NSW), and s 26 of the *Partnership Act 1958* (Vic).

7 *In re Ritson; Ritson v Ritson* [1899] 1 Ch 128 at 130-131.

8 For other jurisdictions, see for example s 22 of the *Partnership Act 1892* (NSW), and s 26 of the *Partnership Act 1958* (Vic).

9 [2020] HCA 7 at [41].

10 [2020] HCA 7 at [42].

11 [2020] HCA 7 at [43].

12 [1994] STC 360 at 377.

13 [2020] HCA 7 at [45].

14 [2020] HCA 7 at [63].


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Tax Education

The foundations: a step towards CTA

The Tax Institute's 2019 study period 3 CTA1 Foundations dux shares her thoughts on the importance of strengthening your tax knowledge.

Van Thi Quynh Nguyen, Tax Accountant, Delta Wealth and Tax Solutions, WA

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I'm hoping to complete the whole Tax Agent Program, and possibly the Chartered Tax Adviser Program, offered by The Tax Institute within a two to three-year time frame.

What are the challenges of juggling study and work?

Time management and self-discipline are the keys to a successful balance between study and work. Spreading out and revisiting the subject's modules throughout the semester, instead of binge studying just before the final exam, help to reinforce the knowledge in your mind. Applying the learned concepts and examples into your work and daily life also helps tremendously.

What advice do you have for other tax professionals considering the course?

Completing the Tax Agent Program at The Tax Institute not only helps you to fulfill the education requirements of registering as a tax agent with the Tax Practitioners Board, but also equips you with practical, in-depth and up-to-date knowledge in Australian taxation law. The program encompasses a very user-friendly and comprehensive online study platform that includes materials from various resources, access to taxation and law books, and very responsive support.

Member Profile

This month's column features Julianne Jaques, CTA, Barrister, Victorian Bar.

Member since

1995

Areas of specialty

I specialise in taxation litigation and taxation policy.

Why are you a member of The Tax Institute?

Being a member of The Tax Institute allows me to meet and learn with the best tax practitioners in Australia, who work in many different roles across the broad spectrum of taxation issues. I also enjoy the collegiality among the members, particularly on the various committees and at events — with many thanks to Tax Institute staff for organising the events so well!

In short, I'm a member of The Tax Institute because of the other people in it.

How is your membership beneficial to your practice and clients?

The Tax Institute helps to give me an extra edge when advising clients by keeping me up to date and connecting me with other practitioners from whom I learn taxation lore, as well as taxation law. It's important to know the tax law, but it's equally important to understand how it works in practice. The best advice a practitioner can give comes from combining a detailed knowledge of the tax law with a broader understanding of how different approaches are likely to play out in practice. Then we can give our clients not only the benefit of our knowledge, but also the benefit of good judgment. The ability to do this is what distinguishes the great advisers from the good, and the connections made at the Institute are invaluable in achieving it.

How did you end up in tax?

In the second year of my economics/law degree at Monash University, I decided that, rather than continue to work part-time in the Myer children's shoe department (with some pride, I am a qualified children's shoe-fitter), I would try to get a part-time job in a local accounting firm. Thirty "cold-call" letters later, Coopers & Lybrand offered me a job working 20 hours each week in their newly opened Waverley office, very close to Monash University. Because I was studying law, Coopers & Lybrand put me in its tax division. My official title was trainee accountant and I had a charge-out rate of $45 per hour, which blew my mind.

That was when I started in tax, and I have never left. Tax has stayed with me from my time at an accounting firm (Coopers & Lybrand), to a law firm (Freehills), to my doctorate at the University of Melbourne (completed part-time while working), to my time as a ministerial adviser (to the Assistant Treasurer in the Howard Government), and now at the Bar and as a member of the Tax Practitioners Board and the Board of Taxation.

What are the challenges for tax practitioners this year?

One month ago, I would have said staying up to date with new law, meeting strict lodgment deadlines, dealing with measures announced but not enacted, and finding and retaining good staff.

But March 2020 was a long month in Australia. Now the biggest challenge is dealing with the fallout from the COVID-19 crisis. Many tax practitioners are on the front line assisting clients whose cash flow has collapsed. This involves getting across the measures implemented by the government to help businesses to weather the economic freeze, helping clients to access those measures, helping clients to liaise with the ATO, and helping clients to negotiate with suppliers, customers and financiers to try to ensure that they are in the best financial position possible to make a speedy recovery, once the recovery phase begins. And all of this must be done largely in the virtual world with emails, telephone calls and video conferencing. There are a lot of challenges for tax practitioners at the moment, and a lot of people are relying on them. The importance of everyone involved in our tax system working together with goodwill has never been higher — whether they be ATO officers, Treasury officials, members of the government or tax practitioners, either with a firm or in-house.

Most memorable career moment to date

That's easy — being awarded The Tax Institute's 2020 Chartered Tax Adviser of the Year!

Then there's a couple that come second — as a barrister, it would be appearing in the High Court in the *Bywater* and *Sharpcan* cases.

How do you relax?

What's that?

I like to read (my book group keeps me sane) and to travel with my husband and our four wonderful children.

Advice to those entering the profession

Commit and lean in.

Limiting deductions for "vacant land"

by David Montani, CTA, National Tax Director, Nexia Australia

Amending legislation to limit deductions for "vacant land" operates by adding a qualifier to every provision in the tax Acts that provides for a deduction. Also, there are wider implications than merely losing some deductions, and consequences arise from the interaction with the capital gains tax regime. Although some welcome exceptions were introduced during the legislative process, traps remain for the unwary, including new tax risks for smaller-scale property developments. This includes circumstances where land with completed houses or units, incredibly, will be regarded as "vacant". With no grandfathering, options may be limited for existing holdings of land, and some established structuring norms must now be re-evaluated. This article sets out what constitutes "vacant land", how the new law operates to deny deductions, the available exceptions, and the broader consequences. A number of practical examples illustrate the outcomes, which then shine a light on weighing up alternative structuring options for future acquisitions of land.

Background

The income tax law allows taxpayers to deduct the costs of holding vacant land if it is held for a purpose of gaining or producing assessable income or in carrying on a business for the purpose of gaining or producing such income. That is satisfied where a taxpayer acquires vacant land with the requisite purpose, albeit that any income might be derived only in the future. Common examples include acquiring land on which to build a rental property and acquiring land to develop for sale at a profit. Practical difficulties arise for the Commissioner of Taxation in administering the law when a taxpayer's claimed intent is in doubt. In the absence of actions by the taxpayer consistent with their stated intention of producing assessable income (eg to commence constructing a property), there is often limited evidence beyond the taxpayer's assertions.

The solution enacted by parliament was to curtail allowing deductions for vacant land. The Treasury Laws Amendment (2019 Tax Integrity and Other Measures No. 1) Bill 2019 was introduced to parliament in 2019. Schedule 3 of the Bill contained measures to significantly narrow who can claim deductions relating to holding vacant land. Responding to concerns raised, the Senate amended the Bill to include several exceptions to which the House of Representatives agreed, and the Bill was passed, receiving royal assent on 28 October 2019.

Applying from 1 July 2019 to all non-exempt land, landowners now have a new matter to contend with among their taxation affairs, one which might require re-evaluating some long-established norms. Consequential matters include the treatment of denied deductions, the interaction with the capital gains tax regime, some presumably unintended consequences, and advising clients to assist them with decisions that they need to make.

New provision limits deductions

Various provisions in the *Income Tax Assessment Act 1997* (Cth) (ITAA97) and the *Income Tax Assessment Act 1936* (Cth) (ITAA36) (collectively, "the tax Acts") provide for allowable deductions, and they are conveniently listed in s 12-5 ITAA97.[1] Division 26 ITAA97 then sets out a series of specific limitations on deductions. The Bill inserts new s 26-102, which contains the rules for the new limitation relating to vacant land. Although the main source of deductions affected by s 26-102 will be those deductions arising under the general deduction provision of s 8-1 ITAA97, the new provision affects any provision under the tax Acts that provides for a deduction.

Basic rule: target situation

Section 26-102(1) ITAA97 essentially adds a qualifier to every provision in the tax Acts that provides for a deduction. However, before getting to that, let's start by focusing on understanding the target situation. Drawn from the wording in s 26-102(1), the target situation is this:

- a taxpayer incurs a loss or outgoing at a particular time
- relating to "holding land", and
- there is no "substantial and permanent structure"
- in use or available for use on the land
- having a purpose that is "independent of, and not incidental to, the purpose of any other structure or proposed structure".

The taxpayer in the above situation holds "vacant land" in relation to which the loss or outgoing is incurred. Having set out the target situation, the provision then adds a qualifier to the taxpayer's entitlement to any deduction "under this Act".[2] The qualifier is that the taxpayer can deduct the loss or outgoing only to the extent that the land is in use, or available for use, in carrying on a business for the purpose of gaining or producing assessable income, and at a specified time. The business in which the land is used can be carried on either by the taxpayer or certain related parties. In other words, for a taxpayer in the target situation — holding vacant land — every provision in the tax Acts that allows a deduction in relation to holding that land now has the s 26-102(1) qualifier bolted onto it.

Let's break down the components of the basic rule qualifier: loss or outgoing; land; holding land; substantial and permanent structure; in use or available for use; independent purpose; and in use, or available for use, in carrying on a business. Then we will examine the various exceptions, with a number of examples along the way.

Loss or outgoing

The kinds of outgoings subject to the new limitation are those "relating to holding [vacant] land". These include interest and other ongoing costs of borrowing (eg fees and charges), borrowing costs, council rates, land tax, insurance and maintenance. The denial also applies to an otherwise deductible loss, such as under a profit-making undertaking. More on that later.

Land

Land is not defined, and so it takes on its ordinary meaning. The relevant area of land is that part to which the loss or outgoing relates. A loss or an outgoing can relate to the entirety of land covered by a single title, only part of the land under one title, or land covered by multiple titles.[3] As fixtures attached to land are a stand-alone criterion for examination (considered below), it makes sense that the term "real property" was not used, as that includes fixtures under common law.

> *"... the selective application of s 26-102(1) ... will now require weighing up alternative structures for holding land."*

Holding land

Holding land is not defined. However, according to the explanatory memorandum (EM), holding land not only means owning the freehold title, but also holding a long-term lease and a lessee in general. Accordingly, s 26-102(1) applies separately to the owner and lessee of the same parcel of land in relation to their respective losses or outgoings.[4]

Substantial and permanent structure

Substantial and permanent structure is not defined. The ordinary meaning of structure includes a building and anything else built or constructed.[5] To be substantial, it needs to be significant in size, value or some other criteria of importance in the context of the particular property. For example, a letterbox will not be substantial, and a residential garage is unlikely to be substantial.[6] To be permanent, the structure needs to be fixed and enduring, but it is not expected to remain standing forever.[7]

In use or available for use

For land to not be vacant, it is not enough that there merely be a substantial and permanent structure on it. Any such structure must also be "in use or available for use". There is limited guidance on what this means, and the EM does not address this requirement. Based on the ordinary meaning, the structure would need to be engaged with activity of some kind or be available so. For example, imagine a newly constructed commercial building that is complete, but a lead contamination in the water supply means that tenants cannot move in until the contamination is resolved. Although there is clearly a substantial and permanent structure on the land, the building is arguably not yet in use or available for use. Accordingly, the land will remain as "vacant land" until the contamination is resolved.

Independent purpose

A substantial and permanent structure that is in use or available for use must then have an independent purpose that is not incidental to the purpose of another structure. This is a question of fact, and needs to be considered in the context of the structure, the land, and any other structures on the land.[8] Structures whose purpose is to support other structures, or increase their utility, will not meet this criteria. These include pipes, powerlines, and a residential garage or shed.[9]

Examples of substantial and permanent structures with an independent purpose would include a commercial building, a commercial car parking complex, a woolshed, a grain silo and a residential house (although some residential premises are subject to additional conditions (see further below)).

Qualifier: carrying on a business

Having set out what is a substantial and permanent structure in use or available for use with an independent purpose, land that has *no* such structure is "vacant land". The s 26-102(1) qualifier will then apply to the vacant land's holding costs.

Applying the qualifier, the holding costs (initially deductible under whatever provision in the tax Acts provides for the deduction) will be deductible only to the extent that the land is in use, or available for use, in carrying on a business for the purpose of gaining or producing assessable income.[10] The relevant business is not limited to being carried on by the landholder, and can also be carried on by certain related parties,[11] including an affiliate,[12] an entity of which the landholder is an affiliate, a spouse or minor child of an individual landholder, and an entity "connected with"[13] the landholder. This caters for the typical ownership structures whereby land or other assets used in a business are firewalled from business risk by being held in a different entity to that which carries on the business.

The land must be in use, or available for use, in carrying on a business at the time the loss or outgoing is incurred. Alternatively, if the business ceased before incurrence, and the loss or outgoing is deductible because of the prior use/availability of the land, it must have been in use/available in carrying on a business at that earlier time.[14]

The extension of the availability of deductions to land not actively in use, but merely available for use, in carrying on a business, will encompass land that is available for business purposes or for future use.[15]

Section 995-1 ITAA97 provides an inclusive definition of "business", and there is a considerable body of case law concerned with what amounts to carrying on a business. While that is beyond the scope of this article, it is noted that the Commissioner's views in TR 2019/1 cannot be relied on for this purpose, as that ruling is confined to determining the applicable tax rate, for specific past income years, for companies under s 23 of the *Income Tax Rates Act 1986* (Cth).

The use of the words "to the extent" means deductibility is apportioned where vacant land is only partly used in carrying on a business.

Summary

Non-vacant land

If, at the time a loss or an outgoing relating to holding land is incurred, there is a qualifying substantial and permanent structure on the land, the land is not vacant. Thus, the s 26-102(1) qualifier will not apply to losses or outgoings (deductible elsewhere) incurred in relation to holding it.

