THE JOURNAL FOR MEMBERS OF THE TAX INSTITUTE

Taxation in Australia

VOL 54(11) JUN 2020

Origin: an electric shock

Enzo Coia, CTA

Icing, spreads and tax avoidance purposes

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THE TAX INSTITUTE

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Invitation to write

We welcome original contributions that are of interest to tax professionals, lawyers, academics and students.

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Tax News – at a glance

by TaxCounsel Pty Ltd

May – what happened in tax?

The following points highlight important federal tax developments that occurred during May 2020. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 601 (at the item number indicated).

BAS agent services expanded

A legislative instrument made under the *Tax Agent Services Act 2009* expands the concept of a BAS service to cover certain services provided under the legislation that was enacted to give effect to the government's coronavirus response package (TAS 2020/1). **See item 1.**

COVID-19: working-from-home deductions

The Commissioner has released a practical compliance guideline that details the approaches that the ATO will accept for the purposes of individuals claiming deductions in relation to the expenses of working from home as a result of the COVID-19 measures, including a temporary short-cut method of calculating additional running expenses from 1 March 2020 until at least 30 June 2020 (PCG 2020/3). **See item 2.**

JobKeeper schemes

The Commissioner has issued a practical compliance guideline that provides guidance on how the ATO will apply its compliance resources to schemes to obtain access to the coronavirus economic response payment (the JobKeeper payment), or an increased amount of a JobKeeper payment (PCG 2020/4). **See item 3.**

Capacity charges capital expenditure

The Federal Court (Thawley J) has held that "capacity charges" payable under an agreement for the exclusive supply of electricity and which were, in substance, paid up-front in a lump sum were outgoings of capital or of a capital nature and, so, not allowable as general deductions (*Origin Energy Ltd v FCT (No. 2)* [2020] FCA 409). **See item 4.**

Up-front payments capital expenditure

The Federal Court (Jagot J) has held that payments identified as "prepaid rent" and which were paid when entering into lease and licence arrangements in relation to the operation of a number of McDonald's restaurants were outgoings of capital or of a capital nature and, so, were not deductible as general deductions (*Mussalli v FCT* [2020] FCA 54). **See item 5.**

One or two projects

In a recent case involving an appeal against a decision of the Commissioner on a private ruling application in relation to the operation of the capital expenditure project provisions (Subdiv 40-I ITAA97), the Federal Court (Logan J) has held that the appeal was not competent but that, if it were, there was only one project, and not two as contended for by the taxpayer (*BAC Holdings Ltd v FCT* [2020] FCA 413). **See item 6.**

No deferment of penalty proceedings

In preliminary proceedings, the AAT (constituted by Deputy President Steward J) has refused an application by a taxpayer (that was challenging transfer pricing assessments in the Federal Court (to be heard by Steward J)) that the determination of its objections to the associated assessments to administrative penalties be deferred until the proceedings in relation to the transfer pricing objections had been decided (*DXGQ and FCT* [2020] AATA 807). **See item 7.**

Summons set aside by AAT

The AAT has set aside a summons issued on the application of the taxpayer to a now retired ATO officer in relation to the formation of the opinion that there had been fraud or evasion on the part of the taxpayer which justified the issue of amended assessments to the taxpayer for the 2007 to 2010 income years outside the normal assessment amendment period (*Chhua and FCT* [2020] AATA 832). **See item 8.**

Tax agents

In recent decisions, the AAT was called on to consider issues relating to the review of decisions of the Tax Practitioners Board made in relation to the cancellation of two agents' registrations. **See item 9.**

Input tax credit denied

The AAT has dismissed a challenge to the disallowance of an input tax credit claimed in relation to the purchase of certain vacant land on the basis that the taxpayer was not carrying on an enterprise when the land was acquired and, so, the acquisition was not a creditable acquisition (*304 Wanda Street Pty Ltd and FCT* [2020] AATA 921). **See item 10.**

Capital gains and non-residents

The Federal Court (Thawley J) has held that a non-resident beneficiary was assessable on distributions by a resident trust which were sourced from capital gains made by the trust from the disposal of shares which were not taxable Australian property. The decision (*Peter Greensill Family Co Pty Ltd (trustee) v FCT* [2020] FCA 559) is considered in the Tax Tips column in this issue of the journal at page 607.

President's Report

by Peter Godber, CTA

Members are carrying a heavy load

President Peter Godber on how we are helping tax practitioners to navigate the unprecedented burden of COVID-19.

I can't recall hearing feedback from members like there has been in the weeks since the introduction of the JobKeeper rules.

At the pointy end when the regime was about to start and the cash was to flow to employers, there was still uncertainty about how the alternative decline in turnover tests worked in specific circumstances, how you calculated comparable turnover, and at the very end, how you applied the service entity rules and the other rules announced within a week of the initial employer cash payment obligations being due.

Treasury and the ATO were trying hard to get rules and guidance out, businesses wanted answers — and who was in the middle trying to make it all work? It was the advisers and tax agents, many of whom are our members.

Members have carried the heavy load of applying the new and sometimes uncertain rules while satisfying clients who have had to make significant cash payments to employees. On top of the usual pre-15 May compliance workloads, we have had a rather unprecedented burden, and that has been acknowledged.

Through our participation in the National Tax Liaison Group with other leading professional bodies, we have been close to the roll-out of the federal government stimulus measures and, in particular, the JobKeeper rules. There is no doubt that the regulatory bodies have received responsive consultation and assistance, and through that process, we have been attuned to what should be the bigger issues and concerns, both technical and practical, on behalf of members. Where we have had to represent concerns directly, we have done so. However, the joint bodies' work has been respected and effective.

That doesn't mean the position members have found themselves in as intermediaries in the system was in any way healthy. Members need great support and understanding in times like these. I think we are being heard. Tax return lodgment deadline deferrals and some administrative concessions have been announced. However, it is non-stop when it comes to identifying practical matters of concern in extreme times like the present.

There is always a lot to do to continue to improve our tax system, but the impact of pressures on the health and wellbeing of members is often not fully understood. We are doing our best, but these COVID-19 times have highlighted the many professional challenges for members — complexity in the rules, dealing with clients under pressure, and tight deadlines.

The Tax Institute is dedicating more resources to help members in an increasingly uncertain world. The new member portal, an increase in technical resources, and the online streaming of events are all part of it. For example, we have done our best to roll out informative webcast sessions on JobKeeper at no cost to members.

We are developing additional strategies to help us keep abreast of the needs of our members. In response, we will tailor our content and delivery of knowledge. Our engagement with members in future will hopefully present greater opportunities for dialogue among members, individually and as part of small communities. Sharing thoughts, experiences and questions will help us in a challenging professional environment.

No doubt you will be pleased to hear that we are reviewing our website, and our member interfaces, and committing to invest more in our knowledge content management and accessibility. This is all to support members. Timely access to knowledge is critical.

Our internal leadership team is working hard with National Council to bed down our strategies for the next few years, and they will be important years for the growth of the Institute. We are putting down the roadmap now, and we will come out at the end of our COVID-19 limitations with shared enthusiasm about the year or two ahead of us — all for the greater benefit and education of our members.

For now, everyone at The Tax Institute wishes our members the best in staying healthy during these COVID-19 times.

CEO's Report

by Giles Hurst

Recognising the resilience of our members

CEO Giles Hurst offers support to members in all aspects of their professional endeavours as we aim for a "new normal".

This month, it appears that there is light at the end of the COVID-19 tunnel, although our optimism remains cautious and we recognise that our community is not out of the woods just yet.

Each of our members has faced, is facing or will face challenges during this time — some big, some small, some shared, some intensely personal. No matter what your pressure points are, we're here to support you in all aspects of your professional endeavours.

For many members, this means assistance in understanding and applying new stimulus measures and rules for your clients. We are supporting you with a range of free webinars on key stimulus topics, including the much-discussed JobKeeper and cash flow boost schemes.

We continue to receive positive feedback on the value of these events and the impact that they have on your practice. We're rolling out a number of new webinar series to cover other essential topics and will continue to do so as needed. This is made possible in no small part by the volunteers, committee members and speakers who continue to support us, despite facing their own challenges. Ours is a community that is good because it is fuelled by people who do good. Thank you to all who are a part of it.

Last month, Robyn Jacobson, chartered tax adviser and registered tax agent, joined us as Senior Advocate and we have all already benefitted from her expertise and passionate advocacy.

As you are likely aware, Andrew Mills, CTA (Life), has also recently joined the Institute as Director, Tax Policy and Technical. Andrew was Second Commissioner at the Australian Taxation Office until the end of last year and has long been an involved supporter of The Tax Institute, serving as president in 2006-07. We are honoured to have him step into this new role at such a crucial time.

Bringing 40 years' experience to the team, Andrew's appointment, like Robyn's, forms part of our commitment to support the voice of tax professionals amid COVID-19 and in the future.

There has never been a more important time to stay connected to your Institute. As I write this, membership renewals are flowing in. This is perhaps testament to the sense of optimism our members feel towards their profession, The Tax Institute and the road to recovery that we are currently paving. Over the coming weeks and months, we will be sharing a range of practical tools, templates and resources to further strengthen the value we deliver to you.

What our new normal looks like

Recently, talk has turned to getting back to "normal" in our professional and personal lives as the COVID-19 situation is slowly coming under control. Restrictions on gatherings and social distancing have eased somewhat and are likely to continue doing so. I sincerely hope these developments have helped to lift some of the pressures that our members are feeling.

The question for all of us now is just what "normal" might look like — for our profession, the economy and, indeed, the world.

I believe the way we work may never go back to exactly how it was before, but I'm hopeful that, as an organisation, The Tax Institute and its members will come out on the other side stronger than before. After all, it takes pressure to make a diamond.

Practically speaking, our plans are progressing with the caution that a global event of this significance demands.

We are looking forward to being able to once again hold face-to-face events — albeit in small groups to begin with. Our team has successfully brought events and education online, but it will be a treat to see our members in person again. Keep an eye on your inbox for more information on when and how this will happen.

The Institute is also planning for a gradual return to our office locations around Australia, with one eye always on the safety of our people, and the practical question of getting to, and being at, work while remaining at an appropriate social distance.

I hope you are starting to see your own "new normal" emerge as well, and I have no doubt that the resilience that has shaped our profession will continue to carry us into the future. My admiration and support go out to you all.

Tax Counsel's Report

by Angie Ananda, CTA

JobKeeper program

The objective of the JobKeeper program is to keep Australians in jobs and to support businesses affected by the coronavirus. Recent amendments are discussed below.

Background

Under the JobKeeper program, eligible employers will be able to claim a fortnightly payment of $1,500 per eligible employee from 30 March 2020.

Generally, eligible employers (including not-for-profits) will be eligible for the subsidy if:

- their business has an aggregated turnover of less than $1b (for income tax purposes) and they estimate that their GST turnover has fallen, or will likely fall, by 30% or more; or
- their business has an aggregated turnover of $1b or more (for income tax purposes) and they estimate that their GST turnover has fallen, or will likely fall, by 50% or more; and
- their business is not subject to the major bank levy.

The basic turnover test is satisfied where your projected GST turnover for the turnover test period falls short of your current GST turnover for the relevant comparison period, by the specified percentage (generally 30%).

There has been much confusion and difficulty in relation to satisfying the basic turnover test. As a result, further guidance has been released and alternative tests have been formulated.

Given the necessary speed at which the JobKeeper provisions were legislated, it perhaps should have been expected that there would be amendments and additions to the rules. On balance, I think it is fair to say that, in the world of COVID-19, it was more important to get the basic rules in place and deal with issues as they arise.

The most recent legislative instrument is discussed below.

Payments and benefits: amendment rules

The *Coronavirus Economic Response Package (Payments and Benefits) Amendment Rules (No. 2) 2020* clarify certain elements of the JobKeeper program. This instrument:

- provides a modified decline in turnover test for certain group structures;
- adjusts the way in which Commonwealth payments are treated when calculating a university's turnover;
- extends the JobKeeper scheme to certain charities;
- adjusts the way in which payments made by the government and the United Nations are treated when calculating a charity's turnover;
- includes a notification requirement to confirm that all employees of a participating entity must be given the opportunity to agree to be nominated;
- imposes additional requirements that must be met for children to be eligible nominees;
- extends the JobKeeper scheme to include certain religious practitioners; and
- makes various consequential and minor technical amendments.

Our members have had many questions in relation to two of the issues that have been addressed by this instrument, namely, group structures and children. The Tax Institute has worked hard alongside other professional bodies and the National Tax Liaison Group to bring changes about in these areas.

Group structures

Some groups are structured in a way such that most or all of the employees are employed by one "employer" entity. Such entities are unlikely to be able to satisfy the basic decline in turnover test under the JobKeeper provisions, even though the group to which they belong may have experienced a significant decline in the turnover.

This issue has been addressed in this instrument which provides a modified decline in turnover test for an employer entity (modified test). The modified test applies in addition to the basic test. That is, an employer entity can satisfy the decline in turnover test either by satisfying the basic test or the modified test.

Under the modified test:

- instead of using the employer entity's projected GST turnover for the turnover test period, the sum of the projected GST turnovers for that period of each test member is used; and
- instead of using the employer entity's current GST turnover for a relevant comparison period, the sum of the current GST turnovers for that period of each test member is used.

Children

The instrument provides that children aged 16 or 17 years are only eligible for JobKeeper if, in addition to the general requirements, they:

- are "independent" as defined under the *Social Security Act 1991* (Cth); or
- were not studying full-time as defined in the *Social Security Act 1991*.

The objective of the amendments is to ensure that 16- and 17-year-olds undertaking full-time study on 1 March 2020 cannot be eligible employees or business participants and are encouraged to continue to engage in full-time education.

Conclusion

Given the nature and timing of the JobKeeper program, it was inevitable that amendments were going to be made — and more may be required. It is important that we keep working with all stakeholders, including the ATO and Treasury, to ensure the best possible outcomes for our members and the tax system.

Tax News – the details

by TaxCounsel Pty Ltd

May – what happened in tax?