Where the loss or outgoing is incurred after ceasing to hold the land, a deduction can be available if the land was not vacant immediately before ceasing to hold it.[16]

Vacant land

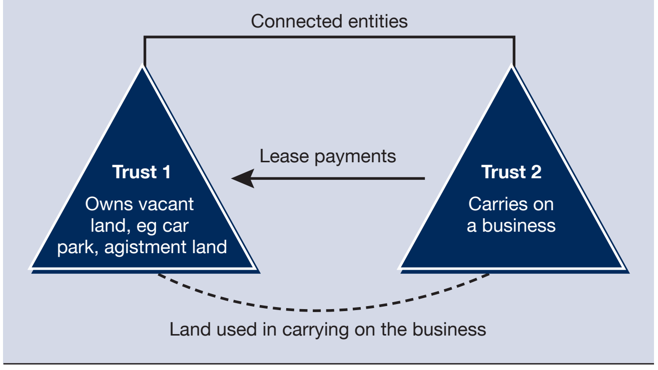
Where a loss or an outgoing incurred in relation to holding vacant land is deductible at first instance under any provision in the tax Acts, s 26-102(1) adds the qualifier. The section allows the deduction under the originating provision only to the extent that the land is used, or available for use, in carrying on a business by the holder or a related party. Where s 26-102(1) does deny a deduction, the denial is permanent as there is no provision for a deduction at a future time. However, there is some scope for tax recognition through the interaction with the CGT rules, and there are some blanket exceptions to s 26-102(1). But, first, a couple of examples to illustrate the basic rule.

Example 1. Land used in a business by connected entity

A business is carried on in a trust, and it leases vacant land that is wholly used in its business. The land is held in a related trust so that it is not exposed to the business trust's business risk. This is a typical structure of commonly controlled entities used to maximise asset protection (see Diagram 1). The trusts are connected entities.

Trust 1 and Trust 2 are both landholders, as owner and lessee, respectively. Trust 1 incurs the typical kinds of landholding costs (interest, rates etc), and Trust 2 incurs the lease outgoing paid to Trust 1. These are allowable deductions under s 8-1 ITAA97 for both entities, respectively. However, the land does not have a substantial and permanent structure on it. Accordingly, it is vacant land, and so s 26-102(1) qualifies those deductions by allowing them only to the extent that the land is used in carrying on a business, either by the landholder or by a related party.

Diagram 1. Landowner and lessee



In relation to Trust 1, although it does not use the land in carrying on a business, an entity connected with it does. Accordingly, those deductions pass the s 26-102(1) qualifier and remain fully deductible under s 8-1.

In relation to Trust 2, which is also a landholder (lessee), it wholly uses the land in carrying on a business. Accordingly, Trust 2's lease and other outgoings also pass the s 26-102(1) qualifier and remain fully deductible under s 8-1.

Residential premises: additional conditions

Certain residential premises must satisfy two additional conditions in order to be regarded as a substantial and permanent structure.[17] The conditions apply where the residential premises are constructed or substantially renovated by the landholder while holding the land, that is, if the landholder acquires land with existing residential premises, and they do *not* renovate it, these additional conditions do not need to be met. The meanings of "residential premises" and "substantially renovated" are taken from *the A New Tax System (Goods and Services Tax) Act 1999* (Cth).

In order to be regarded as a substantial and permanent structure, constructed/renovated residential premises must satisfy both of the following additional conditions:

– it is lawfully able to be occupied; and
– it is leased, hired or licensed (in most cases, rented out), or available so.

The first additional condition essentially requires having the occupancy permit from the relevant state/territory authority.

The second additional condition would be evidenced by the relevant agreement and the receiving of income, or the typical appointment of an agent and/or advertising. This is particularly noteworthy for a development of residential property for sale under a profit-making undertaking, that is, the development is not of a size and scale that would constitute carrying on a business. While occupancy permits would of course be obtained, the properties are not rented, nor available for rent — they're for sale. Accordingly, they will not satisfy the second additional condition, and thus are not regarded as a substantial and permanent structure. In other words, land with completed houses, units etc in this circumstance, incredibly, is regarded as "vacant land".

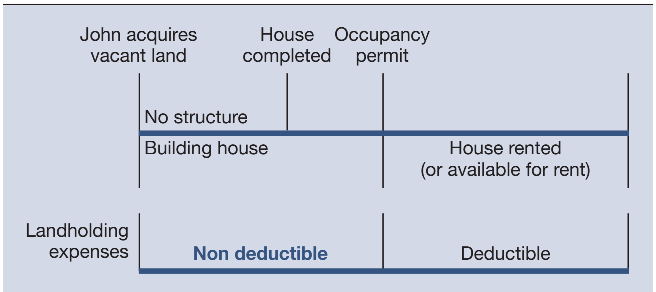
Where such a development is profitable, this will make little difference. However, s 26-102(1) will deny a deduction where a loss arises. How this compounds an already difficult situation is illustrated below.

Example 2. Build a house to rent

John acquires vacant land and engages a builder to build a house. He engages a real estate agent who, on receiving the occupancy permit, advertises the house for a tenant.

The various landholding outgoings referred to earlier (interest etc) are deductible under s 8-1 ITAA97 at the first instance.

Diagram 2. Timeline



However, s 26-102(1) then applies the qualifier. As the land is not used in carrying on a business, the provision will deny the s 8-1 deductions up to the point set out in Diagram 2. After that point, the land is no longer vacant, and thus s 26-102(1) ceases to deny deductions under any provisions in the tax Acts.

Diagram 2 assumes that John acquired the land on or after 1 July 2019. But what if he acquired it before, and 1 July 2019 falls somewhere in the non-deductible period? Quite simply, that period is divided into pre- and post-1 July 2019. The outgoings will be deductible under s 8-1 ITAA97 up to 30 June 2019. But, from 1 July 2019 to the time the occupancy permit is issued and is available for rent, s 26-102(1) will deny deductions for holding costs as per above.

Exceptions

Having worked through the basic rule, there are several exceptions whereby s 26-102(1) has no application. The exceptions are divided into two types:

– excluded classes of entity; and
– for all other entities, particular circumstances.

Where an exception applies, the s 26-102(1) qualifier will not apply to any provision in the tax Acts that allows a deduction. That is, a loss or an outgoing must still satisfy whatever relevant provision (eg s 8-1, Div 25 etc) that provides for a deduction in the first place, and if it does, that's generally the end of the matter.

Excluded classes of entity

Under s 26-102(5) ITAA97, the following kinds of entities are exempted from the deduction-denying effect of s 26-102(1), no matter what their circumstances:

– corporate tax entities (ie companies, and certain entities treated as companies);[18]
– non-self-managed superannuation funds;
– managed investment trusts;
– public unit trusts; and
– unit trusts and partnerships where all unitholders/partners are the above kinds of entities.

This entity carve-out exemption list is the same as that found in the provisions denying deductions relating to travel and depreciation for residential rental properties.[19] Again, all the exception does is shield these entities from the s 26-102(1) qualifier in relation to deducting a loss or an outgoing. However, they still need to satisfy the provision in the tax Acts that allows the deduction in the first place. In example 1 (above), if either trust was instead a company, their respective allowable deductions would not be subjected to the s 26-102(1) qualifier in the first place.

Particular circumstances

The "particular circumstances" exception is relevant for all remaining kinds of entities, such as individuals, discretionary trusts, self-managed superannuation funds, and unit trusts and partnerships not subject to the entity class exclusion. The exceptions are:

– exceptional circumstances;[20]
– primary producers;[21] and
– arm's length dealing.[22]

Exceptional circumstances. This exception is intended for natural disasters and other unforeseeable events that destroy, or render unusable, a substantial and permanent structure. It applies where land was previously not subject to s 26-102(1) because of the existence of a permanent and substantial structure on it, and then a circumstance affected the structure, resulting in the land otherwise becoming subject to the deduction-denying effect of s 26-102(1).

The first-instance triggering of s 26-102(1) must be wholly or mainly because of that circumstance. Further, the circumstance must be exceptional and beyond the reasonable control of the landholder or the relevant earlier-mentioned related parties. This will be so if they did not cause the circumstance, and there was nothing that a reasonable person in their position should have reasonably done to prevent the circumstance.[23]

A simple example is where a commercial building is accidentally destroyed by fire, or damaged, rendering it unusable. Qualifying circumstances can also include where a property contained a defect when it was acquired, but this is discovered later, stopping it from being used.[24]

There is perhaps a drafting oversight in the wording of this exception. As noted above, it applies where land was previously not subject to s 26-102(1) because of the existence of a permanent and substantial structure on it. However, land is not immune from s 26-102(1) merely because of the existence of such a structure, but rather because of the existence of a structure that is in use or available for use with an independent purpose. Perhaps it is proper to read those additional words into the exception as its purposive intent. To illustrate the effect of that, refer back to the earlier-mentioned example of the newly constructed commercial building that was not yet available for use due to a lead contamination. In that example, although there is a substantial and permanent structure, it is not yet in use or available for use. Therefore, there has not yet been a time when the land is not subject to s 26-102(1). Accordingly, it would not satisfy the first requirement of this exception, and thus the exception would not apply.

The Commissioner has stated (non-binding) that the exception also applies if the circumstance occurred before 1 July 2019.[25] The exception does not apply to circumstances that do not affect the structure itself. For example, if the landholder suffers financial hardship that delays the completion of renovations.[26] It would seem that this would also be the case where the financial hardship arises from the economic fallout of the COVID-19 virus.

A three-year time limit applies for this exception. If, after the time limit expires, the land is still without a qualifying substantial and permanent structure, s 26-102(1) will commence applying. However, the Commissioner has the power to extend the time limit. Written records of the circumstance and its effect on the affected structure must be kept until five years after the end of an income year in which deductions are claimed in reliance on this exception.

Primary production. This exception is available only to entities with a link to primary production, but beyond that contains few limitations. Section 26-102(1) will not apply to land where:

- it is leased, hired or licensed to another entity (related or unrelated);
- the landholder is carrying on a business of primary production, or one of the earlier-mentioned related parties does (connected, affiliate etc); and
- the land does not contain residential premises, and none are being constructed.

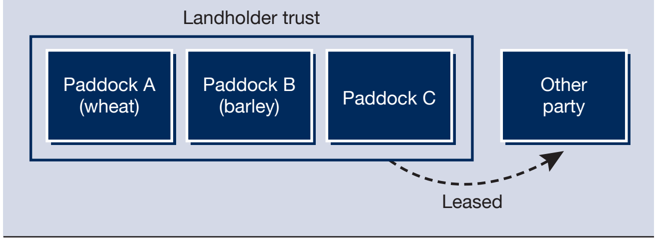
Primary production business is defined in s 995-1 ITAA97. The use to which the land is put by the other entity is irrelevant, and there is no connection required between the land and the primary production business that is carried on by the landholder or related party. The landholder itself might carry on no primary production activities, but if one of the related parties carries on a primary production business, then the exception is available.

Example 3. Primary production link

A farmer carries on a primary production business through a discretionary trust and has three paddocks. Two paddocks are being used in the business, but the third is leased to another party (see Diagram 3).

The paddocks do not have a substantial and permanent structure on them, and so are vacant land. However, paddocks A and B represent land that is wholly used in carrying on a business (the type of business does not matter) for the purpose of gaining or producing assessable income. Accordingly, they satisfy the qualifier that s 26-102(1) imposes on any provision that allows a deduction (eg s 8-1). Paddock C, on the other hand, is not used in carrying on a business. Accordingly, deductions relating to paddock C that are allowed in the ordinary course under other provisions will, at first instance, be denied under the s 26-102(1) qualifier.

Diagram 3. Paddocks



However, s 26-102(8) ITAA97 will then prevent s 26-102(1) from applying because the landholder carries on a primary production business and leases the vacant land to another party. In other words, the deductions under those other provisions are shielded from the s 26-102(1) qualifier, and thus remain deductible. The overall result is that no deductions are denied under s 26-102(1), albeit for different reasons for paddocks A and B, compared to paddock C.

Arm's length dealing/carrying on a business. This exception is relatively straightforward for vacant land that would otherwise fall victim to s 26-102(1). Under this exception, s 26-102(1) will not apply to vacant land where:

- it is leased, hired or licensed to another entity as a result of a dealing at arm's length;
- the land is used, or available for use, in carrying on a business; and
- the land does not contain residential premises, and none are being constructed.

A key difference with this exception is that the use to which the land is put by the other entity is very much relevant. The meaning of "dealing at arm's length" is derived from case law precedents, and the definition in s 995-1 ITAA97 merely adds that any connection between the parties, and any other relevant circumstance, must be considered.

Related parties can deal with each other on an arm's length basis, provided the arrangement is consistent with what independent parties might agree to.[27] However, if the parties are the kinds of related parties referred to earlier (connected, affiliate etc), this exception would not need to be relied on. The reason is that the s 26-102(1) qualifier that the land be used in carrying on a business (in this case, by a related party) would be satisfied in the first place.

Tax treatment of denied deductions

Deductions denied under s 26-102(1) cannot be deducted at a later time. Most will add the land's cost base for CGT purposes as third element expenditure.[28] However, some deductions do not qualify as third element expenditure, such as borrowing costs. Also, when calculating the reduced cost base, third element expenditure is excluded. That means that deductions denied under s 26-102(1) cannot create or increase a capital loss.

For land acquired before 21 August 1991, third element expenditure is not applicable, so any denied deductions will not add to the land's cost base.

In summary, where denied deductions are not included in the CGT mechanisms, there is no tax recognition.

Residential profit-making undertaking

Land may be acquired for development as part of a profit-making undertaking, that is, the intent is to profit from the development and sale (rather than to derive income from holding it as an investment), but the activity is not of a size and scale that amounts to the carrying on of a business. (If it did, the land would be trading stock, and the trading stock provisions in Div 70 ITAA97 would apply when determining assessable and deductible amounts.)

All of the development costs are carried forward and factor into calculating a profit or loss when all or part of the land is sold. Any profit arising is a single-figure amount of assessable income under s 6-5 ITAA97. A capital gain would also arise, but this is reduced under the anti-overlap rule in s 118-20 ITAA97. Also, a loss arising from a profit-making undertaking is an allowable deduction under s 8-1 ITAA97. Generally, any capital loss simultaneously arising would be reduced via a reduction in the reduced cost base.[29]

Interaction with s 26-102

So, how does this profit–calculation process interact with the application of s 26-102(1) for a residential development? This brings into sharper focus a technical tax issue for property that has lingered for many years. The issue is the correct tax treatment of landholding costs (interest, rates etc) when calculating the profit — very much the kinds of outgoings that s 26-102(1) targets.

The Commissioner's view in TD 93/D115 (which languished for several years until being withdrawn) was that these holding costs are not deductible as incurred. Rather, they are a component when calculating any assessable profit, and thus should be carried forward, along with the development costs, and factor into calculating the profit at the later time. Under the Commissioner's never-finalised view, s 26-102(1) is not relevant to those holding costs as the matter of deductibility does not arise in the first place.

The alternative view is that holding costs are not part of calculating the profit, but rather are expenses incurred in deriving the eventual profit. On that view, those costs are deductible under s 8-1 when incurred, and do not factor into the calculation of the (larger) assessable profit when derived later on. Until now, this largely amounted to a timing difference. However, for a residential profit-making undertaking, s 26-102(1) would now permanently deny a deduction for the holding costs as incurred. Remember that, as the residential development is for sale, it won't satisfy that second additional condition for residential property to be a substantial and permanent structure. This would leave the taxpayer in a worse position compared to the Commissioner's view, as the eventual profit assessed will be a larger figure by an amount equal to the holding costs incurred previously — which are denied a deduction. The matter is now one of permanent difference.

Based on the above, the pragmatic approach would be to embrace the Commissioner's never-formalised view in TD 93/D115 when calculating the (smaller) assessable amount on the sale of the property. Delayed tax recognition for those holding costs is better than no tax recognition at all.

Example 4. Smaller-scale development

Some years ago, Steven and Elyse purchased a residential rental property, comprising an old house on a large block. At the end of the current lease term, they decide to develop the site. They demolish the house, subdivide the property into two smaller lots, and build a residential unit on each lot for sale. The venture is not of a size and scale that amounts to carrying on a business, but rather embarking on a profit-making undertaking.

As Steven and Elyse did not construct or renovate the house, those two additional conditions that residential premises must satisfy in order to be a substantial and permanent structure do not apply. Accordingly, when the tenants move out and the house is no longer rented or available for rent, it remains open for it to continue to be a qualifying substantial and permanent structure until its demolition. The issue arising here is that of when s 26-102(1) starts operating to deny deductions — when the tenants move out, or at the later time when the house is demolished. For it to be the later time, the house must be "in use or available for use" during the intervening period. Is it possible for a vacated house, merely waiting to be demolished, to be in use or available for use?

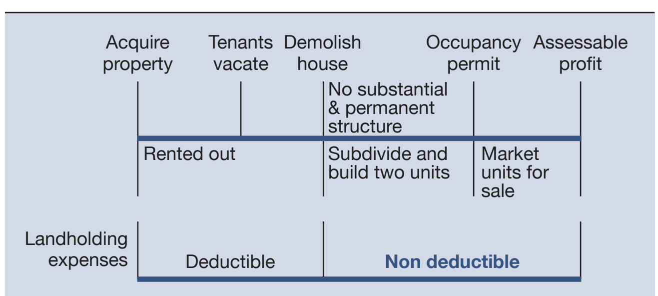
If the only possible way that residential premises could be "in use or available for use" is to be rented or available for rent, then the second additional condition for newly constructed or renovated residential premises to be a substantial and permanent structure would be unnecessary. Therefore, arguably, the answer to the above question is yes, it *is* possible for a vacated house, merely waiting to be demolished, to be "in use". It might be said that the house being attached to the land ventured into the profit-making undertaking makes it inextricably part of that venture which has commenced, and thus it is "in use". On that basis, s 26-102(1) would start denying deductions from demolition, and not from the earlier time when the tenants vacate. In practice, the gap in time might be relatively small and the difference immaterial.

In any event, once the house is demolished, the land no longer has a substantial and permanent structure on it and is now vacant land. Accordingly, s 26-102(1) will, from that point, deny deductions for interest, rates etc, as the land will not pass the qualifier of being used in carrying on a business. Further, as the units are newly constructed, the additional two conditions for residential premises to be a substantial and permanent structure will apply to them. Accordingly, even when the units are completed and occupancy permits issued, they will not be rented or available for rent. Accordingly, the land will continue to be regarded as vacant land.

Diagram 4 shows the result from the application of s 26-102(1).

On the basis of embracing the Commissioner's view on calculating any assessable profit, there would be virtually no deductions for s 26-102(1) to deny during the non-deductible period in any case, as all of the holding costs will be carried forward as part of calculating the eventual profit.

Diagram 4. Timeline



Profit-making undertaking loss: warning

As noted above, a loss arising under a profit-making undertaking is generally deductible under s 8-1 ITAA97. However, residential property developments for sale will typically be regarded as vacant land because the constructed residential premises will not satisfy that second additional condition to be a substantial and permanent structure, being rented or available for rent. Therefore, the loss relates to holding vacant land and s 26-102(1) will deny a deduction for that loss. This is a harsh outcome, for which there is no discernible policy basis. Smaller-scale developments now have this added risk factor.

Although no one undertakes a development intending to make a loss, where one does arise, s 26-102(1) compounds an already difficult situation by denying a deduction for the loss. It should be noted what whether a particular development is merely a profit-making undertaking, or crosses the line to carrying on a business, is a question of fact. A taxpayer cannot simply choose to be carrying on a business (and therefore pass the s 26-102(1) qualifier).

Example 5. Profit-making undertaking

Brad acquires vacant land and constructs a house for sale as a profit-making undertaking. For the reasons noted above, the land will be regarded as vacant land throughout Brad's entire ownership of it. Accordingly, s 26-102(1) will deny a deduction for all losses or outgoings relating to Brad's holding of the land. That includes denying a deduction for a loss incurred on sale.

Brad's total outgoings are as follows:

	Cost base $	Reduced cost base $
Purchase land, transfer duty	500,000	500,000
Development/construction costs (ex-GST)	600,000	600,000
Interest, land tax etc.	200,000	–
Total	1,300,000	1,100,000

With s 26-102(1) now operating, what would the income tax and CGT outcomes be if Brad sold the property for (ex-GST):

- $1.6m;
- $1.2m; or
- $1.0m?

It can be seen that $1.6m represents a good profit, $1.2m represents a modest loss (but is also within the cost-base/reduced-cost-base no-man's land), and $1.0m represents a heavy loss.

The outcomes are summarised in Table 1.

Where an economic loss is incurred, this is not matched by an equal amount of allowable deduction or capital loss. Again, this is a harsh result in what is already a difficult situation.

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The 2019-20 income year is the first one in which new s 26-102 ITAA97 applies. This will require paying closer attention to the landholdings of entities which are outside the excluded classes in order to identify any such holdings that constitute vacant land. It may be straightforward to identify land in relation to which deductions will now be denied under s 26-102(1), in which case, this perhaps could be attended to within the normal scope arrangement. Where denied deductions are added to the land's cost base, a practical approach would be to add them to the land's carrying cost on the balance sheet. Otherwise, ensure that a record of additions to the cost base is carried forward.

If determining whether or not s 26-102(1) applies, and determining the outcomes, will not be a straightforward exercise, then that may well be outside the existing scope arrangement for the annual compliance work. It is suggested that an additional fee for the additional work is discussed/confirmed with the client beforehand. Either way, there will be a need to educate affected clients.

Table 1. Compare economic and tax outcomes

Sale price	$1.6m	$1.2m	$1.0m
Economic gain/(loss)	$300,000	($100,000)	($300,000)
Tax outcome	$300,000 assessable income	No tax recognition	($100,000) capital loss
Does the tax outcome match the economic outcome?	✓	✗	✗

Note: the technical detail behind the above outcomes is set out in the appendix.

Advising clients on structuring

Until now, for many clients, it may have been a simple given where land assets would be held, eg a discretionary trust. However, the selective application of s 26-102(1)'s denial of deductions will now require weighing up alternative structures for holding land.

Alternative example 2. Build a house to rent

In example 2 (above), the property was acquired in an individual's name and thus the entity class exception to s 26-102(1) did not apply. The same outcome would arise for a discretionary trust. If the property were instead acquired in a company, the entity class exception would apply and thus no deductions would be denied by s 26-102(1). But that would also mean that there would be no general 50% discount on any future capital gain, and any negative gearing losses would be locked inside the company.

The question is which would cause the bigger tax cost:

1. losing some deductions (mitigated somewhat by reduced CGT when selling the property, due to being added to the land's cost base); or
2. losing the general 50% discount, and the timing effect of any negatively geared losses being locked inside the company?

In most cases, option 2 would likely produce the bigger tax cost. Accordingly, option 1 would be the lesser of two evils, and thus an individual or a discretionary trust would remain the preferred structure options. While the preferred structure might be unchanged from before s 26-102(1) was introduced, the key is to have undertaken this comparison.

Alternative example 5. Profit-making undertaking

Example 5 (above) illustrated the harsh tax outcomes that will arise for a residential profit-making undertaking that underperforms. But again, the project was undertaken in an individual's name, and the same outcomes would also arise in a discretionary trust. Any profit arising will be assessable income (with the accompanying capital gain reduced under the s 118-20 ITAA97 anti-overlap rule). The income tax outcomes for a profit can ultimately be the same if the project were undertaken in a company owned by a discretionary trust.[30] In fact, using a company could produce additional benefits, such as:

- retaining profits in the company after the company rate of tax (without the complications of the trust-with-corporate-beneficiary structure as set out in Div 7A of the *Income Tax Assessment Act 1936* (Cth)); and
- drawing the profits by dividend over time in a tax-effective manner, or even quickly without over-taxation.[31]

As companies are exempt from s 26-102(1), the economic losses in the two underperforming scenarios would be reflected in a s 8-1 ITAA97 allowable deduction of the same amount. Nobody undertakes a property development expecting to make a loss, but in the event that they do make a loss, at least there would be full tax recognition for their economic loss. Also, a tax loss locked inside a company is better than no tax recognition at all.

For smaller-scale developments, a discretionary trust might have been the standard choice of structure. That norm is now disrupted, with a company now likely to be preferred. There is no downside if a profit arises, but the risk of a loss not getting tax recognition is eliminated.

Existing holdings of land

For land that is yet to be acquired, tax practitioners can attend to the required discussions and advice for clients. However, where land already held will be subject to denied deductions under s 26-102(1), options are much more limited. One option would be to transfer the land to an exempt entity, such as a company. However, the consequential transfer duty and administrative costs may well make that unviable.

For example, in example 4 (above), Steven and Elyse obviously do not expect to make a loss on their development, and they would probably judge the transfer duty cost as not being worth insuring against a loss, if one arose, having no tax recognition. It would also bring forward any CGT liability. However, this is for them to decide, after having been informed on where they stand. There is perhaps also a not-insignificant general anti-avoidance risk.

If the least bad option is to leave the ownership of the land as is, and subjected to some denied deductions, practitioners need to make clients aware of where they stand under the law. That includes, in situations like example 4, making them aware of, if they were to make a loss, the harsh tax outcome that would compound that situation.

Conclusion

The outcomes from the introduction of s 26-102 range from a minor irritation due to deductions for a period being denied, to having to re-evaluate structuring norms, to unnecessarily compounding the financial difficulty of an under-performing smaller-scale residential development. The key is planning for the optimum structure to hold land and educating affected clients on how s 26-102 will impact them.

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References

1 Also listed in s 12-5 ITAA97 are the provisions that affect deductions.
2 "[T]his Act" means both the ITAA97 and the ITAA36, according to s 995-1 ITAA97.
3 Note 2 of s 26-102(1) ITAA97; EM, paras 3.14 to 3.17.
4 EM, para 3.28.
5 Note 1 of s 26-102(1) ITAA97.
6 EM, paras 3.18 to 3.19.
7 EM, para 3.20.
8 EM, para 3.21.
9 EM, para 3.22.
10 This is the second appearance of the words "in use, or available for use". The first appearance relates to the structure on the land, whereas this appearance relates to the land itself.
11 S 26-102(2) ITAA97.
12 S 328-130 ITAA97.
13 S 328-125 ITAA97.
14 S 26-102(3) ITAA97.
15 EM, paras 3.31 to 3.32.
16 S 26-102(1)(b) ITAA97.
17 S 26-102(4) ITAA97.
18 S 960-115 ITAA97.
19 Ss 26-31 and 40-27 ITAA97.
20 S 26-102(6) and (7) ITAA97.
21 S 26-102(8) ITAA97.
22 S 26-102(9) ITAA97.
23 Supplementary EM, para 1.17.
24 Supplementary EM, para 1.11.
25 ATO, *Deductions for vacant land, Exceptional circumstances exemption*, 16 December 2019. Available at www.ato.gov.au/General/Property/Land---vacant-land-and-subdividing/Deductions-for-vacant-land/#Exceptional circumstancesexemption.
26 Supplementary EM, para 1.19.
27 Supplementary EM, para 1.42.
28 S 110-25(4) ITAA97.
29 S 110-55(9) ITAA97.
30 The trust will need to make a family trust election to ensure that franking credits on dividends paid by the company will flow to beneficiaries.
31 For example, s 205-70(5) ITAA97 enables a franked dividend to be paid in the first year that a company has taxable income, despite not yet having any franking credits, without punitive outcomes.
32 Broadly, s 110-55(9) ITAA97 provides for the reduced cost base (RCB) to be reduced by any amount that you can deduct as a result of a CGT event happening to the CGT asset. However, no reduction is made for a cost that could never have formed part of the RCB or is excluded from it. In other words, a reduction will only happen in relation to costs that were included in the RCB in the first place.