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

Government initiatives

1. BAS agent services expanded

A legislative instrument made under the *Tax Agent Services Act 2009* (Cth) (TASA09) expands the concept of a BAS service to cover certain services provided under the legislation that was enacted to give effect to the government's coronavirus response package (TAS 2020/1).

As a result of the legislative instrument, BAS agents can now legally support Australian businesses by ascertaining and advising about their entitlements and liabilities under the new JobKeeper payment and cashflow support for business initiatives.

The Commissioner's perspective

2. COVID-19: working-from-home deductions

The Commissioner has released a practical compliance guideline that details the approaches that the ATO will accept for the purposes of individuals claiming deductions in relation to the expenses of working from home as a result of the COVID-19 measures, including a temporary short-cut method of calculating additional running expenses from 1 March 2020 until at least 30 June 2020 (PCG 2020/3).

Under the short-cut method, employees and business owners can claim a deduction of 80 cents for each hour that they work from home due to COVID-19 as long as they are:

- working from home to fulfil their employment duties and not just carrying out minimal tasks, such as occasionally checking emails or taking calls; and
- incurring additional deductible running expenses as a result of working from home.

A separate or dedicated area of the home (such as a private study) does not need to be set aside for working.

The short-cut method rate covers all additional running expenses, including:

- electricity for lighting, cooling or heating and running electronic items used for work (for example, a computer), and gas heating expenses;
- the decline in value and repair of capital items, such as home office furniture and furnishings;
- cleaning expenses;
- phone costs, including the decline in value of a handset;
- internet costs;
- computer consumables, such as printer ink;
- stationery; and
- the decline in value of a computer, laptop or similar device.

While a taxpayer does not have to incur all of these expenses, the taxpayer must have incurred additional expenses in some of those categories as a result of working from home due to COVID-19. Also, a record (for example, timesheets or diary notes) must be kept of the number of hours worked from home as a result of COVID-19. If the shortcut method is used, the note "COVID-hourly rate" must be included in the taxpayer's 2019-20 tax return.

If the short-cut method is used to claim a deduction for additional running expenses, a further deduction cannot be claimed for any of the listed expenses.

The guideline, however, does not cover occupancy expenses (such as rent, mortgage interest, property insurance and land taxes). These will not become deductible only because the taxpayer is required to work from home temporarily as a consequence of COVID-19. Occupancy expenses are only deductible if part of the home has the character of a place of business (as to which see TR 93/30).

3. JobKeeper schemes

The Commissioner has issued a practical compliance guideline that provides guidance on how the ATO will apply its compliance resources to schemes to obtain access to the coronavirus economic response payment (the JobKeeper payment), or an increased amount of a JobKeeper payment (PCG 2020/4).

An entity's entitlement to an amount of a JobKeeper payment that results or would result from such schemes may be denied in whole or in part under s 19 of the *Coronavirus Economic Response Package (Payments and Benefits) Act 2020*. When deciding whether to apply compliance resources, the Commissioner's predominant considerations will be the occasion for and result of the scheme in the context of the entity and its external operating environment. In particular, the Commissioner will be concerned with an entity that accesses or increases JobKeeper payment entitlements:

- where the entity's business is not significantly affected by external environmental factors beyond its control; and/or
- in excess of those that would maintain pre-existing employment relationships.

However, if:

- the external operating environment is affected by factors beyond the control of the entity (and its related parties);
- that affected external operating environment significantly impacts the business of the entity or another entity in which the entity's employees serve; and
- the entity enters into the scheme in response to that impact and satisfies the decline in turnover test; and
- the JobKeeper payment that the entity receives is for individuals who were employed by the entity and serving

in the significantly impacted business prior to that time and who remain employed as a result of that JobKeeper payment,

the Commissioner generally will not apply his compliance resources to consider the application of s 19.

The Commissioner's application of compliance resources will be driven by the substance of the outcome achieved, more than the type of arrangement entered into.

For the avoidance of doubt and for the guideline to apply, the entity does not need to show that COVID-19 was the factor beyond the control of the entity (and its related parties) that affected the entity's external operating environment.

The guideline gives a number of examples of the application of the general principles to particular scenarios.

Recent case decisions

4. Capacity charges capital expenditure

The Federal Court (Thawley J) has held that "capacity charges" payable under an agreement for the exclusive supply of electricity and which were, in substance, paid up-front in a lump sum were outgoings of capital or of a capital nature and, so, not allowable as general deductions (*Origin Energy Ltd v FCT (No. 2)*[1]).

In May 2008, the New South Wales Government announced its intention to implement recommendations in respect of the electricity industry in NSW, including that the state divest itself of the generation businesses of each of the three state-owned generators, including Eraring Energy (a statutory state-owned corporation), and the retail arms of its three electricity businesses.

In November 2008, the NSW Government adopted a revised strategy which would see the state withdrawing from electricity retailing and transferring to the private sector the right to trade the output of publicly owned generators. Under this strategy, the state announced that it would continue to own and operate its power stations, as well as the transmission and distribution lines, but would "exchange the risk and volatility of earnings from [the state's] wholesale electricity trading for secure, predictable payments by the private sector (in return for the right to buy and sell wholesale electricity)". The NSW Government stated that it would recover revenue, for the trading rights, sufficient to cover the costs of electricity production and delivery over the term of the trading rights contract, and that the relevant agreement might include an upfront component.

Against this context, on 1 March 2011, Origin Energy Electricity Ltd (OEEL) and Eraring Energy entered into two agreements, called "GenTrader Agreements". One agreement related to the Eraring power station, a large coal-fired power station. The other related to the "Shoalhaven Scheme" which was a "pumped storage hydro scheme" involving the Kangaroo Valley and Bendeela pumping and power stations.

Under the GenTrader Agreements, OEEL agreed to pay a number of charges to Eraring Energy, including substantial "capacity charges". Under "deposit deeds", OEEL placed interest-bearing deposits of $856,000,000 (Eraring) and $11,080,000 (Shoalhaven) with the NSW Treasury. These represented the net present value of all of the annual capacity charges payable under the GenTrader Agreements for the term of those agreements, being 22 and 28 years.

In the case of Eraring Energy, the capacity charges were $145,385,320 in the first full year. They reduced each year, at a rate of approximately 85% of the prior year's charge, such that the capacity charges in the last year were $7,222,996. Shoalhaven's payments were similarly "front-loaded". OEEL authorised and directed NSW Treasury to pay each year, out of the security deposit, the relevant capacity charge to Eraring Energy.

Origin Energy Ltd (Origin), the head company of the consolidated group of which OEEL was a member, contended that the capacity charges were deductible in full as general deductions (under s 8-1 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97)) in each of the income years in which those charges were incurred. Origin also contended that, if the amounts were not deductible because they represented capital expenditure, the charges were deductible as "black hole" expenditure over five years under s 40-880 ITAA97. Origin contended that the capacity charges were paid for the acquisition of electricity from Eraring Energy under the GenTrader Agreements, which it referred to as long-term "supply contracts".

The Commissioner, however, contended that the capacity charges were capital in nature because the advantage sought by incurring the expenditure was an extension of OEEL's profit-making structure, not simply the annual supply of electricity to OEEL for on-sale.

Thawley J held that the capacity charges were not deductible under s 8-1 ITAA97 because they were outgoings of capital or of a capital nature. In his Honour's view, a number of factors indicated that the expenditure was an affair of capital. The overarching reason for this conclusion was that the advantage sought by the expenditure was an acquisition of a new or extended profit-making structure. OEEL acquired the right to trade the entire output of the power stations for an extended period and to profit from that structure having regard to the various risks and opportunities acquired. OEEL's profit-making structure was significantly extended and altered for an extended term, with the ability to further extend the term.

The expenditure was not properly characterised as being merely for the yearly acquisition of electricity by OEEL for on-sale at a profit, even if that was a part of what was acquired by the expenditure. As a matter of practical and business reality, what OEEL sought to achieve was the acquisition of a business structure constituted by the right to trade the entire output of the power stations, the operation of which would be managed by the owner, but over which OEEL had significant elements of control and in respect of which it bore risk and gained opportunities for profit.

In relation to s 40-880 ITAA97, Thawley J held that the expenditure fell within one or other of the exclusions contained in s 40-880(5)(d) (expenditure in relation to a lease or other legal or equitable right) or (f) (expenditure that could, apart from s 40-880 be taken into account when working out the amount of a capital gain or capital loss from a CGT event).

5. Upfront payments capital expenditure

The Federal Court (Jagot J) has held that payments identified as "prepaid rent" and which were paid when entering into lease and licence arrangements in relation to the operation of a number of McDonald's restaurants were outgoings of capital or of a capital nature and, so, were not deductible as general deductions (*Mussalli v FCT*[2]).

McDonald's Australia Ltd (MAL) offered Mr Mussalli leases and licences to operate McDonald's Family Restaurants on a number of sites. The offers included the terms of a full lease and licence (FLL) which varied depending on whether MAL owned the premises (in which case, the term was 20 years) or leased the premises (in which case, the term was one day less than the head lease). By accepting MAL's offer, the Mussalli Family Trust (MFT) agreed to a later entry into the FLL for each restaurant, including a seven-day cooling off period.

The letters of offer foreshadowed a number of required payments, including, under the FLL, a base rent amount payable monthly plus GST and a percentage rent amount calculated by reference to monthly gross sales plus GST. Each of the letters of offer also included a provision to the effect that the agreement included an option for the offeree to reduce the percentage rent, subject to a prepayment of rent plus GST on the day of handover.

Mr Mussalli accepted each of the offers to operate the restaurants, including to pay the "prepayment of rent" so as to reduce the percentage rent payable. The leases for the sites of these restaurants only referred to the reduced amount of percentage rent payable and did not refer to the option to reduce the percentage rent.

Subsequently, MAL made further offers to Mr Mussalli to operate a further three existing McDonald's Family Restaurants. The FLLs for these restaurants were similar to the earlier FLLs, save that they provided that, if the lessee exercised the prepayment option, the percentage rent payable by the lessee for the term would be reduced to the amount calculated in accordance with a specified method.

The trustee of the MFT claimed deductions in respect of the upfront amounts under s 8-1 ITAA97, but with the deductions spread over 10 years (s 82KZMD of the *Income Tax Assessment Act 1936* (Cth) (ITAA36)).

Jagot J said that she accepted the Commissioner's primary case that the payments were made to secure the rights to operate the businesses on better terms as to rent for the term of the FLLs and most likely longer. Further, this same conclusion would be reached if the transaction documents were considered in isolation or were considered in the context of the surrounding circumstances. Further, the same conclusion would be reached irrespective of the accounting evidence or with regard to the accounting evidence.

Jagot J also accepted the Commissioner's contention that, in the case of each restaurant, the upfront payments secured the acquisition of a more profitable business structure by securing an enduring reduction in ongoing costs. The fact that the upfront payments were not refundable on termination of the FLLs suggested that they were not made to secure the right to occupy the premises under the lease and, rather, were capital in nature.

6. One or two projects

In a recent case involving an appeal against a decision of the Commissioner on a private ruling application in relation to the operation of the capital expenditure project provisions (Subdiv 40-I ITAA97), the Federal Court (Logan J) has held that the appeal was not competent but that, if it were, there was only one project, and not two as contended for by the taxpayer (*BAC Holdings Ltd v FCT*[3]).

The taxpayer (BACH) operated Brisbane Airport pursuant to a long-term lease from the Commonwealth. For many years, there had been an identified need to bolster the capacity of Brisbane Airport by the construction of a further runway parallel to the existing main runway. In 2007, BACH received approval to construct a new parallel runway (NPR) to meet this need. Construction of the NPR began in 2012.

On 23 August 2017, BACH applied to the Commissioner for a private ruling as to whether certain initial activities associated with the construction of the NPR were themselves a "project" for the purposes of Subdiv 40-I ITAA97 and, if so, when that "project" started to operate. The private ruling was sought in respect of the 2011 to 2017 income years.

By 12 April 2018, the Commissioner had made and issued assessments in respect of the 2011 to 2017 income years. Those assessments were, materially, predicated on a view of the meaning and effect of Subdiv 40-I which differed from that promoted by BACH in its private ruling application but which was consistent with the ruling made by the Commissioner in his private ruling.

The difference between BACH and the Commissioner was whether, as BACH contended in its private ruling application, the two phases of the construction of the NPR in effect comprised discrete "projects" for the purposes of Subdiv 40-I ITAA97 or whether, as the Commissioner came to conclude, the construction of the NPR was but one "project", which would not commence to operate until the first aircraft landed or took off.

The primary contention advanced by BACH was that the relevant "project" was not the totality of the NPR project phases but instead a subset of those phases. The subset which it contended constituted a discrete "project" was the "geotechnical design of the NPR and related experimental land reclamation and monitoring activities". As so defined, the alleged "project" excluded the latter part of the second project phase from the definition. In other words, the phase 2 runway and taxiway construction (including a new road access tunnel) was, inferentially, said to be a separate "project". It was this characterisation of discrete initial and final "projects" which the Commissioner rejected in the ruling.

Logan J considered various challenges by the Commissioner to the competency of BACH's objection grounds. However, what is of more significance are his Honour's his views on the "project" point.

His Honour said that the internal pricing structures and the related agreements with users of BACH's facilities, prior to the completion of the NPR, were not relevant to the determination of whether or not, for the purposes of Subdiv 40-I ITAA97, the "Phase 2 Runway and taxiway construction (including a new road access tunnel)" were discrete from a "project" constituted by the earlier activities, described as "the geotechnical design of the New Parallel Runway … and related experimental land reclamation and monitoring activities". On the scheme facts as posited, the latter were not an end in themselves, only a means to an end, and that end was always the completed NPR. That was always the "project" for the purposes of Subdiv 40-I ITAA97. Axiomatically, an airfield, large or small, once constructed, commences to operate when the first aeroplane lands on it or takes off from it, whichever is the sooner. That, after all, is the purpose of constructing an airfield.

7. No deferment of penalty proceedings

In preliminary proceedings, the AAT (constituted by Deputy President Steward J) has refused an application by a taxpayer (that was challenging transfer pricing assessments in the Federal Court (to be heard by Steward J)) that the determination of its objections to the associated assessments to administrative penalties be deferred until the proceedings in relation to the transfer pricing objections had been decided (*DXGQ and FCT*[4]).

In essence, the preliminary dispute before the AAT arose because the taxpayer would have preferred to find out whether it was successful, in whole or in part, in showing that the Commissioner's primary tax assessments were excessive before it wished to prosecute the penalty review proceedings. Because it believed that it would succeed in showing this, there would never be a need to consider the issue of penalty. Costs and time would thereby be saved.

The Commissioner, however, disagreed and contended that the "usual" course should be adopted, that is, the penalty review proceedings should take place immediately after the completion of the trial of the primary tax proceeding. In other words, the Commissioner wished the penalty issue to be tried before the outcome of the proceeding in the Federal Court was known.

The Deputy President said that the usual case is that the issues of primary tax and penalty tax are dealt with at the one hearing. It is commonly accepted that this is the most efficient way of resolving related proceedings. In more recent times, taxpayers have often pursued the review of penalties separately in the AAT (to secure merits review, for example, of the Commissioner's power to remit penalty tax), with issues of primary tax being dealt with in the Federal Court. In such cases, a judge of the Federal Court, who is also a presidential member of the tribunal, often hears both matters.

Steward J said that it may often be highly undesirable for issues of primary and penalty tax to be heard at the same time in a transfer pricing case where Div 13 ITAA36 has been applied. It can lead to the cross-examination of witnesses about their subjective reasons for undertaking an impugned transaction — such as a loan between related companies — in the middle of a trial about primary tax where that issue is entirely irrelevant. In such cases, there should be a strict demarcation between the court proceedings and the review by the AAT. Steward J said that there should not be any concurrent hearing; rather there should be consecutive hearings and that should be the case here.

8. Summons set aside by AAT

The AAT has set aside a summons issued on the application of the taxpayer to a now retired ATO officer in relation to the formation of the opinion that there had been fraud or evasion on the part of the taxpayer which justified the issue of amended assessments to the taxpayer for the 2007 to 2010 income years outside the normal assessment amendment period (*Chhua and FCT*[5]).

Both the Commissioner and the former ATO officer applied to the AAT for the summons to be set aside. The particular opinion appeared to have been recorded in March 2013 and the former officer stated in an email of 9 December 2019 that he had no recollection of the matter.

The AAT said that the decision of the Full Federal Court in *Binetter v FCT*[6] made it plain that the issue for the tribunal in the substantive proceedings would be whether the taxpayer had discharged the onus of showing that the opinion that there was fraud or evasion should not have been formed.

The question posed in the present application concerned the summons issued to the former employee. That was in the context of the provisions of the *Administrative Appeals Tribunal Act 1975* (Cth) which provide, among other things, that the procedure of the tribunal is within its discretion, such proceedings to be conducted with as much expedition as a proper consideration of the matter permits, while allowing the tribunal to inform itself on any matter in such manner as it thinks appropriate.

Further, in the circumstances of the present application to set aside the summons directed to the former employee, the former employee's statement made by email that he did not have "any recollection of these events of almost 7 years ago" was dispositive. There was no other evidence before the tribunal that the former employee had any other purpose in stating that he had no recollection of the events. Necessarily, his evidence would not assist in the review of the decision and determination of the principal application. Accordingly, the summons should be set aside and the former employee released from the obligation of attending to give evidence at the hearing.

9. Tax agents

In recent decisions, the AAT was called on to consider issues relating to the review of decisions of the Tax Practitioners Board (TPB) made in relation to the cancellation of two agents' registrations. The AAT decisions are noted below.

No deregistration stay

In one decision, the AAT refused to grant a stay of the decisions of the TPB to cancel the tax agent registrations of an individual (Mr Rizkallah) and of a company (Le'Sam Accounting Pty Ltd) of which he was a director (*Le'Sam Accounting Pty Ltd and Tax Practitioners Board*[7]).

The applicants' present troubles arose out of an incident in which somebody within the firm used the ATO Tax Agent Portal to access information about a former client without that client's authority. The decision to access the information was particularly problematic in circumstances where Mr Rizkallah was the respondent in legal proceedings brought by the former client. The TPB was dissatisfied with Le'Sam Accounting Pty Ltd's responses to its enquiries about the incident.

The TPB also decided that Mr Rizkallah no longer met the registration requirement under s 20-5(1)(a) TASA09 that he be a fit and proper person. The TPB made that decision after concluding Mr Rizkallah was ultimately responsible (in his capacity as the supervisor of the company's operations and staff) for the unauthorised access to the ATO Tax Agent's Portal.

Mr Rizkallah and the company applied for a review of the TPB's deregistration decision and also for a stay of its decisions. In declining to grant a stay, the AAT considered the following factors: the prospects of success; the consequences for the applicants should a stay order be refused; the interests of other individuals; the public interest; the consequences for the respondent board if a stay were not ordered; and whether the application for review would be rendered nugatory if the stay were not ordered.

It may be noted that the issue of whether a decision of the TPB to cancel a tax agent's registration should be stayed pending the hearing of the substantive application relating to the decision to cancel a registration has arisen in a number of cases. For a recent decision in which the AAT granted a stay, see *Norman and Tax Practitioners Board*.[8]

Reduction of non-reapplication period

In the other case, the AAT affirmed the decision of the TPB to cancel the agent's registration but reduced the four-year non-reapplication period imposed by the board to three years (*Elsawi and Tax Practitioners Board*[9]).

The tax agent conceded that certain conduct breached s 30-10(1) TASA09 (acting honestly and with integrity) and the AAT said that this conduct was sufficiently serious to merit termination on its own. The conduct represented one of the most serious forms of sanctionable conduct relevant to the practice of a tax agent. Including the conceded breaches, the AAT found that the tax agent did knowingly lodge multiple false BASs in relation to multiple clients. While the amounts that the tax agent received were ultimately paid back, this was a relatively minor matter in mitigation and did not exonerate him.

The AAT considered that the agent's established contravening conduct did merit the application of a prohibition period but did not rise to the level meriting the maximum five-year period. After considering all of the circumstances, the AAT concluded that a three-year prohibition period was appropriate.

10. Input tax credit denied

The AAT has dismissed a challenge to the disallowance of an input tax credit claimed in relation to the purchase of certain vacant land on the basis that the taxpayer was not carrying on an enterprise when the land was acquired and, so, the acquisition was not a creditable acquisition (*304 Wanda Street Pty Ltd and FCT*[10]).

304 Wanda Street Pty Ltd (Wanda) was incorporated on 12 April 2016. Shortly afterwards, it became registered for GST, but with effect from its date of incorporation. Wanda was the corporate trustee of the Wanda Street Trust which was established by deed dated 12 April 2016.

At that time, Wanda's sole director and shareholder was Ms JA Kim. She was an "in-house" lawyer who worked at CAP Accounting/Accolade Advisory (Accolade) under the supervision of a Mr Sam Cassaniti, who was one of the two principal Wanda Street Trust beneficiaries.

In May 2016, a few weeks after its incorporation, Wanda acquired a vacant 14-hectare block of land at Pindimar, near Port Stephens in New South Wales, from Pindimar Holdings Pty Ltd (PindiHold). That company, also the trustee of a private trust, had Accolade's office as its principal place of business and was then apparently controlled by another Accolade employee, its office manager Mr Michael Lowe.

Wanda's acquisition of the land was the subject of a 30 May 2016, $700,000, contract for sale, and a same dated mortgage to Reliance Financial Services Pty Ltd (Reliance) which also operated from Accolade's premises, and mainly lent to Accolade's clients. Mr Sam Cassaniti and Accolade's accountancy practice manager, Mr David Cassaniti, who was a former director of PindiHold and had recently resigned as a director of Reliance, organised the mortgage. The mortgage: (1) indicated that Wanda was acting as trustee of the Wanda Street Trust; (2) secured both a principal amount of $800,160 and the (unstated) balance of PindiHold's (unparticularised) mortgage interest debt to Reliance; (3) contained a 10% daily compounding interest rate; and (4) required repayment by 30 June 2018 but did not impose any intervening periodic payment obligation.

Apart from the somewhat unusual obligations that Wanda assumed under the mortgage to Reliance, Wanda contributed nothing to the settlement of the purchase. Nor was there any evidence of it having made any subsequent repayment (of either principal or interest). Twenty-one months after the May 2016 purchase, Wanda lodged a development application relating to the land. That application was refused on 27 September 2018, though perhaps repeated, in an amended form, in February 2019.

After considering the evidence, the AAT said that the evidence established that Wanda had no funds of its own at the time of the property acquisition, had not been revealed to have generated any subsequent income, had never repaid any of the Reliance mortgage amount, and apparently had never enquired about, and had never known, at any time since 2016, the amount of the mortgage debt.

Wanda's apparently total indifference to its financial circumstances (apart from its pursuit of the input tax credit claim) tended away from any reliable conclusion that Wanda could be regarded as having any particular enterprise intention when it acquired the property in May 2016, and as having then commenced an enterprise at the time of its acquisition of the property.

Although not necessary to do so, the AAT also held that the supply by PindiHold to Wanda was not a taxable supply.

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References

1 [2020] FCA 409.
2 [2020] FCA 544.
3 [2020] FCA 413.
4 [2020] AATA 807.
5 [2020] AATA 832.
6 [2016] FCAFC 163.
7 [2020] AATA 890.
8 [2020] AATA 640.
9 [2020] AATA 998.
10 [2020] AATA 921.


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Tax Tips

by TaxCounsel Pty Ltd

Foreign residents and CGT

A recent Federal Court decision considered how the ITAA36 and the ITAA97 operate where the trustee of a resident discretionary trust distributed to a foreign resident capital gains that had resulted from the disposal of shares.

Background

The issue for decision by the Federal Court in *Peter Greensill Family Co Pty Ltd (trustee) v FCT*[1] was whether the fact that a presently entitled beneficiary of a resident discretionary trust was a foreign resident immediately before a CGT event happened in relation to CGT assets (shares) of the trust that were not taxable Australian property, meant that the foreign resident capital gain disregarding provision in s 855-10(1) of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) was called into play.

Thawley J held that s 855-10(1) ITAA97 had no operation and that the beneficiary (or the trustee on the beneficiary's behalf) was assessable.

Subsequent to the handing down of the judgment, the trustee taxpayer made an interlocutory application to the court seeking that the court review and reconsider the orders made and the reasons given in the judgment (*Peter Greensill Family Co Pty Ltd (trustee) v FCT (No. 2)*[2]) Thawley J dismissed the application.

The facts

The Peter Greensill Family Trust (PGFT) was a discretionary trust that was established by deed dated 21 January 2010 (trust deed). The trustee of the PGFT was Peter Greensill Family Co Pty Ltd (PGFC), a company that was incorporated in Queensland on 7 January 2010.

Alexander Greensill, a beneficiary of the PGFT, was at all relevant times a resident of the United Kingdom and not an Australian resident for the purposes of the Australian taxation laws.

From what is stated in the judgment, the relevant terms of the trust deed followed what would be expected in a typical discretionary trust deed and, relevantly, provided that:

- the trustee stood possessed of the trust fund and income of the trust fund for the benefit of the beneficiaries in accordance with the terms of the trust deed (cl 2.1);
- the trustee stood possessed of the income and capital derived by the trustee in any financial year on trust absolutely for the beneficiaries or any one or more of them to the exclusion of the other(s) and in such shares and proportions as the trustee might in its absolute discretion determine on or before the last day of the financial year (cl 3.1);
- a beneficiary was absolutely and presently entitled to an amount of income or another amount (including the capital component) if the trustee made a determination in the beneficiary's favour of such income or capital (cl 3.4);
- the trustee might determine to what extent a receipt or an outgoing of the trust fund was income or capital (cl 3.6);
- until the vesting day, the trustee might apply the capital of the trust fund or any part of it for the benefit of any one or more of the beneficiaries either in cash or by in specie distribution of assets of the trust fund and otherwise on such terms and conditions as the trustee might in its absolute discretion decide (cl 4.2); and
- any determination of the trustee pursuant to various provisions (including cl 3.1) was to be recorded in a written minute signed by the trustee (cl 5.1).

The Greensill Capital Pty Ltd shares

On 4 November 2011, PGFC, as trustee of the PGFT, was issued 100 ordinary shares in Greensill Capital Pty Ltd (GCPL) for $0.267 ($0.00267 per share). GCPL was an Australian financial services company which owned Greensill Capital Management Co (UK) Ltd, Greensill Capital (UK) Ltd and other entities, both in Australia and overseas.

The following further transactions affected PGFC's shareholding in GCPL in its capacity as trustee for the PGFT:

- on 15 December 2011, PGFC was issued a further 275 ordinary shares in GCPL for $0.73425 ($0.00267 per share);
- on 25 May 2012, 15 of the ordinary shares held by PGFC in GCPL were converted to B class shares;
- on 15 February 2013, 50,000,000 non-redeemable preference shares in GCPL were issued to PGFC for $500,000 ($0.01 per share);
- on 12 December 2014, 360 ordinary shares in GCPL held by PGFC were split into 360,000 ordinary shares, and 15 B class shares in GCPL held by PGFC were split into 15,000 B class shares. The amount paid per ordinary share and per B class share after the share split was $0.00000267; and
- on 5 April 2017, 54,444 ordinary shares in GCPL held by PGFC were converted to 54,444 B class shares.

During the income year ended 30 June 2015, PGFC (as trustee) disposed of a total of 37,680 ordinary shares in GCPL (which it had acquired for $0.1006056 ($0.00000267 per share)) for $13,074,987.25. As a result of these disposals, PGFC made capital gains from the happening of CGT event A1 totalling $13,074,628.

On 30 June 2015, PGFC (as trustee) made the following written resolutions:

- the net income of the trust for the year ended 30 June 2015 was to be the net income as determined under s 95 of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) excluding franking credits and any capital gains; and

– to the extent that the trustee had received and treated any capital gain earned during the year ended 30 June 2015 as capital of the trust and in accordance with cl 3.8 and cl 4.3 of the trust deed, any capital gain related to the sale of GCPL shares was distributed 100% to Alexander Greensill.