Appendix. Technical details for example 5 outcomes

		Sale price (ex-GST)		
		$1.6m	$1.2m	$1.0m
Before effect of s 26-102(1)	Economic gain/(loss)	$300,000	($100,000)	($300,000)
	S 8-1 deduction	N/A	($100,000)	($300,000)
	Capital proceeds	$1,600,000	$1,200,000	$1,000,000
	Cost base	$1,300,000	$1,300,000	$1,300,000
	Reduced cost base	$1,100,000	$1,100,000	$1,100,000
	Capital proceeds exceed cost base?	Yes	No	No
	Reduced cost base exceeds capital proceeds?	No	No	Yes
	Capital gain	$300,000	N/A	N/A
	Capital loss	N/A	N/A	($100,000)
	S 110-55(9) adjustment to reduced cost base?[32]	N/A	No[33]	Yes. RCB reduced by $100,000, to $1m[34]
	Effect of above	N/A	No change to capital gain/loss outcomes	RCB now equals capital proceeds *Capital loss reduced to nil*
	Assessable profit	$300,000	N/A	N/A
	S 118-20 adjustment	Capital gain reduced to nil	N/A	N/A
Effect of s 26-102(1)	S 26-102(1) deny above s 8-1 deduction?	N/A	Yes	Yes
	S 110-55(9) adjustment to reduced cost base?	N/A	No[35]	Not anymore Original RCB reinstated[36]
Overall outcomes		$300,000 assessable profit (unchanged)	No capital gain or loss (unchanged) S 8-1 deduction now denied	$100,000 capital loss reinstated S 8-1 deduction now denied

33 At first instance, there would be a reduction in the RCB by the $100,000 deduction arising. However, that deduction is arguably representative of the third element expenditure that is excluded from the RCB. Therefore, there is no reduction in the RCB.

34 Of the $300,000 deduction arising, it is arguable that $200,000 relates to the third element expenditure excluded from the RCB, and only $100,000 relates to costs included in the RCB. Therefore, under s 110-55(9) ITAA97, the RCB is reduced by $100,000 only.

35 Due to s 26-102(1) ITAA97, there is now no amount that can be deducted. Accordingly, s 110-55(9) ITAA97 is now not applicable in any case.

36 Due to s 26-102(1) ITAA97, there is now no amount that can be deducted. Accordingly, s 110-55(9) ITAA97 now does not cause any reduction in the RCB.

Structuring cross-border transactions: part 2

by Renuka Somers, Senior Tax Advisor, US–Australia Tax Desk, and Peter Harper, CEO and Managing Director, Asena Advisors, LLC

In part 1 of this article, we noted that draft taxation determinations TD 2019/D6 and TD 2019/D7 raise important considerations in international tax planning and the structuring of Australian investments, with capital gains (whether foreign-sourced or not) attributed to a foreign resident beneficiary of an Australian resident trust being assessable to that beneficiary unless the trust is a fixed trust. In part 2, we delve into the international tax planning issues that the draft taxation determinations create, particularly in relation to Australia's international tax treaty obligations, and the potential impact that these determinations could have in how cross-border investments are structured.

Introduction

The Australian Taxation Office's draft taxation determinations TD 2019/D6 and TD 2019/D7 (collectively, the DTDs), which were released in September 2019, generated much controversy and criticism. The DTDs purport to extend the reach of the Australian capital gains tax rules to capital gains of a foreign resident beneficiary (FRB) of an Australian resident non-fixed trust, regardless of the source of those gains.

In part 1 of this article, we considered the changes proposed by the DTDs and the disconnect between the changes and relevant provisions of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) and the *Income Tax Assessment Act 1997* (Cth) (ITAA97). In part 2, we discuss the potential impact of the DTDs on international tax planning, and particularly how the ownership structure of Australian investments could significantly impact the tax outcomes for FRBs.

International tax planning

As noted in part 1 of this article:

- generally, under Div 855 ITAA97, foreign residents and trustees of a foreign resident trust (FRT) for CGT purposes may disregard the capital gains and losses in relation to CGT assets which are not "taxable Australian property" (TAP);[1]
- TAP includes direct or indirect interests in Australian real property, certain mining, quarrying or prospecting rights, and business assets (other than Australian real property) of an Australian permanent establishment;[2]
- an FRT is a trust that does not satisfy the requirements for being an Australian resident trust for CGT purposes. A trust is an "Australian resident trust for CGT purposes" at any time during the year:[3]
  - if the trust is not a unit trust: either the trustee is a resident or the central management and control of the trust is in Australia; or
  - if the trust is a unit trust: (1) either any property of the trust is situated in Australia or the trustee carries on business in Australia; and (2) either the central management and control of the unit trust is in Australia or residents held more than 50% of the beneficial interests in the income or property of the trust;
- the assessable income of a beneficiary of a trust who is not under any legal disability, and who is presently entitled to a share of the income of the trust, includes their share of the net income of the trust attributable to the period when the beneficiary was a resident, and their share of the net income of the trust attributable to a period when the beneficiary was not a resident and which is also attributable to sources in Australia;[4]
- an FRB (individual or company) which makes a capital gain or loss on an interest in a fixed trust which is not TAP is exempt from CGT pursuant to s 855-40 ITAA97. Additional conditions must be satisfied if the interest is TAP.[5] The trustee of a fixed trust is not liable to pay tax in respect of an amount which has been disregarded for such an FRB;[6] and
- based on the ATO's statements in TD 2019/D6, these provisions do not extend to exempting the extra capital gain recognised under Subdiv 115-C ITAA97 where an FRB derives a capital gain from a *non-fixed trust*.

For international tax planning purposes, the DTDs create some unique concerns as:

- they specifically avoid commenting on how the application of Australia's double tax agreements (DTAs) would be addressed. This creates uncertainty as to how the ATO's interpretation of the law can affect, and be affected by, Australia's treaty obligations; and
- the effect of the DTDs is that the Australian tax consequences will vary for gains derived from the disposal of non-TAP assets, depending on whether the gain is derived:
  - through direct ownership by the foreign resident;
  - as an FRB of a fixed Australian resident trust;
  - as an FRB of a non-fixed Australian resident trust; or
  - as an FRT.

The DTAs

Australia's DTAs aim to allocate taxing rights between Australia and treaty countries with respect of income movements between the countries.

In this section, we review the allocation of income rights under the Australia–United States income and capital tax treaty (the treaty)[7] in the context of the DTDs.[8]

"Residents" of the US or Australia who are "qualified persons" are entitled to the benefits available under the treaty.[9] The term "qualified persons" includes individuals, government bodies and listed entities, as well as unlisted entities that satisfy both an ownership test and a base erosion test.[10]

These tests require that:

– 50% or more of the aggregate voting power and value (of a company) or beneficial interest (in trusts or partnerships) is owned, directly or indirectly, on at least half the days of the company's taxable year by qualified persons;[11] and

– less than 50% of the entity's gross income for the tax year is paid or accrued, directly or indirectly, to persons who are not residents of either Australia or the US in the form of tax deductible payments for the taxes covered by the treaty.[12]

The beneficial interests in a trust are considered to be owned by its beneficiaries in proportion to each beneficiary's actuarial interest in the trust, with the interest of a remainder beneficiary being 100% less the aggregate percentages held by income beneficiaries. If it is not possible to determine the actuarial interest of any beneficiaries in a trust, the ownership test will not be satisfied unless all possible beneficiaries are qualified persons.[13]

For the purposes of the treaty, a person is a "resident of Australia" if the person is an Australian corporation, or "any other person (except a company as defined under the law of Australia relating to Australian tax) who, under that law, is a resident of Australia".[14] This is subject to the proviso that in relation to any income, a person who is subject to Australian tax on income from sources in Australia, or is a partnership, an estate of a deceased individual, or a trust, "shall not be treated as a resident of Australia except to the extent that the income is subject to Australian tax as the income of a resident, either in the hands of that person or in the hands of a partner or beneficiary, or, if that income is exempt from Australian tax, is so exempt solely because it is subject to United States tax".[15]

Similar provisions apply with respect to the term "resident of the United States".[16]

The treaty specifically covers Australian capital gains[17] and provides that:

– capital gains from the alienation of real property are generally taxed by the country of source,[18] and gains from business assets and shares in property holding companies are subject to specific rules.[19] These types of assets would constitute TAP for Australian purposes and are outside of the changes proposed in the DTDs;

– income from dividends, interest and royalties may be taxed in the country of residence of the recipient, with the source country applying a withholding tax of between 5% and 15%, depending on the percentage of shareholding (for dividends) and whether amounts arise in connection with a permanent establishment or fixed base, in the source country.[20] These types of income, while potentially deriving from non-TAP assets, are passive income streams and unrelated to the gains from non-TAP interests referred to in the DTDs; and

– gains from non-TAP assets could be characterised as "other income" for the purposes of the treaty, and, based on art 21 of the treaty, would be taxable by the country of residence, unless sourced in the other country:[21]

> "ARTICLE 21 Other Income
>
> (1) Items of income of a resident of one of the Contracting States, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.
>
> (2) The provisions of paragraph (1) shall not apply to income, other than income from real property as defined in paragraph (2) of Article 6 (Income from Real Property), derived by a resident of one of the Contracting States where that income is effectively connected with a permanent establishment or fixed base situated in the other Contracting State. In that case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.
>
> (3) Notwithstanding the provisions of paragraphs (1) and (2), items of income of a resident of one of the Contracting States not dealt with in the foregoing Articles of this Convention from sources in the other Contracting State may also be taxed in the other Contracting State."

Therefore, under art 21(3) of the treaty, as "the other Contracting State", Australia would *not* have taxing rights in respect of the income of an FRB (residing in the US) that is derived from non-TAP assets, and which is not sourced in Australia. Under the terms of the treaty, it is the US that has those rights. Consequently, this could lead to double taxation for the FRB, by being subject to tax in both countries.

Generally, where income is taxed in both countries, treaty relief may be provided by the country of residence crediting the tax paid or payable in the source country against the tax payable in the country of residence.[22] However, in this case, Australia is technically not the "source country". Further, query whether the income may be deemed to be sourced in Australia if it is not the country which is actually given the taxing rights under the treaty.[23] The only connection to Australia is via the residency (Australian), and form of (non-fixed), the trust from which the income was distributed. So the likelihood of the US providing a foreign tax credit in respect of the income attributed to the (US resident) FRB could be limited by this technicality.

An FRB taxpayer in this situation may need to resort to invoking the mutual agreement procedure in the treaty as a remediation measure, and would need to prove that the tax imposed on income attributed to them results, or would result, in taxation not in accordance with the provisions of the treaty.[24] This would require an FRB who is a resident of the US to present their case to the US Internal Revenue Service (IRS) within three years of an ATO assessment and for the IRS to then seek to come to an agreement with the ATO.[25]

How structure impacts tax

What the DTDs illustrate is that, in an international setting, holding interests in non-TAP assets either directly, or through a fixed trust, is far more tax-effective than holding such assets in an Australian resident discretionary trust.

We examine four potential ownership structures in examples 1 to 4 below:

- example 1: interests in non-TAP held through a discretionary (non-fixed) Australian resident trust;
- example 2: interest held directly by a foreign resident individual or company;
- example 3: interest held by an Australian resident fixed trust; and
- example 4: interest held through an FRT.

Interests in non-TAP assets held through Australian resident discretionary trusts

Example 1 demonstrates that, if the DTDs operate in the manner proposed by the ATO, the tax cost of holding non-TAP in an Australian discretionary trust structure would be prohibitive.

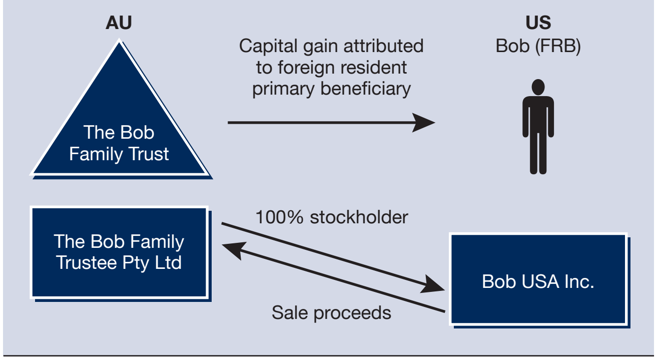
Example 1. The Bob Family Trust

An Australian resident discretionary trust (The Bob Family Trust) owns shares in a US corporation (Bob USA Inc.). Bob USA Inc. is not a "US real property holding corporation". Bob is the primary beneficiary of the trust and relocates from Australia to California, becoming a tax resident of the US and a non-resident of Australia. The Bob Family Trust remains an Australian resident trust and Bob is an FRB. The Bob Family Trust sells the stock in Bob USA Inc. (non-TAP). The gain is distributed to the Bob Family Trust and, in turn, to Bob (see Diagram 1).