During each of the income years ended 30 June 2016 and 30 June 2017, PGFC (as trustee) disposed of further shares in GCPL. As a result of these disposals, PGFC (as trustee) made capital gains from the happening of CGT event A1 totalling $10,070,680 (for the income year ended 30 June 2016) and $35,213,910 (for the income year ended 30 June 2017).

Also, during the income year ended 30 June 2017, PGFC (as trustee) transferred in specie 54,444 B class shares in GCPL to Alexander Greensill in satisfaction of his absolute entitlement to those shares.[3]

For each of the 2016 and 2017 income years, PGFC (as trustee) made written resolutions that had the effect of distributing to Alexander Greensill 100% of any capital gain from the disposal of shares in GCPL. It seems that the resolution for the 2017 income year did not in express terms refer to the possible capital gain that would have arisen (as a result of CGT event E5 happening).

The Commissioner's assessments

After a review of the tax affairs of the PGFT, the Commissioner issued assessments for the 2015, 2016 and 2017 income years to the trustee under s 98 ITAA36 (because Alexander Greensill was a non-resident at the end of each income year).[4] The assessments were made on the basis that the capital gains distributed to Alexander Greensill, being deemed or attributable capital gains of Alexander Greensill under Subdiv 115-C ITAA97, were assessable to the trustee and were not disregarded under Div 855 ITAA97 (and s 855-10 ITAA97 in particular).

The Commissioner disallowed objections that were lodged by the trustee against the assessments and the trustee appealed to the Federal Court. The appeals were dismissed by Thawley J.

The legislation

The relevant legislative provisions are somewhat intertwined and complex. They are set out below.

The provision that ultimately determined whether the trustee's case rose or fell was s 855-10(1) ITAA97 which reads as follows:

> "**855–10 Disregarding a capital gain or loss from CGT events**
>
> (1) Disregard a capital gain or capital loss from a CGT event if:
>
> (a) you are a foreign resident, or the trustee of a foreign trust for CGT purposes, just before the CGT event happens; and
>
> (b) the CGT event happens in relation to a CGT asset that is not taxable Australian property."

The practical effect of the provisions of Div 6E ITAA36 is that the beneficiaries of a trust and the trustee are not assessed under Div 6 ITAA36 in respect of capital gains of a trust estate. Beneficiaries and, where necessary, the trustee are taxed on capital gains of a trust estate through Subdiv 115-C ITAA 1997 (which comprises ss 115-200 to 115-230). That Subdivision applies if a trust estate has a net capital gain for an income year that is taken into account when working out the trust estate's net income (as defined in s 95 ITAA36) for the income year (s 115-210(1) ITAA97).

The provisions of Subdiv 115-C ITAA97 which are of particular relevance are set out below:

> "**115–215 Assessing presently entitled beneficiaries**
>
> *Purpose*
>
> (1) The purpose of this section is to ensure that appropriate amounts of the trust estate's net income attributable to the trust estate's capital gains are treated as a beneficiary's capital gains when assessing the beneficiary, so:
>
> (a) the beneficiary can apply capital losses against gains; and
>
> (b) the beneficiary can apply the appropriate discount percentage (if any) to gains.
>
> *Extra capital gains*
>
> (3) If you are a beneficiary of the trust estate, for each capital gain of the trust estate, Division 102[5] applies to you as if you had:
>
> (a) if the capital gain was not reduced under either step 3 of the method statement in subsection 102-5(1) (discount capital gains) or Subdivision 152-C (small business 50% reduction) — a capital gain equal to the amount mentioned in subsection 115-225(1); and
>
> (b) if the capital gain was reduced under either step 3 of the method statement or Subdivision 152-C but not both (even if it was further reduced by the other small business concessions) — a capital gain equal to twice the amount mentioned in subsection 115-225(1); and
>
> (c) if the capital gain was reduced under both step 3 of the method statement and Subdivision 152-C (even if it was further reduced by the other small business concessions) — a capital gain equal to 4 times the amount mentioned in subsection 115-225(1).
>
> …
>
> (4) For each capital gain of yours mentioned in paragraph (3)(b) or (c):
>
> (a) if the relevant trust gain was reduced under step 3 of the method statement in subsection 102-5(1) — Division 102 also applies to you as if your capital gain were a discount capital gain, if you are the kind of entity that can have a discount capital gain; and
>
> (b) if the relevant trust gain was reduced under Subdivision 152-C — the capital gain remaining after you apply step 3 of the method statement is reduced by 50%.
>
> Note: This ensures that your share of the trust estate's net capital gain is taxed as if it were a capital gain you made (assuming you made the same choices about cost bases including indexation as the trustee).
>
> (4A) To avoid doubt, subsection (3) treats you as having a capital gain for the purposes of Division 102, despite section 102-20[6].
>
> *Section 118–20 does not reduce extra capital gains*
>
> (5) To avoid doubt, section 118-20 does not reduce a capital gain that subsection (3) treats you as having for the purpose of applying Division 102."

"**115–220 Assessing trustees under section 98 of the Income Tax Assessment Act 1936**

(1) This section applies if:

(a) you are the trustee of the trust estate; and

(b) on the assumption that there is a share of the income of the trust to which a beneficiary of the trust is presently entitled, you would be liable to be assessed (and pay tax) under section 98 of the *Income Tax Assessment Act 1936* in relation to the trust estate in respect of the beneficiary.

(2) For each capital gain of the trust estate, increase the amount (the ***assessable amount***) in respect of which you are actually liable to be assessed (and pay tax) under section 98 of the *Income Tax Assessment Act 1936* in relation to the trust estate in respect of the beneficiary by:

(a) unless paragraph (b) applies — the amount mentioned in subsection 115-225(1) in relation to the beneficiary; or

(b) …

(3) To avoid doubt, increase the assessable amount under subsection (2) even if the assessable amount is nil."

"**115–225 Attributable gain**

(1) The amount is the product of:

(a) the amount of the capital gain remaining after applying steps 1 to 4 of the method statement in subsection 102-5(1); and

(b) your share of the capital gain (see section 115-227), divided by the amount of the capital gain.

…"

"**115–227 Share of a capital gain**

An entity that is a beneficiary or the trustee of a trust estate has a ***share*** of a capital gain that is the sum of:

(a) the amount of the capital gain to which the entity is specifically entitled; and

(b) if there is an amount of the capital gain to which no beneficiary of the trust estate is specifically entitled, and to which the trustee is not specifically entitled — that amount multiplied by the entity's adjusted Division 6 percentage of the income of the trust estate for the relevant income year."

The contentions

The applicant trustee's position was that the capital gains distributed to Alexander Greensill were capital gains "from a CGT event" which were to be disregarded by the operation of s 855-10(1) ITAA97. It was submitted that Alexander Greensill's "capital gains were from the happening of CGT events" to exempt assets, that is, assets that were not taxable Australian property. It followed, so it was contended, that there was no amount in respect of Alexander Greensill within s 115-220 ITAA97 on which the trustee was liable to be assessed under s 98 ITAA36.

As indicated above, the Commissioner's position was that Alexander Greensill was deemed to have made capital gains as a result of s 115-215(3) ITAA97. Those deemed capital gains were not disregarded under s 855-10 ITAA97 and Alexander Greensill was assessable on his net capital gain for each income year, the calculation of which would include those deemed capital gains. The Commissioner also contended that the trustee was liable for the tax that had been assessed to it as trustee, regardless of whether s 855-10 ITAA97 applied to disregard the capital gains deemed to have been made by Alexander Greensill.

The decision

In dismissing the appeals for each income year, Thawley J said that the application of the relevant ITAA36 and ITAA97 provisions to the facts were in summary as follows:[7]

"(1) The PGFC (as trustee of the PGFT) made a capital gain in each of the income years ended 30 June 2015, 30 June 2016 and 30 June 2017. This capital gain arose because CGT events happened with respect to PGFC's disposals of the shares. The net capital gain of the trust estate from the relevant CGT events was included in PGFC's assessable income (s 102-5 ITAA97) and in the calculation of its net income for the particular income year.

(2) Section 855-10(1) ITAA97 did not apply so as to disregard any of the trust estate's capital gains. First, the trust was not a foreign resident or the trustee of a foreign trust for CGT purposes (s 855-10(1)(a)). Secondly, the amount which s 115-220 ITAA97 required the trustee to be taxed on under s 98 ITAA36 was not a capital gain and could not fall within s 855-10(1). Section 115-220 ITAA97 requires an *amount* to be added to the assessment of a trustee under s 98 ITAA36, in part to facilitate recovery of tax in the case of non-resident beneficiaries. It was not a capital gain referred to in s 855-10(1) which was being added.

(3) Subdivision 115-C ITAA97 applied in relation to the trust estate's capital gains, because the trust estate had a net capital gain in each of the relevant income years, which was taken into account in working out the trust estate's net income (s 115-210(1); Div 6E ITAA36).

(4) Alexander Greensill, as a presently entitled beneficiary, was assessed under s 115-215 ITAA97. The purpose of that section 'is to ensure that appropriate amounts of the trust estate's net income attributable to the trust estate's capital gains are treated as a beneficiary's capital gains when assessing the beneficiary' so that the beneficiary can apply any available capital losses or discount percentage against those gains (s 115-215(1)).

(5) The amount of the capital gains that the beneficiary is 'treated' by s 115-215 as having is determined by reference to the calculation under s 115-225(1), headed 'Attributable gain'.

(6) The trustee was assessed under s 98 ITAA36 in accordance with s 115-220 ITAA97."

His Honour went on to say[8] that s 855-10(1) had no relevant application to the facts of the case. It did not operate to disregard any capital gain in the calculation of the amounts required to be calculated under ss 115-215 and 115-220 in Subdiv 115-C:

1. for Subdiv 115-C to apply to the PGFT at all, the PGFT must have a net capital gain, which required that it have capital gains that were not disregarded (s 115-210(1)). The opening words of s 115-220(2) refer to "each capital gain of the trust estate", in this case being a reference to each capital gain of the PGFT. Section 855-10(1) did not apply to disregard the capital gains of a resident trust estate;
2. s 855-10(1) does not operate to disregard the amount which is the product of any calculation made under

Subdiv 115-C. The amount calculated under s 115-220 is added to the assessment under s 98 ITAA36. It was not a capital gain as such to which s 855-10(1) could apply; and

3. an amount calculated under s 115-215 is not a capital gain from a CGT event. It is an amount which is calculated by reference to CGT events which occurred in respect of CGT assets of a trust.

Thawley J said, in relation to (1) and (2) above, that the trustee submitted that the reference in s 115-220(2) ITAA97 to "the amount mentioned in subsection 115-225(1) in relation to the beneficiary" meant Alexander Greensill's capital gain as disregarded by s 855-10 ITAA97. In answer, Thawley J said that the statutory language did not permit that conclusion. The "amount of the capital gain" referred to in s 115-225(1)(a) ITAA97 is the capital gain of the trust estate in relation to which the section applies. It is not a reference to any capital gain of the beneficiary. Section 115-225(1)(a), read with the s 102-5 method statement, allowed for the trust estate's capital gains to be reduced by its capital losses. This would not be achieved if s 115-225(1)(a) were understood as applying to capital gains and losses taken to have been made by the beneficiary.

Further, the reference to "your share of the capital gain" in s 115-225(1)(b) is a reference, inter alia, to "the amount of the capital gain to which the [beneficiary] is specifically entitled" (s 115-227(a)). The result of the calculation required by s 115-225(1) is simply an amount which the statute requires to be calculated. It is not a capital gain capable of being the subject of s 855-10(1).

His Honour said that the amount of "attributable gain" calculated under s 115-225(1) is used for the purposes of each of ss 115-215(3), 115-220(2) and 115-222(2) and (4). Each of those provisions uses the words "for each capital gain of the trust estate" and then refers to the amount mentioned in s 115-225(1). This confirms that "the capital gain" referred to in s 115-225(1)(a) is the capital gain of the trust estate. The function of s 115-225(1) is to apportion the capital gain of the trust estate among the trustee and beneficiaries of the trust estate according to their "share" as determined under s 115-227. That portion is then brought to tax under one of s 115-215, 115-220 or 115-222, as appropriate.

As to (3) above, his Honour said[9] that, under s 115-215, the beneficiary is deemed to have a capital gain notwithstanding that a CGT event did not happen to an asset of the beneficiary (s 115-215(4A)). The ultimate object of this deeming, and the provision as a whole, was to permit the beneficiary to apply against the deemed capital gain any capital loss or capital gains discount available to that beneficiary (s 115-215(1)).

Thawley J said that the amount of each of the beneficiary's deemed capital gains under s 115-215(3) is worked out by reference to the amount mentioned in s 115-225(1):[10]

> "(1) First, it is necessary to apply steps 1 to 4 of the s 102-5 method statement to the trust estate's capital gain. This involves reducing the trust estate's capital gain by the trust estate's capital losses and applying any discounts applicable to the trust estate. Section 115-225(1) then requires the beneficiary's share of that capital gain to be calculated under s 115-227.
>
> (2) Secondly, if there were reductions when applying the s 102-5 method statement — that is, if paragraph (b) or (c) of s 115-215(3) apply — it is necessary to 'gross up' the amount so calculated to reverse out any discounts that were taken into account when applying the s 102-5 method statement for the trust estate."

The resulting capital gain, treated by s 115-215(3) as a capital gain of the beneficiary, is then included in the calculation of the beneficiary's net capital gain under s 102-5. As mentioned, the express statutory point of this is to allow the beneficiary to apply his own capital losses and discounts (s 115-215(1)). The Commissioner correctly noted that the "gross up" provisions would not work properly if the capital gain in the trust estate's hands was disregarded by reason of s 855-10.

When providing for the beneficiary's deemed capital gains under s 115-215 to be reduced by the beneficiary's capital losses under s 102-5, the provision is consistent with the regime in Div 6 ITAA36. A beneficiary to whom s 97 or 98A(1) applies has an amount added to his assessable income, which may then be reduced by his allowable deductions. However, a trustee taxed under s 98 (because a presently entitled beneficiary is a non-resident) is to be assessed on the relevant share of the net income without any deduction (s 98(3)). Any discrepancy between the trustee's and the beneficiary's tax liability is addressed by the credit and refund to the beneficiary in s 98A(2).

"From" a CGT event

Thawley J said[11] that it was true that Alexander Greensill had capital gains attributed to him under Subdiv 115-C for the purpose of permitting him to apply any capital losses or discounts available to him. However, that is not a "capital gain … from a CGT event" within the meaning of s 855-10(1).

His Honour went on to say that the meaning of a connecting word such as "from" depends on the context in which the word is used. When used as a term to indicate a connection between two matters, "from" has been interpreted as meaning that there must be a causal connection between the matters.[12] The *Oxford English Dictionary* defines "from" as referring to an element of causation or derivation, defining "from" as denoting "derivation, source, descent" or "ground, reason, cause, or motive". His Honour went on:[13]

> "Causation plays a role, at the very least as a sine qua non in that there cannot be a capital gain without a CGT event, but causation is not the exclusive criterion by which the statutory question in s 855-10(1), whether a capital gain is 'from' a CGT event, is answered. The answer to the question involves an assessment of the degree of connection between the two subject matters for it to be said that one (the capital gain) is 'from' the other (a CGT event).
>
> The use of the word 'from' indicates, in this statutory context, a greater degree of connection between the relevant matters than phrases such as 'in relation to' or 'in respect of' which have been held to 'do no more … than signify the need for there to be some relationship or connection between two subject matters': *Australian Competition and Consumer Commission v Maritime Union of Australia* [2001] FCA 1549."

Thawley J concluded that the statutory context suggested that "from", when used in s 855-10(1) in the phrase "from a CGT event", should be understood as requiring a direct connection between the capital gain and the CGT event. It was not intended to apply to an amount which is "attributable to a CGT event" which occurred to another person, even where that other person is a trustee. Such an amount is not a capital gain "from" the event.

Later in his judgment, Thawley J said:[14]

> "Understood in context, s 855-10(1) indicates that the capital gain to be disregarded is that which is made by an entity immediately as a consequence of the happening of a CGT event; a capital gain which is attributed to a beneficiary, because of a CGT event happening to a CGT asset owned by a trust, was not intended to fall within the phrase 'a capital gain … from a CGT event'. The capital gain deemed to have been made by a beneficiary under s 115-215 of the ITAA 1997 is not a 'capital gain … from a CGT event' within s 855-10(1)."

His Honour noted that capital gains made by a beneficiary of a fixed trust might be disregarded under s 855-40 ITAA97. The language employed by that provision provided support for the understanding of s 855-10(1). It applies to a capital gain "you make in respect of your interest in a fixed trust" where, among other matters, the gain "is attributable to a CGT event happening to a CGT asset of a trust". This language was quite different to the language of s 855-10 which requires the capital gain to be "from" a CGT event. The note to s 855-40(2) indicates that the provision operates with respect to the capital gain taken to have been made by a beneficiary under s 115-215 ITAA97. Section 855-10, which does not contain such a note, operates differently and does not provide for the disregarding of capital gains attributed to the beneficiary of a non-fixed trust under Subdiv 115-C. That Div 855 should be understood, through the process of statutory construction, as having been intended to operate in this way was, in his Honour's view, supported by the legislative history and extrinsic material.

Observations

The decision of Thawley J in the *Peter Greensill Family Co Pty Ltd* case highlights the difficulties which the CGT provisions of the ITAA97 may give rise to as they apply to capital gains derived by a trust.

His Honour noted that s 855-10(1) ITAA97 would have applied if the beneficiary, rather than the trust, had owned and disposed of the shares, but the provision did not operate to disregard a capital gain of the trust attributed to the beneficiary under Subdiv 115-C ITAA97.

That the Commissioner took the position he did in the *Peter Greensill Family Co Pty Ltd* case is not surprising as it reflects views that he had expressed as far back as 2007 (see ID 2007/60). The Commissioner's views in ID 2007/60 are repeated in TD 2019/D6.

It is submitted that there may possibly be an argument that, on the facts of the case, the disregarding of a capital gain that is mandated by s 885-10(1) ITAA97 is of the capital gains made by the trust on the disposal of the shares so that there would be no capital gain that could be the subject of the provisions of Subdiv 115-C ITAA97. On this argument, the capital gains would be treated as any capital gain that is disregarded, for example, a capital gain that is made from the happening of CGT event A1 that is disregarded because the particular asset was acquired pre-CGT (s 104-10(5) ITAA97).

The total amount of the capital gains involved in the case was in excess of $58m and it is therefore likely that an appeal to the Full Federal Court will be taken. That likelihood has increased having regard to the fact that the trustee brought an interlocutory application several days after the judgment was handed down seeking the court to exercise its power to review and reconsider its orders made and the reasons for its decision. As noted earlier, that application was dismissed by Thawley J.

TaxCounsel Pty Ltd

References

1 [2020] FCA 559.

2 [2020] FCA 597.

3 CGT event E5 would have happened when Alexander Greensill became absolutely entitled.

4 See s 98(2A) and (3) ITAA36. Relevantly, under those provisions, the trustee is assessable on so much of the beneficiary's share of the net income of the trust estate as is attributable to a period when the beneficiary was not a resident and is also attributable to sources in Australia. Section 98A ITAA36 provides that, where a trustee is assessed as a result of the operation of s 98, the beneficiary is also to be assessed on a share of the net income, and the beneficiary receives a credit (and may receive a refund) to the extent that the trustee pays tax on the amount for which it is assessed as a result of the operation of s 98.

5 The heading to this Division is "Assessable income includes net capital gain".

6 Section 102-20 ITAA97 relevantly provides: "You can make a capital gain or capital loss if and only if a CGT event happens."

7 [2020] FCA 559 at [39].

8 [2020] FCA 559 at [40].

9 [2020] FCA 559 at [46].

10 [2020] FCA 559 at [47].

11 [2020] FCA 559 at [50].

12 *Deal v Father Pius Kodakkathanath* [2016] HCA 31.

13 [2020] FCA 559 at [52] and [53].

14 [2020] FCA 559 at [60].


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Tax Education

Study versus work: finding the balance

The Tax Institute's 2019 study period 3 CTA2A Advanced dux shares his views on the importance of study.

Elliot Gillard, Client Manager/Accountant, Devenny Payne Taxation & Business Services, Victoria

Can you provide a brief background of your career in tax?

I started with Devenny Payne as a graduate in 2013 after completing a Bachelor of Commerce at The University of Melbourne. From there, I completed the CPA Program in 2015. Devenny Payne is a public accounting practice with the majority of clients in the small to medium range. We enjoy working with and helping these clients to better understand and evaluate their long-term goals.

What is the most valuable aspect of studying CTA2A Advanced with the Institute?

The CTA2A Advanced course is good in that it reinforces many of the areas that we cover in public accounting. As some of the content goes into a lot of detail, some of which we do not see on a day-to-day basis, it is good to be able to flesh out the knowledge around the areas we do not work in extensively and to fully understand the logic behind some of the legislation.

What are your areas of new confidence?

The course helped to shore up my knowledge on the nuances and unintended consequences of trust distributions, especially with streaming.

What was the reason for undertaking CTA2A Advanced with the Institute?

I undertook CTA2A Advanced in order to build as much knowledge as possible while I am working. As accounting changes so rapidly, I believe that, as soon as you stop studying, you can become complacent and miss major changes that may affect clients.

Where to now for you when it comes to continuing tax education?

I am currently working through CTA2B Advanced. Once I have completed this course, I am looking at options for my tax agent licence. After that, I will look into financial planning to see if that would be a good value add for where I want to go next.

What are the challenges of juggling study and work?

I find that I need to stay disciplined and balanced to be able to manage work, study and my personal life. I have a set routine that I do for each subject to make sure I am where I need to be for each exam.

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

If you are going to commit to the CTA2A Advanced program, make sure you dedicate appropriate time so that your schedule allows you to work through the course systematically.

Member Profile

This month's column features Adrian Varrasso, ATI, from MinterEllison, Victoria.

Member since

2010

Areas of specialty

I work in general corporate tax, largely specialising in transactional work (M&A, restructuring, demergers and capital management), with particular experience in infrastructure, property, and mining and resources, which covers debt/equity, cross-border tax issues, tax consolidation, CGT and everything in between, including employment tax related matters. I prefer to describe my areas of specialty as everything other than GST and stamp duty.

Why are you a member of The Tax Institute?

Despite the fact that my membership lapsed for a few years as a younger tax lawyer (and hence my Associate status rather than Fellow status), it has been the key membership to accompany a profession in tax. The Institute is the leading body for tax education and a fantastic base from which one can connect with fellow tax professionals, stay on top of the most recent tax developments, and be trained at the brilliantly organised and structured tax workshops and seminars throughout the year. And, in recent times, I also enjoy reading Senior Tax Counsel Bob Deutsch's articles in *TaxVine*.

How is your membership beneficial to your practice and clients?

As mentioned, the training and updates on current tax reform (legislative, judicial and administrative) are instrumental to your ability to service your clients, as they expect that we are across all tax developments, which, given the volume of tax laws and the pace at which tax reform occurs, is quite an ask. But it is made achievable thanks to the support provided by being a member of The Tax Institute.

How did you end up in tax?

I satisfied my parents' wishes. No, seriously, they had no involvement. I did Commerce/Law at university and didn't want to be a lawyer. With an accounting major, I ended up in a Big 4 firm and had a choice of "tax" or "audit". Audit didn't sound very good. It was that simple. And to top it off, I became a lawyer.

What are the challenges for tax practitioners this year?

Oh, that's easy — one word, JobKeeper! What a nightmare.

Most memorable career moment to date

Clearly, being selected by a phenomenal panel (I don't say this just because they chose well, they're very, very impressive) as the 2020 Corporate Tax Adviser of the Year. The best moment was immediately after the announcement, when the most brilliant tax advisers in the country came up to congratulate me in person. I sort of got swamped by a few — they know who they are — they made it very special!

How do you relax?

Pre-isolation, I spent time outdoors, exercising, socialising and at children's birthday parties. In isolation, I find a quiet space and have some time alone on Netflix/Stan.

Advice to those entering the profession

Embrace it. Every research task and every ruling, case, explanatory memorandum you read will, in the long run, build into a very rewarding career. It is a very challenging area (it's not easy, there aren't many black and white answers, and the law and interpretation by judiciary and regulators change almost daily), which is what makes it special. You would be bored otherwise.

Origin: an electric shock

by Enzo Coia, CTA, Partner, Deloitte

The Federal Court recently decided the case of *Origin Energy Ltd v FCT (No. 2)*, with Thawley J handing down his judgment on 30 March 2020. The case concerned payments for the supply of electricity over a period of many years. The Commissioner was successful in arguing the payments were non-deductible on the basis they were capital in nature. The decision is consistent with recent tax cases that apply a pragmatic and purposive view of the facts rather than a literal interpretation of the legal agreements. Substance over form. The case also contains some helpful insights on the potential breadth (or lack of breadth) of s 40-880 of the *Income Tax Assessment Act 1997*, which allows deductions for certain business capital expenditure.

What happened?

Origin Energy Ltd v FCT (No. 2) was recently decided in the Federal Court by Thawley J.[1] Origin Energy Electricity Ltd (OEEL) and Eraring Energy entered into two agreements, called "GenTrader Agreements". Under these agreements, OEEL agreed to pay Eraring Energy substantial "capacity charges" for the supply of electricity. Under "deposit deeds", OEEL placed interest bearing deposits with the NSW Treasury. These represented the net present value of the annual capacity charges payable under the GenTrader Agreements for the term of those agreements, being 22 and 28 years.

What did the taxpayer say?

Origin Energy Ltd (Origin), the head company of the consolidated group of which OEEL was a member, contended that the capacity charges were deductible in each of the years of income in which those charges were incurred under s 8-1 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97). Origin submitted that, from a legal, practical and business perspective, the contractual framework between Eraring Energy and Origin was that of a long-term agreement for the supply of electricity by Eraring Energy to OEEL pursuant to which OEEL agreed to purchase essentially all of the generation of Eraring Energy's power plants, at the connection point between those power plants and the transmission system into the grid.

Origin also contended that, if the amounts were not deductible because they represented capital expenditure, the charges were deductible as "business capital" expenditure over five years under s 40-880 ITAA97.

What did the Commissioner say?

The Commissioner contended that the capacity charges were capital in nature and therefore not deductible because the advantage sought by incurring the expenditure was an extension of OEEL's profit-making structure, not simply the annual supply of electricity to OEEL for on-sale. The Commissioner submitted that OEEL bore risks which were inconsistent with the arrangements being classified as a long-term supply contract or analogous to OEEL's tolling arrangements. The Commissioner submitted that Origin acquired the ability to dictate the timing and extent of electricity generation, and thus acquired, in effect, a significant part of Eraring Energy's generation business.

The Commissioner also argued that the amounts were not deductible under s 40-880 as the expenditure was made in relation to a "legal or equitable right" or "could … be taken into account in working out the amount of a capital gain or capital loss".

What did the court say?

Thawley J held that the capacity charges were non-deductible under s 8-1 on the basis that the costs were capital in nature. His Honour also held that the expenditure was not deductible under s 40-880 and instead the capacity charges were properly taken into account under the capital gains tax regime.

Why the court held that the payments were non-deductible

The court found that there were several factors indicating that the expenditure was capital. These are set out principally in paras 87 and 88 of the judgment.

The character of the advantage: adding to the structure or long-term supply?

The court's key reason in finding the payments to be non-deductible was that the advantage sought by the expenditure was an acquisition of a new or extended profit-making structure. It was held that OEEL acquired the right to trade the entire output of the power stations for an extended period and to profit from that structure having regard to the various risks and opportunities acquired. OEEL's profit-making structure was significantly extended and altered for an extended term, with the ability to extend the term further. As such, the expenditure was not properly characterised as being merely for the yearly acquisition of electricity by OEEL for on-sale at a profit, even if that is a part of what was acquired by the expenditure. The court noted that this would oversimplify what the expenditure was for. In addition, such a characterisation fails to recognise that what OEEL sought to achieve by incurring the expenditure, as a matter of practical and business reality, was the acquisition of a business structure constituted by the right to trade the entire output of the power stations. Thawley J noted that, although the operation of the stations would be managed by the owner, OEEL had significant elements of control and in respect of which it bore risk and gained opportunities for profit.[2]

The court found that the overarching conclusion was supported by a consideration of the following matters:[3]

"(1) What had been Eraring Energy's trading business was handed over to OEEL.