In this scenario, the global effective tax rate could be as high 62.10% (if the US allows the foreign tax credit) (see Tax Matrix 1 below):

- as the sale involves the sale of shares in a US corporation that is not a US real property holding corporation, The Bob Family Trust would only be subject to CGT in Australia;
- as a consequence of the DTDs:
  - Bob would now be taxable on the gain in Australia under s 115-215(3) ITAA97, at non-resident tax rates;
  - s 855-10 ITAA97 is not applicable as the non-TAP assets are not held by Bob directly or by a company or an FRT;
  - s 855-40 ITAA97 is not applicable as the trust is not an Australian resident fixed trust; and

Diagram 1. Australian resident discretionary trust owning shares in a US company



Tax matrix 1. Sale of Bob USA Inc. → Capital gain (US) by AU non-fixed trust → Distribution to FRB (AU and US)

Tax in the US: trust		
Gain on sale of Bob USA Inc.		$100.00
Total US tax paid		–
US effective tax rate		0.00%
Tax in Australia: FRB		
Net income of the trust		$100.00
Gross-up of US tax paid		–
Gross income in Australia		$100.00
Australian CGT general discount	50%	$(50.00)
Net capital gain		$50.00
Beneficiary tax payable by trustee (s 98(3) ITAA36) (non-resident beneficiary)		
Distribution to beneficiary (net capital gain)		$50.00
Gross-up of discount capital gain		$50.00
Distribution to beneficiary		$100.00
Less: discount capital gain		–
		$100.00
Tax payable by trustee (non-resident rates)	45%	$(45.00)
Net distribution		$55.00
Total AU tax paid		$45.00
AU effective tax rate		45%
Tax in the US: FRB		
Distribution to beneficiary (net capital gain)		$100.00
Federal income tax (@ 37%)	37%	$(37.00)
California state income tax (@ 13.3%)	13.3%	$(13.30)
US federal NIIT (3.8%)	3.8%	$(3.80)
Less: AU foreign tax credit (if allowed by the US)		**$37.00**
Distribution to beneficiary		$82.90
Total US tax payable by beneficiary		$17.10
US effective tax rate		17.10%
Global effective tax		$62.10
Global effective tax rate		62.10%

 – as Bob is an FRB, the trustee would be assessed under s 98(3) ITAA36 on the attributed capital gain; and

– as a US tax resident, Bob would be liable to pay taxes in the US on his worldwide income[26] and would be assessable on the gain in the US. It is questionable whether, under the DTA, the US would grant a foreign tax credit in respect of the taxes paid in Australia (see discussion above), potentially creating a global tax rate of 99.1% (through a combined tax rate of US federal 37%, US net investment income tax (NIIT) 3.8%, California state 13.3%, and Australian 45%, disregarding exchange rate differentials). If the US did allow the Australian foreign tax credit, it would be limited to the US federal tax payable on the distribution,[27] leaving an 8% differential (between the Australian rate of 45% and the US federal rate of 37%), leaving a global effective tax rate of 62.10%.

Interests in non-TAP assets held through other structures

In contrast:

– if the shares in Bob USA Inc. were held directly by Bob and Bob USA Inc. did not hold any TAP, no tax would be payable in Australia under s 855-10 ITAA97; and

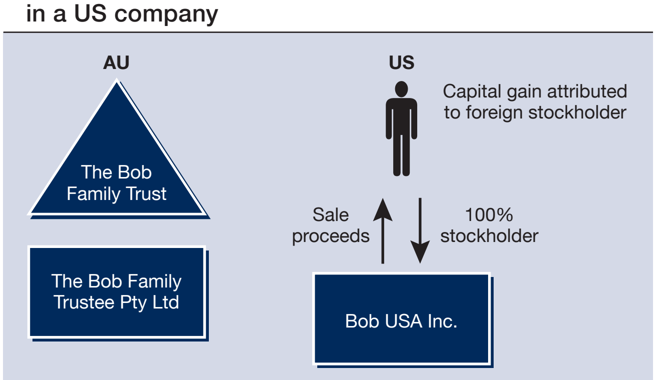
– if the shares (non-TAP assets) were held by an Australian resident fixed trust, the capital gain attributed to Bob would be exempt from tax in Australia under s 855-40 ITAA97.

In each of these scenarios, this would create a global effective tax rate of 37.10% (see examples 2 and 3, and Diagrams 2 and 3). These results create tax planning opportunities for Australian entrepreneurs who are expanding overseas, to hold their interests in a US structure either personally or through Australian resident fixed trusts.

It also means that, if an interest in non-TAP was held by an FRT, the gain would be exempt from tax in Australia under s 855-10. So, if in the above example, Bob controls a US trust and is the "grantor" of the trust for the purposes of the US grantor trust rules,[28] a gain on non-TAP assets would be attributed to him for US tax purposes and would be taxable at the rate of 37.10% (see example 4 and Diagram 4).

Example 2. Interest held through direct ownership by a foreign resident individual or company

Diagram 2. Foreign resident individual owning shares in a US company

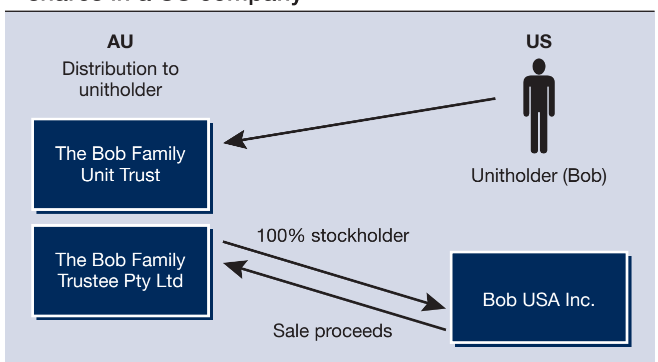


Tax matrix 2. Sale of Bob USA Inc. → Capital gain by US person (US)

Tax in the US: Bob		
Gain on sale of Bob USA Inc.		$100.00
US federal corporate tax (@ 20%)	20%	$(20.00)
US federal NIIT (3.8%)	3.8%	$(3.80)
California state CGT (@ 13.3%)	13.30%	$(13.30)
Net		$62.90
Total US tax paid		$37.10
US effective tax rate		37.10%
Tax in Australia: non-resident, non-tap asset		
Gain derived by foreign resident		–
Tax payable by beneficiary (non-resident rates)	45%	–
		–
Total AU tax paid		–
AU effective tax rate		0%
Global effective tax		$37.10
Global effective tax rate		37.10%

Example 3. Interest held by an Australian resident fixed trust

Diagram 3. Australian resident fixed trust owning shares in a US company

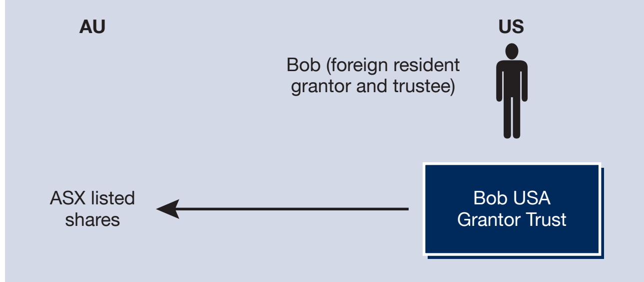


Tax matrix 3. Sale of Bob USA Inc. → Capital gain (US) by AU fixed trust → Distribution to foreign resident unitholder (AU and US)

Tax in the US: AU fixed trust		
Gain on sale of Bob USA Inc.		$100.00
Total US tax paid		–
US effective tax rate		0.00%
Tax in Australia		
Net income of the trust		$100.00
Gross-up of US tax paid		–
Gross income in Australia		$100.00
Australian CGT general discount	50%	$(50.00)
Net capital gain		$50.00
Tax payable by trustee (s 98(3) ITAA36) (non-resident beneficiary)	45%	–
Net distribution		$50.00
Unitholder		
Distribution to unitholder		$50.00
Gross-up of tax paid by trustee		–
Gross-up of discount capital gain		$50.00
Distribution to beneficiary		$100.00
Less: discount capital gain		–
Net distribution		$100.00
Tax payable by unitholder (non-resident rates)	45%	–
Less: tax paid by trustee		–
Tax payable by beneficiary (non-resident rates)		–
Total AU tax paid		–
AU effective tax rate		0%
Tax in the US: foreign resident unitholder		
Distribution to unitholder (net capital gain)		$100.00
US federal CGT (@ 20%)	20%	$(20.00)
California state income tax (@ 13.3%)	13.3%	$(13.30)
US federal NIIT (3.8%)	3.8%	$(3.80)
Less: foreign tax credit		–
Net		$62.90
Total US tax payable by foreign resident unitholder		$37.10
US effective tax rate		37.10%
Global effective tax		$37.10
Global effective tax rate		37.10%

Example 4. Interest held through an FRT

Diagram 4. Foreign resident trust owning Australian non-TAP assets



Tax matrix 4. Sale of Bob USA Inc. → Capital gain (US) by FRT → Distribution to FRB (US)

Tax in the US: US grantor trust		
Gain on sale of Bob USA Inc.		$100.00
Gain assessed to grantor		$100.00
US federal corporate tax (@ 20%)	20%	$(20.00)
US federal NIIT (3.8%)	3.8%	$(3.80)
California state CGT (@ 13.3%)	13.30%	$(13.30)
Net		$62.90
Total US tax paid		$37.10
US effective tax rate		37.10%
Tax in Australia		
Not applicable — FRBs and FRTs may disregard the capital gains and losses in relation to non-TAP CGT assets (s 855-10 ITAA97)		

Conclusion

As presently worded, the DTDs will have a significant impact on the FRBs of Australian resident non-fixed trusts, subjecting them to CGT in Australia, even on gains which do not have an Australian source. As discussed in part 1 of this article, it is difficult to reconcile the proposed operation of the DTDs with the current legislative framework within which the DTDs seek to operate. It is also difficult to reconcile them with the intent and operation of the DTAs.

The DTDs could make it compelling for Australian entrepreneurs to restructure the assets held by their Australian trusts *before* they leave Australia for the US, or to return to Australia before a significant sale or other disposal of non-TAP held in an Australian resident non-fixed trust. We may also see the use of unit trusts becoming more prevalent in such cases.

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References

1 S 855-10 ITAA97.

2 Ss 855-15 and 855-20 ITAA97.

3 S 995-1(1) ITAA97.

4 S 97(1) ITAA36.

5 At least 90% (by market value) of the underlying assets of the trust must not be TAP. Alternatively, at least 90% (by market value) of the assets held by other fixed trusts in which the first trust has a direct or indirect interest must not be TAP (s 855-40(5) to (8) ITAA97).

6 S 855-40(3) ITAA97.

7 *Convention between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, 1982, as amended by the United States Protocol (No.1) 2001.

8 The treaty substantially reflects the basis of allocating income rights in Australia's other DTAs.

9 Art 16(1) of the treaty.

10 Art 16 of the treaty.

11 Art 16(2)(g)(i) of the treaty.

12 Art 16(2)(g)(ii) of the treaty.

13 *The US Treasury Technical Explanation of the Protocol between the Government of the United States of America and the Government of Australia signed at Canberra on September 27, 2001, amending the Convention between the United States of America and Australia with respect to taxes on income signed at Sydney on August 6, 1982*. Available at www.treasury.gov/resource-center/tax-policy/treaties/Documents/teaustra.pdf.

14 Art 4(1)(a)(i) to (ii) of the treaty.

15 Art 4(1)(a)(iii) to (iv) of the treaty.

16 Art 4(1)(b) of the treaty.

17 Art 2(1)(b)(i) of the treaty.

18 Arts 6 and 13 of the treaty.

19 Art 13 of the treaty.

20 Arts 10 to 12 of the treaty.

21 Art 21 of the treaty.

22 Art 22 of the treaty.

23 Art 27 of the treaty.

24 Art 24(1)(a) of the treaty.

25 Art 24(1)(b) of the treaty.

26 S 7701(a)(30) of the US *Internal Revenue Code* (IRC).

27 S 904 IRC.

28 A "grantor trust" is taxed under ss 671 to 679 of the IRC as if it is owned in whole or in part by the "grantor", with the income of the trust being attributed to the grantor to the extent to which the grantor is considered to "own" the trust, ie if they have created the trust, or directly or indirectly made a gratuitous transfer of property to a trust, or retain power to control or direct the trust's income or assets. For a further discussion on grantor trusts see "Is your Australian trust a "grantor trust" for US tax purposes?". Available at https://asenaadvisors.com/blog/is-your-australian-trust-a-grantor-trust-for-us-tax-purposes.

Constructive ownership under the WA Duties Act

by Jared Clements, Lecturer, Law School, University of Western Australia

The constructive ownership rules have been a problematic area of the *Duties Act 2008* (WA) since it was first introduced. The rules often failed to link entities to landholders in circumstances where, conceptually, one would think an entity ought to be linked. The rules also did not always aggregate interests where landholders held a combination of direct or indirect interests in a lower entity through multiple ownership chains. While this meant that the rules would often provide taxpayers with a pleasant surprise, it became increasingly clear over the years that the technical drafting of the rules left much to be desired. The constructive ownership rules were recently amended to address these problems. This article examines the new constructive ownership rules and illustrates how they work. It also identifies the main differences between the new rules and the constructive ownership rules in other states and territories. And, perhaps most importantly, the article answers the question: have the broken links in WA's constructive ownership rules been fixed?

Introduction

One of the threshold issues when advising on landholder duty is determining whether a company is a "landholder" for the purposes of the *Duties Act 2008* (WA) (Duties Act). This necessarily involves a consideration of whether that company or any of its linked entities has an entitlement to land assets in Western Australia which meets or exceeds the $2m landholder duty threshold. The constructive ownership rules (also commonly referred to as the "linked entity rules") provide a mechanism to trace through corporate groups to determine whether a company has an indirect entitlement to land assets through any of its linked entities. If there is an indirect entitlement to land assets through a linked entity, this is then taken into account, both when determining whether the company is a "landholder" and when calculating the landholder duty on a relevant acquisition. While the focus of this article will be on how the constructive ownership rules apply to companies, it is important to note at the outset that the rules can also apply to unit trust schemes, discretionary trusts and partnerships.

The constructive ownership rules have, historically, been a problematic area of the Duties Act because they did not always capture direct or indirect entitlements to land assets arising through multiple ownership chains in complex corporate groups. The rules also often failed to link entities which, conceptually, ought to have been linked. The constructive ownership rules were recently amended by the *Revenue Laws Amendment Act 2019* (WA) to address these problems. This article considers the recent amendments, explains when an entity will be "linked" to another entity under the new rules, and provides a practical example to illustrate how the new rules work. It also identifies the main differences between WA's new rules and the constructive ownership rules in other states and territories and suggests some potential areas for reform.

Overview of the constructive ownership rules

The Duties Act imposes landholder duty on a relevant acquisition of an interest (eg ordinary shares) in an entity that is a "landholder" (s 151 of the Duties Act). Accordingly, the first step when advising on landholder duty will often be to determine whether the company which is to be acquired is a "landholder" for the purposes of the Duties Act.

Section 155(2) of the Duties Act provides that a company will be a "landholder" if, immediately before an acquisition:

- it is entitled to land assets in WA or an entity linked to the entity is so entitled; and
- the total value of all such entitlements is $2m or more.

The general effect of s 155(2) is that a linked entity's proportionate share of land assets will be included when determining whether the $2m threshold is met. In this way, the Duties Act ensures that the value of land assets held directly by a company or indirectly through its linked entities are captured.

Furthermore, s 186 of the Duties Act provides that, when calculating duty in respect of a relevant acquisition, the value of a landholder is taken to be the sum of:

- the unencumbered value of the land assets, chattels, or land assets and chattels in WA (whichever is relevant) to which the landholder is entitled; and
- the unencumbered value of the land assets, chattels, or land assets and chattels in WA (whichever is relevant) to which any linked entity in respect of the landholder is entitled.

As a consequence, a linked entity's entitlement to land assets and chattels will be taken into account when determining the duty liability on a relevant acquisition. It is therefore necessary to consider when an entity will be "linked" to a landholder for the purposes of the Duties Act.

When will entities be "linked"?

In broad terms, s 156(4) of the Duties Act provides that an entity is "linked" to another entity if:

- it has an interest of at least 90% in the other entity (in circumstances where the other entity is listed); or
- it has a "total direct or indirect interest" in the other entity of at least 50% (in all other circumstances).

Section 154A of the Duties Act sets out how to calculate the "total direct or indirect interest" that one entity (ie a higher entity) has in another entity (ie a lower entity). A higher entity will have a direct or indirect interest in a lower entity if there is one or more ownership chains between the higher entity and the lower entity (s 154A(2) of the Duties Act). For these purposes, an "ownership chain" will exist where a higher entity holds an interest (eg ordinary shares) in a lower entity (s 154A(3)(a) of the Duties Act). An ownership chain may also be comprised of two or more entities, with each entity successively holding a direct interest (eg ordinary shares) in the next (s 154A(3)(b) of the Duties Act). Furthermore, it is possible for more than one ownership chain to exist between a higher entity and a lower entity (s 154A(2) of the Duties Act) and there is no minimum percentage interest which a higher entity must hold in a lower entity for an "ownership chain" to exist (ss 153 and 154A(3) of the Duties Act).

The general effect of s 154A(5) of the Duties Act is that the percentage of the "total direct or indirect interest" that a higher entity has in a lower entity will be the aggregate of:

– any direct interest that the higher entity has in the lower entity; and
– any indirect interest that the higher entity has in the lower entity.

In broad terms, the "direct interest" that a higher entity has in a lower entity will be the percentage interest that the higher entity has in the lower entity (s 154A(3)(a) and (4)(a) of the Duties Act).

It will be necessary to determine the "indirect interest" that a higher entity has in a lower entity where there are one or more entities interposed between the higher entity and lower entity in an ownership chain (s 154A(3)(b) and (4)(b) of the Duties Act). The "indirect interest" that a higher entity has in a lower entity is calculated by multiplying the percentage of the higher entity's direct interest in the entity immediately below it by the percentage of the direct interest that each consecutive entity in the ownership chain has in the entity immediately below (s 154A(4)(b) of the Duties Act).

The existence of a linkage chain provides another basis for linking two entities for the purposes of the landholder duty rules. In this regard, s 156(2) of the Duties Act provides that each entity below the main entity (ie the entity in which an interest is acquired) in a "linkage chain" that exists immediately before an acquisition will be linked to the main entity. A "linkage chain" will exist if a series of entities, starting with the main entity, is successively "linked" to one another (s 156(3) of the Duties Act). In broad terms, a main entity's indirect interest in an entity linked to it through a linkage chain is determined by multiplying the percentage interest that each consecutive entity holds in the entity immediately below (s 154A(4)(b) of the Duties Act). It is significant to note that the main entity will still be linked to a lower entity through a linkage chain even if its total direct or indirect interest in that lower entity is less than 50%.

Finally, for the sake of completeness, it is worthwhile noting that s 156A of the Duties Act may also apply to link certain entities in circumstances where a transaction involves the acquisition of interests in multiple entities which arise from what is substantially one arrangement, and the acquired entities together have a total direct or indirect interest of at least 50% in a landholder entity.

> *"The constructive ownership rules have, historically, been a problematic area of the Duties Act."*

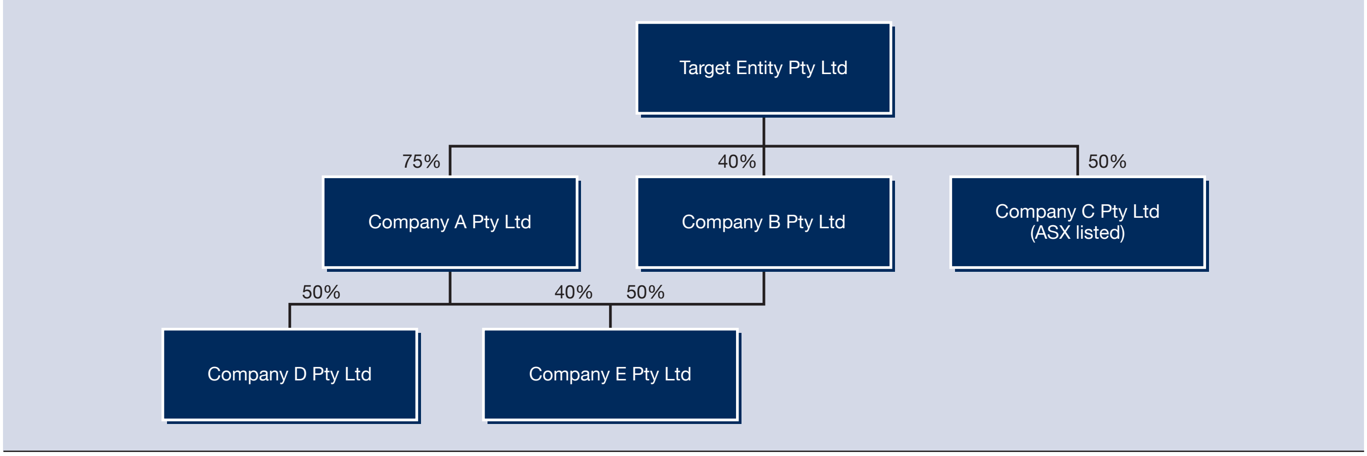
Applying the new constructive ownership rules: a practical example

The easiest way to explain how the new linking rules work is through a practical example. Diagram 1 summarises the corporate group structure for Target Entity and its subsidiaries.

The corporate group is structured as follows:

– Target Entity holds:
  – 75% of the ordinary shares in Company A;

Diagram 1. Corporate group structure for Target Entity and its subsidiaries



  - 40% of the ordinary shares in Company B; and
  - 50% of the ordinary shares in Company C;
- Company A holds:
  - 50% of the ordinary shares in Company D; and
  - 40% of the ordinary shares in Company E;
- Company B holds 50% of the ordinary shares in Company E;
- Target Entity, Company A, Company B, Company D and Company E are unlisted companies. Company C is listed on the Australian Stock Exchange; and
- it is assumed that each of the companies in the corporate group has an entitlement to land assets in WA.

If there was a relevant acquisition of an interest in Target Entity, it would be necessary to consider whether Target Entity was "linked" to any of the other entities in the corporate group immediately before the acquisition. If Target Entity was "linked" to another entity:

- the linked entity's entitlement to land assets would be included when determining whether Target Entity is a "landholder" under s 155(2) of the Duties Act; and
- the linked entity's entitlement to land assets and chattels would be taken into account when calculating the duty on the relevant acquisition under s 186(2) of the Duties Act.

It is therefore necessary to examine whether Target Entity is "linked" to any of the other entities in the corporate group.

Target Entity is linked to Company A

Target Entity has a direct interest of 75% in Company A. As this interest is more than 50%, Target Entity is "linked" to Company A under s 156(4) of the Duties Act.

Target Entity is not linked to Company B

Target Entity has a direct interest of 40% in Company B. As this interest is less than 50%, Target Entity is not "linked" to Company B under s 156(4) of the Duties Act.

Target Entity is not linked to Company C

Target Entity has a direct interest of 50% in Company C. However, as Company C is a listed entity, Target Entity must hold at least a 90% interest in Company C to be linked under s 156(4) of the Duties Act. As Target Entity holds less than a 90% interest in Company C, it is not "linked" to Company C.

Target Entity is linked to Company D

Target Entity does not hold any direct interest in Company D. However, a linkage chain exists between Target Entity, Company A and Company D because each of these entities are successively linked to one another under s 156(3) of the Duties Act. In this regard:

- Target Entity is directly linked to Company A (as Target Entity has a 75% direct interest in Company A); and
- Company A is directly linked to Company D (as Company A has a 50% direct interest in Company D).

In these circumstances, s 156(2) of the Duties Act provides that each entity below the main entity in a linkage chain that exists immediately before an acquisition will be linked to the main entity. As a consequence, Target Entity (as the main entity in the linkage chain) is "linked" to Company D.

To determine Target Entity's indirect interest in Company D, it is necessary to examine the ownership chain that exists between Target Entity and Company D. In the present circumstances, the ownership chain consists of Target Entity, Company A and Company D (ie in this example, the linkage chain and the ownership chain involve the same entities).

The general effect of s 154A(4)(b) of the Duties Act is that Target Entity's indirect interest in Company D is determined by multiplying the percentage interest that each consecutive entity holds in the next entity in the ownership chain. Accordingly, Target Entity's indirect interest in Company D is 37.5% (being the 75% direct interest that Target Entity has in Company A multiplied by the 50% direct interest that Company A has in Company D). It is important to note that, even though Target Entity only holds a 37.5% total direct or indirect interest in Company D, these two entities are still linked under the linking rules due to the existence of the linkage chain.

Target Entity is linked to Company E

Target Entity does not hold any direct interest in Company E. Furthermore, no linkage chain exists between Target Entity and Company E because:

- Target Entity is not linked to Company B (as Target Entity only has a 40% direct interest in Company B); and
- while Target Entity is linked to Company A (as Target Entity has a 75% direct interest in Company A), Company A is not successively linked to Company E (as Company A only has a 40% direct interest in Company E).

However, in the absence of a linkage chain, Target Entity will still be "linked" to Company E under s 156(4) of the Duties Act if it has a total direct or indirect interest of at least 50% in Company E. To determine the total direct or indirect interest that Target Entity has in Company E, it is necessary to examine the ownership chains that exist between Target Entity and Company E. In the present circumstances, two ownership chains can be identified:

- the Target Entity, Company A and Company E ownership chain; and
- the Target Entity, Company B and Company E ownership chain.

The fact that Target Entity only has a 40% direct interest in Company B or that Company A only has a 40% direct interest in Company E does not break the ownership chain (prior to the amendments, this would have broken the ownership chain).

The general effect of s 154A(4)(b) of the Duties Act is that Target Entity's indirect interest in Company E is determined by multiplying the percentage interest that each consecutive entity holds in the next entity in the ownership chain. Therefore, Target Entity has an indirect interest of:

- 30% in Company E by virtue of the Target Entity, Company A and Company E ownership chain (being the 75% direct interest that Target Entity has in Company A multiplied by the 40% direct interest that Company A has in Company E); and
- 20% in Company E by virtue of the Target Entity, Company B and Company E ownership chain (being the

40% direct interest that Target Entity has in Company B multiplied by the 50% direct interest that Company B has in Company E).

As a consequence, Target Entity has a total direct or indirect interest of 50% in Company E (being the aggregate of the 30% and 20% indirect interests that it has in Company E by virtue of the two ownership chains). As Target Entity has a total direct or indirect interest of at least 50% in Company E, Target Entity is "linked" to Company E under s 156(4) of the Duties Act.

The above analysis is summarised in Table 1.