(2) OEEL had substantial control over when and how much electricity was to be generated.

(3) Whilst the power stations were managed and operated by Eraring Energy, OEEL had some involvement in the management and operation of the power stations.

(4) The effect of the contractual arrangements was for OEEL to acquire a number of business risks and opportunities consistent with acquiring a new or extended business structure. These included:

(a) OEEL took over the obligation to supply or procure the supply of coal and fuel to the Eraring power station.

(b) OEEL could request capital improvements and bore the cost of the upgrade to the Eraring power station generating units.

(c) The fixed and variable charges were structured in a way which meant that OEEL bore some of the risk in relation to generation of electricity.

(d) OEEL took on some of the risks associated with a failure to generate electricity.

(e) OEEL took on the obligation to take out substantial levels of insurance, including industrial and special risks insurance to cover loss and damage to the power stations themselves and any consequential losses.

(5) Although the capacity charges were recurrent in form, OEEL paid the whole of them up-front, a matter relevant to the weight to be given to the consideration that recurrent expenditure is often an indicator of expenditure on revenue account.

(6) The lengthy terms of the GenTrader Agreements (approximately 22 and 28 years) and the provisions for extension and termination of the agreements were also consistent with a conclusion that the capacity charges were on capital account."

Origin submitted that the advantage from incurring the expenditure was to acquire electricity to on-sell it into the spot market, and not for the use or ownership of the means of production owned and operated by another. Origin submitted that OEEL "simply purchased electricity under a long-term agreement for sale in the course of its business".[4] It was said that the payment of capacity charges was not the payment of the purchase price of any asset acquired by OEEL or of any rights which comprised a new business.

Thawley J disagreed.

His Honour found that the expenditure was incurred to acquire a substantial extension to OEEL's profit-making structure or a new profit-making structure.[5] The practical business and legal consequence of the transactions was that OEEL acquired the right to trade the whole of the electricity generated by the power stations for 22 and 28 years. The contractual arrangements giving rise to that right were such that OEEL, through its trading activities, could control when and how much electricity was generated. OEEL also took on risks and opportunity with respect to Eraring Energy's generation activities. The court held that the totality of the arrangements gave rise to a new or an extended business structure for Origin, which substantially extended its previous operations.[5]

Once-off or periodic payment?

The court addressed the issue of the once-off nature of the payment as compared to the periodicity on which amounts would be released from the deposit. The court held that the expenditure was, as a matter of substance, "one-off". It said that, while the capacity charges were recurrent in form (usually an indicator that expenditure is on revenue account), the "fact is that OEEL paid all of the capacity charges for a period of 22 (Eraring) and 28 (Shoalhaven) years in advance", and it noted that even:[6]

"… if one looked past the fact that the capacity charges were all paid in advance, to the recurrent form of them, once 'expenditure can be truly characterized as the payment of consideration for a capital … advantage, it will be of a capital nature notwithstanding that the payments are recurrent': *Cliffs International Inc v Commissioner of Taxation* [1979] HCA 8; (1979) 142 CLR 140 at 156."

Was the capital expenditure deductible under s 40-880?

Having found that the expenditure was capital in nature, the court then turned to consider whether any amounts were deducible under the "business capital expenditure" provision s 40-880.

As far as relevant here, that section allows a deduction over five years for capital expenditure in relation to a taxpayer's business. However, a deduction is not available if certain disqualifying reasons are met in respect of the expenditure. Two relevant disqualifications are if the expenditure:

- is in relation to a lease or a legal or equitable right (s 40-880(5)(d)); or
- could be taken into account when working out a capital gain or loss (s 40-880(5)(f)).

The court noted that it was *not* intended that s 40-880(2) always provide a deduction simply because the particular expenditure could not otherwise be taken into account.[7]

The court went on to accept the view that that the phrase "other legal or equitable right" in s 40-880(5)(d) is apt to cover:[8]

"(1) various rights to use, or access, or exploit land, including a *profit-à-prendre*, a *profit-à-rendre* and easements;

(2) comparable rights in relation to tangible chattels, such as chattel leases, bailments and licences; and

(3) comparable rights in relation to choses in action, an example of which might be a licence to use intellectual property within a particular geographical area."

That is a potentially very broad range of cases which would result in non-deductibility under s 40-880.

The court tempered this by saying that whether or not s 40-880(5)(d) does cover such a right depends on the particular facts.

The court went further in noting that the exclusion might also apply in relation to a right where there is no particular underlying asset to which the right relates, such as a restrictive covenant or a franchise. Again, that reading is a potentially very restrictive reading of the scope of the section.

In conclusion, the court held that the GenTrader Agreements gave the taxpayer a bundle of contractual rights which amounted to a chose or choses in action, including what amounted in summary to the right on the part of OEEL to trade the entire output of the power stations for substantial terms of 22 and 28 years. As such, the rights acquired under the agreements fall within the concept of "other legal or equitable right".

The court also found that the capacity charges were paid "in respect of acquiring" Origin's rights in relation to directing the provision of the "contracted supply", and therefore would be "taken into account in working out the amount of" a capital gain or capital loss for the purposes of Pt 3-1 and Pt 3-3 ITAA97.

The contractual rights, including specifically the right to trade, for the contractual term, the generated output of the power stations, produced at the levels directed by OEEL, were CGT assets. It followed that the capacity charges are not deductible under s 40-880(2) because of s 40-880(5)(f).

> *"Origin acquired the right to trade the whole of the electricity generated by the power stations for 22 and 28 years."*

Continuing the trend of purposive findings

The decision in *Origin* adds to the list of cases which reinforce the need to take a purposive view when asking, "what's the payment really for?", in order to determine the tax reflex. Thawley J's judgment notes the primacy of that enquiry, where his Honour states:[9]

> "The answer to the question what the money is really 'for' is not necessarily answered solely by reference to a 'juristic classification of legal rights': *Hallstroms Pty Ltd v Federal Commissioner of Taxation* [1946] HCA 34; (1946) 72 CLR 634 at 648. The answer 'depends on what the outgoing is calculated to effect from a practical and business point of view': *Sharpcan* at [18]; *Hallstroms* at 648. The primary question is the character of the advantage sought by the taxpayer in incurring the expenditure: *GP International Pipecoaters Pty Ltd v Commissioner of Taxation* (1990) 170 CLR 124 at 137."

Very briefly, it seems that the way in which the decision in *Origin* was approached aligns with two recent cases. These are:

– *Healius*[10] (currently on appeal) in which a taxpayer owned medical centres where it provided premises and services to doctors. The taxpayer entered into agreements with over 500 doctors and paid them lump sums for their practices and for them to operate exclusively with it. The agreements suggested that the payments were for "goodwill"; the accounting treatment also reflected a goodwill characterisation. The Commissioner assessed the taxpayer on the basis that the lump sum outgoings were capital and not deductible. The taxpayer successfully argued that the lump sum payments were deductible as they were part of a process by which it operated to obtain regular returns by means of regular outlay. Consequently, the Federal Court (Perram J) found that, notwithstanding that the payments were described in the contracts as relating to goodwill, they were in fact payments to win a customer. The lump sums did not acquire something that was part of the profit-yielding structure. The payments were expenditures made to meet the taxpayer's continuous and recurrent struggle to enlist more doctors. As such, the court looked to the underlying commercial reality of the payments rather than their description in the legal agreements; and

– *Sharpcan*[11] in which the High Court unanimously found that payments relating to gaming machine entitlements were in fact payments for the entitlements which were assets of enduring value acquired as the means of production, necessary for the structure of the business, and a barrier to entry. The High Court therefore held that the purchase price, although paid in instalments, was in the nature of a once-and-for-all outgoing for the acquisition of a capital asset, and thus not deductible under s 8-1 ITAA97. The High Court also found that no deduction was available under s 40-880 on the basis that the payments could be taken into account when calculating a capital gain (which is also consistent with the finding in *Origin*).

Does Origin spark some clarity?

Origin and the cases referred to above highlight the importance of stepping back from the agreements and asking, "what's the payment really for?".[12] Of course, the answer is not as easy as the question.

It seems that, after many decades of jurisprudence, it is still far too difficult to discern whether a payment is for a revenue purpose or a capital purpose. For example, when does a payment turn from being made to acquire a revenue stream (and deductible, as in *Healius* and other cases such as *BP*[13] and *Tyco*[14]) compared to being paid to acquire a structure? The author is pleased to be in good company on the difficulty in coming to such answers. Professor Robert Deutsch recently noted[15] the continuing use of this troublesome, difficult and, at times, artificial distinction between revenue and capital and whether it is time to revisit the whole dichotomy.

In the same article, Professor Deutsch's conclusion is on point where notes:

> "There must be a better, simpler, yet equitable way to get the right outcome without all this seemingly endless debate and argument!"

In practice, how easy is it to know whether a periodic payment gives the taxpayer the structure with which to operate its business? Such a payment would suggest an analogy to the acquisition of a capital asset (such as in *Sharpcan*). In the alternative, when would periodic licence fees in respect of the ability to operate very long-term infrastructure assets be deductible as no capital asset was acquired (such as in *CityLink*[16])?

Reasonable people could form a view that *Origin* was really paying for long-term certainty of supply and that the payment terms provided surety to the counterparty.

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The views expressed in this article are those of the author and are not attributed to Deloitte. The material published in this article should not be used or treated as professional advice.

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Icing, spreads and tax avoidance purposes

by Tony Pane, Consultant, and
Nicholas Dodds, Associate, Thomson Geer

Various conceptions of purpose are fundamental to the tax laws in Australia. Consideration of purpose is either explicitly required, for example, when applying Pt IVA of the *Income Tax Assessment Act 1936* (Cth), or implicit when making some other decision, such as determining whether an amount is incurred in gaining or producing assessable income. Statutory provisions may also raise difficult questions of gradation of purposes for a particular transaction — must the relevant purpose be dominant? Principal? Or merely not incidental? These questions, however, are not unique to Australia. This article explores a recent United Kingdom case regarding the application of a statutory anti-avoidance rule in a cross-border intra-group transaction and the tribunal's approach to assessing the purpose of the transaction in that case, and offers relevant observations on purpose in an Australian context in light of the expanding number of domestic anti-avoidance provisions.

In a recent United Kingdom tax case, *Oxford Instruments UK 2013 Ltd v The Commissioners for Her Majesty's Revenue and Customs*[1] (*Oxford Instruments*), counsel for HMRC referred to the commercial advantage of the return, or spread, on a preference share investment made by Oxford Instruments UK 2013 Ltd (the taxpayer) as being merely "icing on the cake" in an arrangement entered into to secure tax deductions.[2] Counsel for the taxpayer argued that the tax deductions were an *effect*, not a *purpose*, of the arrangement, and the taxpayer had the purpose of earning the spread and, in common with its parent, the purpose of achieving United States refinancing and leverage objectives (US objectives).[3]

From time to time, taxpayers suggest that taxation advantages the subject of a particular dispute are merely "icing on a cake" or a "cherry on top" of a transaction, arguing that the taxation advantage was simply an incidental, albeit enhancing, benefit of an arrangement entered into with another purpose in mind.[4]

Unfortunately for the taxpayer, characterisation of the particular arrangements by the First-tier Tribunal, Tax Chamber,[5] as an optional extra step in this case led to the tribunal's finding, in agreement with HMRC, that the end in view was the generation of tax deductions, and the commercial advantage of the spread was a mere decoration or, more accurately, a means to achieving the tax deduction end.[6]

In this article, the authors explore the tribunal's approach to, and reasoning on, the identification of the end in view in *Oxford Instruments* and offer some observations on purpose as a criterion for the application of a recently expanded class of Australian anti-avoidance provisions.

Oxford Instruments: the ingredients

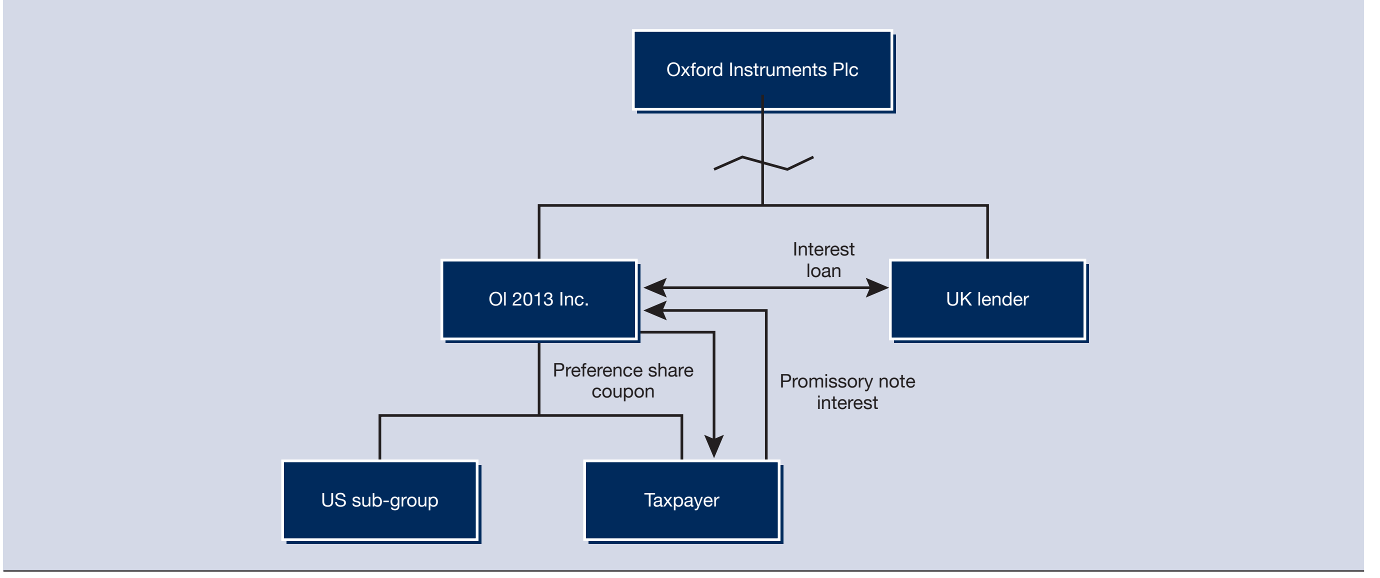
Oxford Instruments essentially involved cross-border debt arrangements within a corporate group that resulted in tax savings in a high tax "borrower" country (in this case, the US) with minimal consequential tax liability in the lower tax "lender" country (in this case, the UK). In large part, the cross-border debt arose from ownership restructuring, with just under 25% of the cross-border debt refinancing an earlier working capital loan provided to the US sub-group.[7] The 2013 cross-border loan arrangements (2013 arrangements) considered by the tribunal were largely the outcome of a tax planning exercise involving advice provided by Deloitte on optimal, tax-efficient refinancing options, with scope for additional leverage. For the purposes of this article, it is not necessary to outline the full factual context, nor to set out in detail all of the relevant UK and US tax rules/issues. The focus of the article is on the purpose criterion considered by the tribunal in respect of one element (step 8) of the 2013 arrangements.

Earlier elements or steps of the 2013 arrangements refinanced debt obligations of the US sub-group to a UK group member (UK lender) (US$60m in 2008 loan notes, issued as part of a 2008 internal recapitalisation, and a US$34m loan in 2009) and created new indebtedness associated with dropping a US shareholding held by another UK group member under a new US holding company (OI 2013 Inc.). These transactions resulted in cross-border debt of US$140m (2013 loan) owed by OI 2013 Inc. to the UK Lender, with a five-year term and an interest rate of 5.5%. The 2013 loan interest expense reduced the earnings and profits of the US sub-group and, given its circumstances, also reduced US tax payable. The differential between the US and UK corporate tax rates at the time and the group's tax attributes in those two jurisdictions generated a material net tax saving. Interest income from the 2008 loan notes and 2009 loan had been fully sheltered by tax losses in the UK group, which were by 2013 nearly exhausted.

The critical element of the 2013 arrangements (step 8) from a UK tax perspective involved the taxpayer subscribing for preference shares in OI 2013 Inc., with the subscription amount satisfied by the taxpayer issuing a US$140m promissory note. The step 8 transactions and the relevant scheme context are depicted in Diagram 1.

The preference share coupon or dividend rate was set at 8.1%, and the promissory note interest rate was 5.5%. It is the loan relationship established by the promissory note that gave rise to the taxpayer's UK tax deductions challenged by HMRC. The authors note in passing that, in order to obtain

Diagram 1. Step 8 transactions



an HMRC clearance under UK anti-arbitrage rules, the taxpayer had voluntarily disallowed 25% of the UK interest deduction.[8] The net UK tax effect of step 8 was to generate tax deductions used to partially offset interest income derived by the UK group on the 2013 loan. At that time, the UK group was projected to be out of tax losses by 2015. The preference share coupon was a non-taxable amount for the taxpayer, and the interest payable by the taxpayer to OI 2013 Inc. was not included in the US tax base because the taxpayer was treated as part of OI 2013 Inc. for US tax purposes, in what is now called a "hybrid mismatch".

The question before the tribunal was whether the taxpayer's promissory note had "an unallowable purpose" under s 441 of the UK *Corporation Tax Act 2009* (CTA09); if so, any debit (the UK equivalent to a deduction in Australian tax law) arising from the promissory note was not to be brought into account.

Section 442 CTA09 defines "unallowable purpose" and, in broad terms, provides that a loan relationship has an unallowable purpose if the purposes for which the company is a party to the relationship, or enters into related transactions, include a purpose ("the unallowable purpose") which is not among the business or other commercial purposes of the company. However, s 442(4) recognises that a purpose of securing a tax advantage for the company or another person (defined as a "tax avoidance purpose") will only be regarded as a business or other commercial purpose if it is not *the main* purpose, or *one of the main* purposes, for the relevant person being a party to the relevant loan relationship (the promissory note).

In a nutshell, the tribunal had to consider the purpose or, if applicable, the purposes of the taxpayer for issuing the promissory note. The finding of an unallowable purpose has the consequence that deductions attributable thereto are not allowable for UK tax purposes.

The above oversimplifies the UK statutory context and the issues before the tribunal, but it provides sufficient context for the analysis which follows.

Section 442 CTA09: purpose test recipe

The tribunal's analysis commenced with the uncontested proposition that the purpose test in this context, in contrast to the objective assessment of purpose contemplated by Australia's general anti-avoidance rules, "involves a question of fact to be determined by reference to the subjective purpose of the [taxpayer]"[9] for issuing the promissory note. The tribunal noted that the taxpayer, being a corporate entity, is to be attributed the purpose of the directors responsible for its governance.[10] One of these directors, Mr Boyd, provided testimony before the tribunal about his intentions (and those of his fellow directors) at the time. Resolutions passed by the taxpayer's board of directors also evidenced those intentions.[11]

The tribunal found that the issue of the promissory note was part of a scheme implemented by the taxpayer's ultimate parent (Oxford Instruments Plc (OI Plc)) following advice (including design work) from Deloitte in order to achieve the US objectives. The promissory note (and the rest of step 8) was not required to achieve the US objectives, but it did seek to mitigate the UK tax impact resulting from the earlier scheme steps. The tribunal identified this UK tax objective as a secondary, and, critically, commercially optional objective of OI Plc.[12] The tribunal found that, while the objectives of the broader scheme and the Deloitte advice informed the intentions of the taxpayer's directors, there had been no abdication of fiduciary duties by the taxpayer's directors to the board of OI Plc or to Deloitte.[13]

At the relevant time, the taxpayer's directors had only recently taken office because the taxpayer had been established to play its designated role in the broader scheme (ie step 8). As noted above, that scheme was designed and implemented for OI Plc to achieve the US objectives at minimal consequential UK tax cost. It was not a scheme entered into to avoid or reduce a UK tax liability that, absent the scheme, was to be encountered. Further, the UK tax outcome resulting from step 8 of the scheme seems to simply be the product of deductions being allowed for costs incurred when making an investment that generates a commercial profit or spread.[14] The directors' resolution approving the preference share investment and the issue of the promissory note referred to commercial objectives of the scheme, including the US objectives and the spread to be earned on the preference share investment.[15] There was no express reference to mitigating UK tax costs otherwise resulting from the earlier scheme steps.

From the evidence provided by Mr Boyd (who was also OI Plc's group finance director), the tribunal had information before it concerning: the planning leading up to the formulation and implementation of the scheme (including details of an alternative scheme); the limited business role of the taxpayer; and tax law changes which led to the premature unwinding of the scheme in 2014 (used to affirm the findings made in respect of contemporaneous information).[16] This factual background informed the findings about the intentions of the taxpayer's directors and, therefore, of the taxpayer.

When looking at the intentions of the taxpayer's directors for issuing the promissory note to acquire the preference shares, the tribunal found:[17]

1. OI Plc had two main purposes[18] for the implementation of the scheme, the first and most significant[19] being the achievement of the US objectives, and the second being the mitigation of the consequential UK tax consequences. Absent that second purpose, OI Plc would not have incorporated the taxpayer, and step 8 would not have occurred;
2. the taxpayer's directors considered the approval of step 8 knowing that it was necessary to achieve OI Plc's second main purpose after the achievement of the first main purpose. The US objectives had been achieved by earlier steps and did not explain why step 8 was approved;
3. the commerciality of the preference share investment decision, including the issue of the promissory note, was "built in" to step 8, or an "inevitable effect or known consequence" of step 8.[20] Accordingly, while it may have been important for the taxpayer's directors to be satisfied that the preference share investment stacked up commercially, it did not explain why they were approving the step 8 transactions. The tribunal concluded that the commercial profit generated by the preference share investment "was simply the means to justify the existence of the transactions which [the taxpayer] needed to implement in order to achieve its sole purpose".[21] Put another way, the achievement of that profit was not "a self-standing purpose in its own right"[22] or, in yet another way, the commercial spread could not have been the end that the taxpayer had in view when it issued the promissory note because it "was simply an inherent immutable part of the package which was being offered to the directors … as a means of securing the tax advantage to which that package was expected to give rise and which the directors could either take or leave";[23] and
4. having concluded that the US objectives and the spread to be achieved on the preference shares were not purposes of the taxpayer's directors, the only logical conclusion was that the sole purpose of the taxpayer with respect to the promissory note "was to play the role that had been allotted to it in the Scheme as a whole — namely, to generate, before taking into account the [voluntary 25% disallowance], the deductions needed to match the incremental net taxable income"[24] that a UK group company was to earn as a result of the first seven steps of the scheme.

The taxpayer's interest obligation under the promissory note offset in full the interest income to the UK group under the 2013 loan, with the UK group to receive an overall net amount equal to the gross dividends (or coupon) on the preference shares plus any dividends that may be declared on the ordinary shares in OI 2013 Inc., the holding company for the US sub-group. However, the offsetting interest amounts (before the voluntary disallowance) from a UK tax perspective did not have a US reflex because, from a US tax perspective, there is only an interest expense. This hybrid outcome (ie US non-recognition of the preference shares and promissory note) explained the scheme and the conclusion that the alleged commercial outcomes were merely the means to the challenged UK tax end. The tribunal's findings essentially acknowledge that everyone involved, including the taxpayer's directors, were on the same page working to achieve a common purpose, which included as a *main* element the UK tax deductions.

"… the spread was 'an inevitable known consequence' of step 8, but not the end in sight."

There was no evidence to suggest that the taxpayer was pursuing any broader investment activity or that there were any actual funds to invest. The taxpayer simply became indebted to its parent company in order to acquire preference shares in that company. Any net return received by the taxpayer was to the ultimate benefit of the parent company, and on the premature unwind of the arrangements, the taxpayer paid a dividend to its parent company equal to the net return. There was no commercial substance to step 8, apart from the expected taxation outcomes.

Without step 8, the scheme can be said to have achieved global tax efficiency by shifting taxable income from the US sub-group to the UK group where, in the short term, there were tax losses and, in the longer term, an expectation that UK tax rates would continue to be materially lower than US tax rates. Such an outcome would not have engaged s 441 CTA09. However, it was open to the tribunal to find that the taxpayer had a main tax avoidance (or unallowable) purpose under that section for step 8, and to describe the spread as "an inevitable known consequence (or effect)"[25] of that step, but not the end in sight.

Observations on purpose in Australia

Various conceptions of purpose are fundamental to the tax laws in Australia. Consideration of purpose is either an explicit necessity, such as when deciding on the application of Pt IVA of the *Income Tax Assessment Act 1936* (Cth) (ITAA36),[26] or implicit when making some other decision about the end to which an action is directed, such as whether an amount is incurred in gaining or producing assessable income.[27] Statutory provisions also raise difficult questions of gradation of purposes for a particular transaction: the purpose may have to be the dominant purpose,[28] a principal purpose,[29] or a main purpose,[30] or simply a not incidental purpose;[31] and it may be the purpose of those who participate in the transaction, or the purpose of the transaction itself, which is relevant in a particular case.

While *Oxford Instruments* dealt with the question of purpose in the context of an anti-avoidance rule with significant differences to those found in Australia, there are nonetheless parallels in the reasoning processes of the tribunal in *Oxford Instruments* and of Australian courts dealing with questions of purpose in anti-avoidance provisions which are worthy of note.

For example, many of the factors considered by the tribunal to be relevant when determining the issues of purpose in *Oxford Instruments* are also referred to in the recently released draft ATO guidance on the administration of general anti-abuse rules (such as the principal or main purpose tests included in Australia's tax treaties) in PS LA 2019/D2. PS LA 2019/D2 offers a lengthy list of questions that may be relevant to allow an ATO officer to understand and consider the objective purposes of an arrangement under review in order to apply those rules, such as:

- What is the broader business context in which the arrangement has been implemented?
- What are the objective effects of the arrangement? That is, what are the results which it produces or is capable of producing?
- How does the arrangement go about achieving its results?
- What do the terms and circumstances of the arrangement indicate about the characteristics of the arrangement and the results it was intended to produce?
- Is there an alternative way that the non-tax objectives of the arrangement could be achieved?
- Is the arrangement more complex or does it contain more steps than is necessary to achieve the non-tax objectives? For example, is there a more convenient, commercial or cost-effective way of achieving the same non-tax objectives?
- What are the non-tax benefits and drivers for establishing each of the relevant entities in each relevant jurisdiction?
- Is the role of any entity in the arrangement explicable solely or principally by tax reasons or for obtaining the relevant benefit?
- Is there a discrepancy between the substance of what is being achieved under the arrangement and the legal form it takes?
- What are the functions, assets and risks of each entity in the arrangement? Does each entity possess the necessary competencies and capacity to manage its functions, assets and risks?

Each of those questions, in one way or another, was considered and answered by the tribunal in *Oxford Instruments* in the course of determining the purpose of the arrangements.

In *Mills v FCT*,[32] Gageler J, with whom the rest of the High Court bench agreed, noted with respect to s 177EA ITAA36 that "[a] purpose is a consequence intended by a person to result from some action".[33] The spread on the preference share investment was an intended consequence of step 8. No doubt, even if the tribunal had recognised this purpose, it would not have regarded it as a *main* purpose of the taxpayer because it was merely a means to another end. While the taxpayer in *Oxford Instruments* sought to place emphasis on the spread and the US objectives, the tribunal was required to reach its own conclusion about the main purposes of the taxpayer, and recognition of the achievement of the spread as a purpose in its own right would not have changed its conclusion.[34]

The tribunal did not need to consider the relative importance which the parties argued ought to be given to the different purposes in order to determine whether the tax avoidance purpose was a main purpose, given its conclusion that step 8 had a sole tax avoidance purpose. The tax advantage in *Oxford Instruments* was not, for example, "subordinate to or in subsidiary conjunction"[35] with the commercial purposes of the scheme, in contrast to the franking credits in the issue of the PERLS V securities in *Mills*. In that case, there was no other way that the Commonwealth Bank could raise tier 1 capital without franking distributions to the same extent,[36] which was relevant for the assessment of purpose conducted via s 177EA of Pt IVA ITAA36.