Differences between WA's constructive ownership rules and other states and territories

All Australian states and territories have some form of constructive ownership rules. In a general sense, the intention of these rules is to ensure that indirect entitlements to land (and goods/chattels in New South Wales, Tasmania and WA) arising through subsidiaries are captured for landholder duty purposes. However, while each of the jurisdictions may have a similar policy intention, there is no uniformity in the technical drafting of the rules between jurisdictions or in the tests which they apply to determine whether or not a company is linked to a landholder entity. Table 2 outlines

Table 1. Summary of how WA's constructive ownership rules apply to the Target Entity corporate group

	Target Entity's direct interest	Target Entity's indirect interest	Target Entity's total direct or indirect interest	Is entity "linked" to Target Entity?
Company A	75%	Nil	75%	Yes
Company B	40%	Nil	40%	No
Company C	50%	Nil	50%	No
Company D	Nil	37.5%	37.5%	Yes
Company E	Nil	50%	50%	Yes

Table 2. Main differences between WA's constructive ownership rules and other states and territories

Jurisdiction	Constructive ownership rules?	Legislative reference	Main differences
ACT	Yes	Ss 81 and 82 of the *Duties Act 1999* (ACT)	– Significantly different technical drafting – A linked entity cannot be an individual, a public unit trust or a listed company – Rules may not always link an entity to a landholder or aggregate interests where there is a combination of direct or indirect interests involving multiple ownership chains
NSW	Yes	Ss 158A, 158 and 159 of the *Duties Act 1997* (NSW)	– Significantly different technical drafting – A linked entity of a private company cannot be a public unit trust or listed company
NT	Yes	Ss 56NA and 56NB of the *Stamp Duty Act 1978* (NT)	– Significantly different technical drafting – Lower linking threshold of 20% which applies to both listed and unlisted entities
Qld	Yes	Ss 166, 167 and 182 of the *Duties Act 2001* (Qld)	– Significantly different technical drafting – Relies on a subsidiary test under the Corporations Act 2001 (Cth) to link entities (this means in many instances that the linking threshold will be > 50%)
SA	Yes	Ss 91 to 96 and 102 of the *Stamp Duties Act 1923* (SA)	– Significantly different technical drafting – Rules may not always link an entity to a landholder where there is a combination of direct or indirect interests involving multiple ownership chains
Tas	Yes	Ss 76 and 77 of the *Duties Act 2001* (Tas)	– Significantly different technical drafting – A linked entity cannot be an individual, a public unit trust or a listed company – Rules may not always link an entity to a landholder where there is a combination of direct or indirect interests involving multiple ownership chains
Vic	Yes	Ss 75 and 76 of the *Duties Act 2000* (Vic)	– Significantly different technical drafting – Lower linking threshold of 20% which applies to both listed and unlisted entities

the main differences between WA's constructive ownership rules and the constructive ownership rules in other states and territories.

While there may be no uniformity in the technical drafting between the jurisdictions, the constructive ownership rules in the Australian Capital Territory, South Australia and Tasmania suffer from some of the same deficiencies as WA's old constructive ownership rules. In this regard, the constructive ownership rules in these jurisdictions may not always link an entity to a landholder where there is a combination of direct or indirect interests involving multiple ownership chains, and therefore the rules may not capture some indirect entitlements to land. In contrast, the constructive ownership rules in NSW, the Northern Territory, Queensland and Victoria should generally capture these entitlements (even though there are quite substantial differences in both the technical drafting of the rules and the tests for determining when entities will be linked). Nevertheless, the lack of uniformity between states and territories makes it necessary to closely examine the specific rules of each jurisdiction, particularly when advising on multijurisdictional landholder duty transactions involving complex corporate groups. Unfortunately, this lack of uniformity also means that the technical discussion of WA's constructive ownership rules in this article may not readily translate to the rules in other jurisdictions.

Conclusion

The Duties Act requires a linked entity's entitlement to land assets to be included when determining whether a company is a landholder for duty purposes. Furthermore, a linked entity's entitlement to land assets and chattels is also taken into account when calculating the duty liability on a relevant acquisition. When the Duties Act was first introduced, the constructive ownership rules did not always capture direct or indirect entitlements to land assets or chattels arising through multiple ownership chains in complex corporate groups. The new constructive ownership rules in WA address this problem and ensure that these entitlements are now captured.

While all states and territories have some form of constructive ownership rules, both the technical drafting of those rules and the tests for determining when entities will be linked differ quite significantly between jurisdictions. This lack of uniformity means that it is necessary to closely examine the specific rules in each jurisdiction, particularly when advising on multijurisdictional landholder duty transactions involving complex corporate groups. While the broken links in WA's constructive ownership rules may have been fixed, it remains to be seen whether other jurisdictions, such as the ACT, SA and Tasmania, will amend their rules to ensure that indirect entitlements to land arising through multiple ownership chains in complex corporate groups are appropriately captured. The WA experience, in this respect, may provide some useful insight on these issues and the approaches which may be taken to address them.

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SMSF succession: minimising risk

Many SMSF trustees/members and advisers are proactively re-examining their succession planning arrangements in view of the COVID-19 pandemic.

In recent months, we have seen a significant increase in succession planning queries and assignments where we have been asked to provide advice and/or documents, including binding death benefit nominations (BDBNs), reversionary pensions, planning for control of a self-managed superannuation fund (SMSF), and implementing timely member exit strategies for those who may be left with a limited time to live.

Indeed, it is not surprising that many SMSF trustees/members and advisers are proactively re-examining their succession planning arrangements in view of the current coronavirus (COVID-19) pandemic.

This article examines some of the key considerations that should be borne in mind when formulating and implementing a successful SMSF succession plan.

What is succession planning?

Succession planning is a critically important aspect of effectively operating an SMSF, although it is often overlooked. Every SMSF member should develop a personal succession plan to ensure that control of their fund passes smoothly and in a manner that fits in with their other estate and succession planning arrangements. Indeed, in times of uncertainty and heightened risk of illness, this is even more critical than ever.

Broadly, SMSF succession planning aims to accomplish the following outcomes:

- that the right people receive the intended proportion of the SMSF money and assets; and
- that the right people gain control of the SMSF to ensure that superannuation benefits are paid as intended.

An optimal SMSF succession plan should achieve these goals in a timely and legally effective manner, with minimal uncertainty and in as tax-efficient manner as possible. However, it should also be recognised that trade-offs may need to be considered, as it would usually be considered preferable that the "right" people receive a benefit and pay tax, rather than the "wrong" people receive a benefit in a tax-efficient manner.

Accordingly, there is no easy "one-size-fits-all" solution for SMSF succession. However, a well thought out SMSF succession plan should:

- determine the person(s) or corporate entity that will occupy the office of trustee on loss of capacity or death of a member;
- in relation to a corporate trustee, determine who the directors of the SMSF trustee company will be (ie who will have control of the company) on loss of capacity or death of directors/members;
- ensure that the SMSF can continue to meet the definition of an SMSF under s 17A of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA);
- determine what each member's wishes are for their superannuation benefits;
- determine to what extent each member's wishes should be "nailed down" through the use of an automatically reversionary pension and/or a BDBN; and
- determine the tax profile of anticipated benefits payments.

Many people have no succession plans in place for their SMSF, which may result in considerable uncertainty arising in the future with respect to the control of the fund and the fate of their member benefits.

Succession on loss of capacity: the role of an EPoA

With the passage of time, there is a significant risk that some SMSF members may lose the capacity to administer their own affairs. In the absence of prior planning, this could result in major uncertainty and risk arising in relation to the control of the SMSF. Having an enduring power of attorney (EPoA) in place can help overcome this problem, as an EPoA appointment is "enduring", enabling a trusted person (ie the member's attorney under an EPoA) to continue to run the SMSF as their legal personal representative (LPR) in the event of loss of capacity.

It is strongly recommended that every SMSF member implement an EPoA as a part of their personal SMSF succession plan. It would not be an exaggeration to say that being an SMSF member without having an EPoA is a significant risk exposure.

Naturally, given the important responsibilities placed on an attorney, a member must trust their attorney to do the right thing by them. Only a trusted person should be nominated, and insofar as the member retains capacity, the EPoA should be subject to ongoing review to ensure its ongoing appropriateness.

Consideration should also be given as to whether the scope of the appointment should be general in nature (ie a general financial power) or limited to the SMSF or to the SMSF trustee. For example, if the member wishes to preclude their attorney from exercising certain rights in relation to, say, their member entitlements or making or revoking their BDBN, this should be expressly provided for as a limitation to the EPoA.

It should be noted that an EPoA is not a mechanism by which an attorney can step into the role of an SMSF trustee or a director of an SMSF corporate trustee. An EPoA merely permits the member's attorney to occupy the office of trustee or director of the corporate trustee to help ensure that the SMSF can continue to operate in a fashion consistent with the member's wishes. This is because a member's attorney appointed under an EPoA is expressly recognised in s 17A SISA for the purposes of the trustee–member rules. However, the attorney must still be appointed in the first place. The appointment mechanism which facilitates the LPR to step into the role of SMSF trustee or director of the corporate trustee is contained in the SMSF deed and the company's constitution. For example, in the context of a corporate trustee, in the absence of other appointment provisions in the constitution, generally a majority of the company's shareholders must exercise their voting rights to appoint a director.

Succession on death: the role of the executor as LPR

The death of a member is another situation where succession to the control of an SMSF should be carefully considered.

Section 17A(3) SISA provides an exception to the trustee–member rules where a member has died. The exception in s 17A(3) provides that a fund does not fail to satisfy the basic conditions of the trustee–member rules by reason only that:

> "(a) a member of the fund has died and the legal personal representative of the member is a trustee of the fund or a director of a body corporate that is the trustee of the fund, in place of the member, during the period:
>
> (i) beginning when the member of the fund died; and
>
> (ii) ending when death benefits commence to be payable in respect of the member of the fund;"

This exception permits an LPR of a deceased member (eg an executor of a deceased person's estate) to be an individual trustee or a director of a corporate trustee in place of a deceased member until the member's death benefits commence to be payable. However, it is important to understand that this provision does not require or create this state of affairs. For example, for s 17A(3) to apply, an LPR must be appointed as either:

- a director of the corporate trustee of the fund pursuant to the constitution of the company; or
- an individual trustee of the fund pursuant to the governing rules of the fund.

The operation of the provision in this way has been confirmed in numerous cases, particularly in *Ioppolo & Hesford v Conti*,[1] *Ioppolo v Conti*,[2] and implicitly in *Wooster v Morris*.[3]

In *Ioppolo & Hesford v Conti*, Master Sanderson described the operation of s 17A(3) as follows:[4]

> "The mechanism of the section is tolerably clear. Section 17A(3) allows for the appointment of an executor as a trustee of the fund but *does not in its terms require such an appointment*. Section 17A(4) provides a period of grace — that is to say it allows a fund six months to organise its affairs so it can remain a SMSF. So in the case of a fund which has two members and which would qualify under s 17A(1), on the death of one of the members it remains a SMSF for six months. If the remaining member has not taken some steps during that period to bring the fund within the terms of s 17A(2) then it will cease to be a SMSF." (emphasis added)

These cases underscore the fact that a deceased person's LPR (ie their executor) does not automatically step into the role of an SMSF trustee or director on a member's death. Broadly, it depends on the provisions of the SMSF deed (most SMSF deeds do not have a mechanism for this to occur) and whether there are other appropriate legal documents in place to make sure that this occurs.

Successor directors

By ensuring that the company constitution of the SMSF trustee contains successor director provisions, it is possible to plan for succession to the role of a director in advance.

Making a successor director nomination allows a director to nominate a person to automatically step into the shoes of the principal's directorship role immediately on loss of capacity, death or a specified event occurring.

The successor director strategy is designed to work in conjunction with a member's overall estate and succession plan to enable an attorney appointed under an EPoA, or an executor of a deceased member's will, to be automatically appointed as a director without any further steps involved.

Naturally, a successor director strategy relies on the right paperwork being in place, including the right constitution and related successor director nomination forms.

Tax considerations on death

The tax profile of death benefits is also a relevant consideration in succession planning.

Where a death benefit lump sum is paid to a tax dependant (ie a death benefits dependant under s 302-195 of *Income Tax Assessment Act 1997* (Cth) (ITAA97)), the dependant will receive the benefit tax-free (ie as non-assessable non-exempt income). A dependant for tax purposes means any of the following (s 302-195 ITAA97):

- the deceased person's spouse or former spouse;
- the deceased person's child, aged less than 18 at the time of death;
- any person with whom the person has an interdependency relationship; or
- any other person who was a dependant of the deceased person just before they died (note that this limb of the definition imports the common law meaning of dependant, which is accepted to include financial dependency).

Accordingly, adult independent children do not generally qualify as a death benefits dependant. Thus, any death benefit payment that they receive (usually when there is no surviving spouse) will be subject to a tax rate of 15% plus applicable levies to the extent that the benefit comprises the taxable component.

When you consider that the average SMSF holds over $1.27m in assets, the tax exposure of death benefit payments made to adult independent children by an SMSF is likely to be significant.

Planning an exit strategy in light of the "death tax"

Given the impact of the effective "death tax" where the likely recipient(s) of the death benefits will not be tax dependants, one tax-effective option is for the member to withdraw the bulk of their superannuation benefits during their lifetime (ie assuming that the member is over age 60 and a relevant condition of release has been met).

Naturally, this is an option that should not be contemplated lightly as the member's entitlements will leave the superannuation environment and there are likely to be very limited opportunities for the member to make further contributions into superannuation.

Additionally, it should be borne in mind that such a withdrawal will mean that the relevant money and/or assets will be exposed to the normal tax environment outside of superannuation and it is possible that the member may go on to live a healthy life for many years after the withdrawal. However, if the option is being seriously contemplated, SMSF trustees/members and advisers will need to carefully consider how to best achieve the intended outcome in relation to implementing the withdrawal by paying:

- ordinary pension payments for any pensions that may be in place; and/or
- lump sum payments for the member's accumulation entitlements and amounts arising on commutation of a pension.

While superannuation benefits can be withdrawn by drawing down on a pension account (ie assuming the pension is an account-based pension with no payment restrictions in place), pension payments can only be paid in cash. Thus, generally this approach will require additional time to realise fund assets, and this can be problematic in an economic downturn and where the fund has illiquid investments.

Additionally, pension payments will not address any accumulation account balance that the member has in the fund. (For completeness, it should also be noted that this will have negative transfer balance cap consequences in relation to there being no debit available to a member's transfer balance account for withdrawals by pension payment, eg if the member wished to preserve their ability to commence retirement phase pensions in the future.)

Thus, to speed up the withdrawal process, an SMSF member looking for a timely exit strategy may wish to arrange for fund assets to be transferred out of the fund, ie by way of a lump sum payment.

Lump sum payments in specie

In view of the above, transferring legal title to relevant fund assets from the SMSF trustee to the member (ie as part of a lump sum payment in kind) is generally considered the most conventional way to achieve a speedy withdrawal of non-cash assets from an SMSF. However, the process of transferring legal title can still take days, weeks or even longer in certain cases, especially if the assets include:

- real estate;
- assets that cannot be readily realised or transferred for various reasons; or
- securities (eg shares or units) where disposal of the securities may be subject to specific requirements or formalities in the applicable constitution or governing rules of the trust or company.

What if time is of the essence?

As noted above, there needs to be ample time to arrange for an effective transfer of legal title especially as you "never know the hour, nor the minute".

If the member dies and the relevant assets remain with the SMSF trustee, the mere existence of a request to cash the relevant fund assets as a lump sum will generally not be accepted by the ATO as a proper basis for treating the benefits as having been paid to the member (ie for legal, tax and accounting purposes).

As there is some complexity and risk associated with this process and in implementing the requisite documents, SMSF trustees/members and advisers who are interested in this exit planning option should contact a lawyer with expertise in SMSF succession to discuss the steps and documents that are most appropriate to the particular circumstances.

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References

1 [2013] WASC 389.
2 [2015] WASCA 45.
3 [2013] VSC 594.
4 [2013] WASC 389 at [20].

Successful Succession

by Tim Donlan, ATI, Nexus Law Group,
and Katerina Peiros, ATI, Hartwell Legal

Foreign person: potential discretionary trust beneficiary

Increased rates of stamp duty and land tax for "foreign" persons in recent years has given purchasers and landowners, particularly trustees, cause to revisit the potential beneficiaries of a trust.

Increasingly, Australians have a greater level of overseas connection or involvement. This may be due to: a higher level of overseas residence for working purposes; ownership of overseas assets for taxation or asset protection purposes; managing inheritance or estate taxes; or, in some cases, avoiding forced heirship. Statistics from the Australian Bureau of Statistics 2016 census also indicated that 28% of Australia's population were born overseas and a further 21% of Australians had one or more parents born overseas.

Whether due to global mobility or other reasons, it is common for families to have some sort of overseas or foreign connection. Residence and location of assets are, of course, relevant for a variety of reasons, including for taxation purposes. This article considers the effect of state and territory legislation regarding foreign individuals, companies or trusts, and their increased liability for stamp duty and land tax in various jurisdictions. General principles in relation to residence for taxation purposes are outside the scope of this article, as are the various criteria as to what constitutes residential property or interests in it.

Commencing from as early as 1 July 2015 in some states, and now applying in all states, foreign individuals, trusts and companies directly or indirectly holding or acquiring an interest in Australian residential or agricultural real estate are subject to higher rates of stamp duty (surcharge), and in some states, as well as in the Australian Capital Territory, higher rates of land tax.[1] There were various phasing or staged introductions as to when the increased surcharge rates apply and as to how the surcharges themselves would increase.[2]

The revenue-driven rationale behind these amendments requires no explanation and is hardly surprising. What may require more careful examination, and may seem somewhat counter-intuitive, are the legislative provisions and various definitions as to exactly who or what qualifies as a "foreign" individual, trust or company.

Definitions

Foreign purchaser

Each state's and the ACT legislation provides slightly different definitions. For example, in Victoria, the relevant legislative provisions state that:

- a foreign purchaser is a foreign natural person, a foreign corporation or a trustee of a foreign trust;[3] and
- a foreign natural person is a person who is not a citizen or permanent resident of Australia, the holder of a permanent visa, or a New Zealand citizen with a special category visa.[3]

Foreign trust

In Victoria, a foreign trust is a trust in which a foreign natural person, a foreign corporation or a trustee of another foreign trust has a substantial interest in the trust estate of that trust.[3]

A foreign natural person, a foreign corporation or the trustee of a foreign trust will be considered as having a substantial interest in a trust when that person or entity, either alone or together with an associate, has a beneficial interest of more than 50% of the capital of the trust or, for example, in Victoria, in the Commissioner's opinion has the capacity to determine or influence the outcome of the decisions about the administration and conduct of the trust.

Broadly a discretionary trust with a wide pool of beneficiaries who can receive capital distributions will be a foreign trust if any one of the eligible beneficiaries is a foreign individual.[4] In Victoria, a person or a member of a class of persons is treated as having a beneficial interest in the maximum percentage of the capital of the trust that the trustee is empowered to distribute to them. Similar provisions exist in other states.[2]

In South Australia, a discretionary trust will be a foreign trust where one or more of the following is a foreign person:[5]

- a trustee;
- a person who has the power to appoint under the trust;
- an identified object under the trust; or
- a person who takes capital of the trust property in default.

Foreign company

A company will be considered a foreign person if an individual not ordinarily resident in Australia, a foreign corporation, or a foreign government holds a substantial interest in the corporation.[4]

The various state and territory Acts and Regulations need to be considered as to how "foreign" ownership will impact on taxation liabilities for the individual, trust or company.

The tax consequences

Stamp duty

A foreign person, trust and company all pay stamp duty on new purchases (or other dutiable transfers) of residential real estate and land tax on existing holdings of residential real estate at surcharge rates. In Tasmania, this also applies to primary production land.

The additional rate of stamp duty on residential land is 7% in Queensland, South Australia, Western Australia and Tasmania, and 8% in New South Wales and Victoria. Tasmania charges an additional 1.5% on primary production land.

Land tax

For land tax for real estate owned by foreign persons, trusts and companies, the surcharge applies in Victoria, the ACT, Queensland and NSW. The other states have not yet enacted legislation.

In Victoria[6] and NSW,[7] the surcharge for 2020 is 2%. Various changes to land tax in South Australia and how they relate to trusts generally from 1 July 2020 are beyond the scope of this article.

Practical problem

Whether a natural person is a foreign resident is generally relatively easy to determine and the relevant tax consequences will follow accordingly, given that little may be able to be done to change either a person's residence or land ownership.

Similarly, with a company or fixed or unit trust, the register of shareholders, unitholders or interest holders will disclose the identity of each key participant and their residency can be determined on the facts or by seeking a private ruling.

The largest impact or potential impact of the foreign landowner legislation regime seemingly relates to discretionary trusts. A discretionary trust may find itself re-classified as foreign if there is a beneficiary who falls within the definition of beneficiary who is not ordinarily resident in Australia, for example, those distant cousins who live overseas often having never received a distribution of either income or capital from the trust.

Example

The deed of the Fringe Family Trust (which is a discretionary trust) names Frank (who is a foreign resident) as an identified object of the trust. The trust intends to purchase residential property in South Australia. As Frank is a foreign resident, the trust is liable for the surcharge.

In South Australia, had Frank not been an identified object of the trust, it would not have been a foreign trust. The outcome in other states would seemingly be different.

The revenue authorities in each state also require the landowner to notify the authority as to whether a party or landowner falls within the relevant definition of a foreign person. In South Australia, for example, the surcharge fee can be self-assessed and paid online. If an instrument giving effect to a transaction is to be lodged for an opinion on duty, the surcharge payable will be assessed at the same time and the surcharge is to be paid when the applicable duty on the instrument is paid.

Failure to self-report meets with serious consequences. For example, in Victoria, failure to notify the relevant authority results in an imposition of penalty tax on the surcharge amount of between 5% (for voluntary disclosure before an investigation starts), 20% (for voluntary disclosure after investigation starts) and 90% (if the authority believes that there was intentional disregard of the law or hindrance of investigation).

All in all, the financial consequences can be quite dire.

Possible solutions

In order to ensure that discretionary trusts are not caught unaware, the general solution may be to exclude any beneficiaries who may cause the trust to be reclassified as "foreign" for either stamp duty or land tax purposes.

It is recommended that that those trust deeds which can be amended be amended to exclude such persons. Subject to the specific terms of the trust deeds, including the amending powers, such amendments should not constitute a resettlement of the trust.

It should be noted, however, that in some jurisdictions, for example, South Australia, a variation to a trust involving the addition or removal of beneficiaries may in itself be deemed as constituting a resettlement of the trust, with subsequent consequences.[8] Any changes to the beneficiaries of trusts that own dutiable property should only be made after careful consideration and, if possible, an opinion is obtained from the relevant authority as to the consequences of doing so.

Possible wording when amending a discretionary trust deed to remove the possibility of the trust including a foreign beneficiary might be along the lines of:

> "Any beneficiary who or which falls within the meaning of 'foreign person [or the definition under the relevant legislation]' as defined in [insert relevant legislation] is excluded as a beneficiary of this trust."

Such amendments would need to be made prior to any purchase taking place in order to avoid the stamp duty surcharge and preferably as early as possible in the land tax year to avoid the imposition of surcharge land tax. These types of amendments will be necessary for an increasing number of Australian families.

Importantly, the surcharges do not affect:

- self-managed superannuation funds whose members may be non-resident, provided the trustees or the directors of a corporate trustee are Australian citizens; or
- transfers of dutiable property to non-resident persons pursuant to statutory exemptions relating to death (ie transfers pursuant to wills and codicils, and on intestacy).[9]

There are certain exemptions from the surcharges that might apply in the various states and the ACT. For example, in Victoria, a foreign purchaser may be entitled to an exemption for the purchase of residential property that is intended to comprise the principle place of joint residence if it is purchased with a spouse who is not a foreign person.

In addition to exemptions, certain refunds for surcharge duty paid might apply in various jurisdictions in circumstances where a relevant foreign person ceases to be a foreign person within certain time frames.[10] Conversely, while it may not apply at the time of purchase of land, the surcharge may become payable in circumstances where a residential landowner becomes a foreign person within three years of the acquisition of the interest in the land. In those circumstances, the surcharge will apply, and the onus is on the owner to notify the Commissioner in writing of the change of status.[11]

Practitioners need to familiarise themselves with the relevant legislation and consider how it affects their clients on a case-by-case basis.

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References

1 All states, as well as the ACT, have introduced legislation to take effect from different dates, for example, in South Australia, the surcharge applies to instruments executed or taken to have been executed after 1 July 2018. See, for example: *Duties Act 2001* (Qld); *Duties Act 1997* (NSW); *Duties Act 2000* (Vic); *Stamp Duties Act 1923* (SA); *Duties Act 2008* (WA); and *Duties Act 2001* (Tas). At the time of writing, no foreign duty or land tax surcharges have been legislated in the Northern Territory; see also: *Land Tax Act 1956* (NSW); *Land Tax Act 2010* (Qld); and *Land Tax Act 2005* (Vic).

2 For example, in Victoria, the applicable additional duty rate increased from 3% between 1 July 2015 and 1 July 2016 to its current rate of 8% from 1 July 2019.

3 S 3(1) of the *Duties Act 2000* (Vic).

4 Australian Government, Foreign Investment Review Board, *Residential real estate – Australian corporations, trusts, and use of other persons* (guidance note 5), 1 July 2017.

5 S 2(14)(b)(ii) of the *Stamp Duties Act 1923* (SA).

6 State Revenue Office Victoria*, Absentee owner surcharge*. Available at www.sro.vic.gov.au/absentee-owner-surcharge.

7 Revenue NSW, *Surcharge land tax*. Available at www.revenue.nsw.gov.au/taxes-duties-levies-royalties/land-tax/surcharge-land-tax

8 S 71(8) of the *Stamp Duties Act 1923* (SA). Revenue SA may treat the removal of a beneficiary as a change in beneficial ownership.

9 See, for example: s 42 of the *Duties Act 2000* (Vic); and s 71(5)(h) of the *Stamp Duties Act 1923* (SA).

10 See, for example, s 72(6) of the *Stamp Duties Act 1923* (SA).

11 See, for example, s 72(7) of the *Stamp Duties Act* 1923 (SA).

Events Calendar

May/June 2020

EVENT	DATE	CPD
Online		
Taxing Times: Part 1 — Tax and employment issues associated with COVID-19 terminations	12/5/2020	1.5
Superannuation Series — Part 5: Related party dealings — should you be worried?	13/5/2020	1
2020 Young Tax Professionals Online Series — Part 1: Revenue / Capital Distinction	18/5/2020	1.5
Payroll Tax Webinar Series	19/5/2020	3
Payroll Tax Webinars — Part 1	19/5/2020	1.5
Aon Webinar Series – Part 1: Cyber risks for tax advisers in the new digital world	20/5/2020	0.75
Superannuation Series — Part 6: Pensions workshop	20/5/2020	1.5
2020 Breakfast Club Series: Tax beyond COVID-19	22/5/2020	1.5
Barossa Online — SME Tax Technical: Part 1 webinar and live Q&A	25/5/2020	4
Barossa Online — SME Tax Technical: Decoding trust income | Session 1 webinar	25/5/2020	1
Barossa Online — SME Tax Technical: The increasing use and threat of s 100A | Session 2 webinar	25/5/2020	1
Barossa Online — SME Tax Technical: COVID-19 stimulus — accessing the tax benefits | Session 3 webinar	25/5/2020	1.5
Payroll Tax Webinars — Part 2	26/5/2020	1.5
Superannuation Series — Part 7: An update from the regulator on practical issues within SMSF & audit and record-keeping	27/5/2020	1.5
2020 Death … and Taxes Online — Part 1: Take on executor roles at your peril!	28/5/2020	1
Barossa Online — SME Tax Technical: Part 2 webinar and live Q&A	1/6/2020	3.25
Barossa Online — SME Tax Technical: Employee obligations — is anyone getting it right? | Session 4 webinar	1/6/2020	1
Barossa Online — SME Tax Technical: Corporatising the SME group | Session 5 webinar	1/6/2020	1
Barossa Online — SME Tax Technical: State taxes — change is now! | Session 6 webinar	1/6/2020	0.75
Superannuation Series — Part 8: Estate planning	3/6/2020	1
Death … and Taxes Online — Part 2: Post death main residence CGT traps	4/6/2020	1

For information on upcoming events, visit **taxinstitute.com.au/cpd**.

Cumulative Index

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The Tax Institute would like to thank the following presenters from our April CPD sessions. All of our presenters are volunteers, and we recognise the time that they have taken to prepare for the paper and/or presentation, and greatly appreciate their contribution to educating tax professionals around Australia.

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