That said, the tribunal did at one point refer to the overall scheme having a sole purpose comprising two parts,[37] and at other points referred to each of those purposes being a main purpose, with the US objectives being the paramount purpose.[38] That, however, is consistent with the comments of the High Court in cases such as *Spotless*,[39] *Consolidated Press Holdings*[40] and *Hart*[41] in a Pt IVA context that, although there was an ultimate economic or commercial purpose of each of the schemes considered in those decisions, that does not, and did not in those cases, preclude the conclusion that there is a dominant purpose of enabling a taxpayer to obtain a tax benefit. The point is expressed pithily by Gleeson CJ in the course of argument in *Hart* in 2003:[42]

> "… all these are just different ways of expressing the one basic proposition, which is, you say there is an ordinary way of going about this and there is an extraordinary way of going about it, and the difference between the ordinary way and the extraordinary way is nothing more and nothing less than the tax benefits that attach to the second alternative."

Given the conclusion in *Oxford Instruments* that step 8 was an optional extra, or an "extraordinary way" of achieving the US objectives, the rationale for step 8 is to be found elsewhere, that is, the real UK tax benefits, rather than the decorative commercial spread. Similarly, in *Orica Ltd v FCT*, the court pointed out that:[43]

> "It may be accepted that the motivation of the people concerned was to utilise the US tax losses by rebooking of the losses through an arrangement which provided virtual certainty of the American subsidiary being able to utilise the tax losses, but their motivation was achieved by schemes with their dominant purpose of the taxpayer getting scheme benefits. *The scheme benefit was the dominant purpose because without it the schemes made no sense*. The relevant entities, through Mr Muculj in particular, entered into the transactions only to generate accounting profits which impacted the group's net profit through the tax deductions which the schemes were necessarily contemplated, and designed, to obtain." (emphasis added)

In view of the similarities in the approaches to identification of purpose, the outcome in *Oxford Instruments* is not surprising, and the taxpayer did not appeal the tribunal's decision. There is, however, a lesson to be learned from *Oxford Instruments* by advisers and participants in such schemes in any jurisdiction that, in an increasing number of statutory contexts, one must ask: what is it that drives this transaction? If it is truly a tax outcome, then, viewed through the lens of an anti-avoidance rule, that outcome will prevail despite the commercial icing.

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8 *Oxford Instruments* at [29].
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10 *Oxford Instruments* at [99].
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15 *Oxford Instruments* at [60(8)].
16 *Oxford Instruments* at [60].
17 *Oxford Instruments* at [104].
18 Note reference to "sole" in [104(2)].
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Discretionary trusts, non-TAP gains, and foreign beneficiaries

by Adam Crowley, ATI, Partner, RSM Australia

The Australian tax system differentiates between residents and non-residents. In the context of fairness, those who contribute to the system should also benefit from the system. As non-residents are typically unable to benefit from government spending in the same way as residents, many would consider it only fair that these individuals are not subject to the same scope of taxation as those who reside in Australia. With this in mind, parliament introduced Div 855 ITAA97. The effect of Div 855 is relatively simple. It seeks to narrow the range of assets that are subject to Australian capital gains tax for foreign residents. While the intent of the provisions is apparent, that is, foreign residents should not be subject to Australian tax on non-taxable Australian property (TAP) assets, the complexity arises where a foreign resident receives a distribution of a non-TAP capital gain via a resident discretionary trust.

Introduction

The foundations of a sound tax system are built on the notions of efficiency, equity and simplicity.[1] Put simply, this means that the tax system should minimise distortion, apply fairly, and be clear and concise in its application.[2]

While determining "fairness" may be subjective, in the context of the Australian tax system, it is generally accepted that "fairness" occurs when individuals in similar circumstances are taxed similarly.[2] It seems to therefore follow that it would also be "unfair" to impose the same scope of taxation on those in different circumstances.

For this reason (in part), the Australian tax system differentiates between residents and non-residents. In the context of fairness, those who contribute to the system should also benefit from the system. As non-residents are typically unable to benefit from government spending in the same way as residents,[3] it is only *fair* that these individuals are not subject to the same scope of taxation as those who reside in Australia.

With this in mind, and a desire to encourage investment in Australia and better align with OECD standards,[4] the parliament repealed former Div 136 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) and introduced Div 855 ITAA97. The effect of Div 855 is relatively simple. It seeks to narrow the range of assets that are subject to Australian capital gains tax for foreign residents.[4]

While the Division seemingly achieves its desired effect for CGT assets held directly, or indirectly via fixed trusts, it falls apart where discretionary trusts are concerned.

The discussion that follows considers the notion of fairness when applying Div 855 in the context of discretionary trusts. To this end, first, it outlines the form of the relevant provisions and their interaction. Second, it considers the applicable case law, recent ATO determinations, and critiques from the profession. Finally, it seeks to demonstrate that what otherwise appears unfair is, in effect, necessary to protect the integrity of the Australian tax system.

CGT and trusts

Division 855 ITAA97

Division 855 provides that a foreign resident's liability for CGT is determined by whether the relevant asset is "taxable Australian property" (TAP) (s 855-15 ITAA97). Broadly, TAP assets are defined to include direct interests,[5] or indirect[6] non-portfolio interests,[7] in real property situated in Australia,[8] assets used in carrying on business through a permanent establishment in Australia,[9] options or rights in the abovementioned,[10] or assets elected to be TAP[11] to defer a capital gain under CGT event I1.[12]

The substantive provisions that mitigate CGT for foreign residents are ss 855-10 and 855-40 ITAA97. Section 855-10 states that foreign residents can disregard a capital gain or loss from a CGT event that happens in relation to a CGT asset that is *not* TAP (non-TAP). Similarly, s 855-40 provides that a foreign resident can disregard a non-TAP gain made through a "fixed trust".[13] In effect, s 855-40(1) seeks to provide comparable taxation treatment to foreign residents as between direct and indirect ownership of non-TAP assets.

While the intent of the provisions is apparent, that is, foreign residents should not be subject to Australian tax on non-TAP assets, the complexity arises where a foreign resident receives a distribution of a non-TAP capital gain via a resident discretionary trust.[14]

Division 6 ITAA36

Under s 95 of the *Income Tax Assessment Act 1936* (Cth) (ITAA36), the net income[15] of a trust estate is calculated as if the trustee were an Australian resident taxpayer. This requires the trust to include income from sources both inside and outside of Australia (s 6-5(2) ITAA97). Where a foreign resident beneficiary has been made "presently entitled"[16] to a share of the trust's net income, the taxation of the beneficiaries' share (or the trustee on the beneficiaries' behalf) is typically administered by ss 97 and 98 ITAA36.

Under these provisions, the assessable income is limited to so much of the share of the trust net income as is attributable to a period when:

– the beneficiary *was* a resident;[17] and
– the beneficiary *was not* a resident and is also attributed to *sources* in Australia.[18]

One anomaly that arises is that, while foreign residents owning assets *directly* are only subject to tax if the asset is "TAP" (s 855-15), those same foreign residents, if made presently entitled to net income (including a net capital gain) via a discretionary trust, would otherwise be taxed by reference to the "source" of the gain if it were not for Div 6E ITAA36 (discussed below). Unfortunately, the CGT rules do not contain any provisions that expressly determine the source, and the TAP tests in Div 855 are said to not be relevant for this purpose.[19] Thus, case law principles of source being a "practical hard matter of fact"[20] will apply.

To evidence the perceived unfairness of this anomaly, should a foreign resident individual directly hold a portfolio interest of ASX listed shares, as the shares are non-TAP, the foreign resident will not be subject to tax under Div 855.[21] Conversely, as the "source" of a gain in relation to shares is typically where the shares are held and the contract for sale entered,[22] if not for the application of Subdiv 115-C and Div 6E (discussed below), should a foreign resident be made presently entitled to the same gain via a discretionary trust, the gain would be subject to tax as being Australian-sourced.

Subdivision 115-C ITAA97 and Div 6E ITAA36

Overlaying the above interaction between capital gains and trust income are "interim measures" introduced in 2010-11 within Subdiv 115-C ITAA97. The practical effect of the Subdivision is to gross-up net capital gains that have been discounted in the hands of the trustee,[23] and to attribute to the grossed-up gain to the beneficiary.[24] Attribution is done first by reference to a beneficiaries' "specific entitlement" to the gain (streaming),[25] and second by reference to the beneficiaries' "present entitlement" to any gain remaining after that.[26]

To avoid double taxation for the beneficiary,[27] Div 6E ITAA36 will apply to adjust the amount assessable to the beneficiary under Div 6 by the amount of the attributable gain under Subdiv 115-C.[28]

Given the removal of the capital gain under Div 6 and its attribution under Subdiv 115-C, when determining whether a capital gain is taxable, either in the hands of a foreign beneficiary or the trustee on their behalf, confusion arises as to whether "non-TAP status" and/or "source" become relevant. If nothing else, complexity ensues.

Case law and the ATO

Oswal

The Commissioner's views on the interaction of the abovementioned provisions first gained notoriety in *Radhika Pankaj Oswal v FCT* (the *Oswal* case).[29] As far as is relevant, the *Oswal* case concerned a resident discretionary trust that made a capital gain in relation to non-TAP shares held in an Australian company.[29] The trustee made Mrs Oswal presently entitled to the net income of the trust estate (which included the gain) and, as at the relevant time Mrs Oswal was a temporary resident, she was arguably afforded foreign resident treatment under the exemption in s 768-915(1)) ITAA97.

As a *foreign resident*[30] presently entitled to a non-TAP capital gain, Mrs Oswal argued, consistent with policy intentions, that s 855-10(1) ITAA97 applied to disregard the capital gain.

Despite accepting that the gain would have been disregarded if the shares were held by Mrs Oswal directly,[31] the Commissioner advanced two arguments against the taxpayer:

1. that Mrs Oswal did not "make a capital gain … from a CGT event", but rather the trustee had the CGT event, and Mrs Oswal's capital gain arose from the attribution under the gross-up rules within s 115-215 ITAA97; and
2. that Div 855 provides absolutely no relief to a beneficiary of a resident *discretionary* trust.[32] That is, s 855-10 does not apply to beneficiaries,[33] and relief for beneficiaries under s 855-40 only applies to *fixed* trusts.

Beyond the obvious "why should it matter if the gain was made directly or indirectly", the most compelling critiques of the Commissioner's arguments are as follows:

– there is nothing in s 855-10 that states a gain must arise from a CGT event that happens *to the taxpayer*.[32] That is, the Commissioner is reading words into the legislation that do not exist;
– s 102-20 ITAA97 explicitly provides that "*you* may make a capital gain … as a result of a CGT event happening to another entity";
– capital gains can only arise *from* CGT events. To the extent that s 115-215 attributed a gain, it merely deemed the beneficiary to have had the relevant CGT event;[32] and
– there is nothing in the language in s 855-10 that excludes beneficiaries from its application.[32]

Unfortunately, as the *Oswal* case was settled before judgment, the above interpretations are left unresolved. Fortunately, we did not have to wait too long for guidance.

Greensill

In a recent decision from the Federal Court in *Peter Greensill Family Co Pty Ltd (trustee) v FCT* (the *Greensill* case),[34] similar issues to *Oswal* were contested.

In the *Greensill* case, the Commissioner assessed the trustee of a discretionary trust under s 98 in relation to $58m of capital gains that it made over a three-year period on the disposal of shares which were not "taxable Australian property". In each year, the trustee resolved to distribute 100% of the capital gains from the sale of those shares to Mr Alexander Greensill, a foreign resident.

Following an ATO review, the Commissioner issued assessments to the trustee under s 98 on the basis that the capital gains distributed to Mr Greensill, being deemed or attributable capital gains under Subdiv 115-C, were assessable to the trustee and not disregarded under Div 855.

The taxpayer contended that the capital gains distributed to Mr Greensill were capital gains "from a CGT event" which were to be disregarded by operation of s 855-10(1). It was submitted that Mr Greensill's capital gains were from the happening of CGT events to exempt assets, and that there was no amount, in respect of Mr Greensill within s 115-220, on which the trustee was liable to be assessed under s 98.

In response, the Commissioner contended that Mr Greensill was deemed to have made capital gains as a result of s 115-215(3), and that those deemed capital gains were not disregarded under s 855-10. As such, Mr Greensill was assessable on his net capital gain for each income year. The Commissioner also contended that the trustee was liable for the tax that had been assessed to it as trustee, regardless of whether s 855-10 applied to disregard the capital gains deemed to have been made by Mr Greensill.

In finding in favour of the Commissioner, Thawley J held that:

- s 855-10(1) did not apply to disregard any of the trust's capital gains as the trust was neither a foreign resident nor a trustee of a foreign trust; and
- the amount which s 115-220 required the trustee to be taxed on under s 98 is an "attributable gain", being simply an amount which the statute requires to be calculated, and is not a capital gain capable of being the subject of s 855-10(1).

In relation to Mr Greensill:

- Mr Greensill, as a presently entitled beneficiary, was assessed under s 115-215; and
- an attributable gain calculated under s 115-215 is not a capital gain *from* a CGT event within the meaning of s 855-10(1). It is an amount which is calculated by reference to CGT events which occurred in respect of CGT assets of a trust.

While much of the taxpayers arguments proceeded upon an assumption that the policy objective of Div 855 was the non-taxation of foreign beneficiaries in respect of non-TAP capital gains, Thawley J was quick to point out that the purpose of the legislation is to be derived from what the legislation says, not from an *a priori* assumption about the desired or desirable operation of the provisions.

While the court has sided with the Commissioner, only time will tell if the decision was the correct one. Given the tax liability involved, one can only assume that an appeal to the Full Federal Court is likely.

Draft tax determinations

Unsurprisingly, the Commissioner's view in TD 2019/D6 is that foreign beneficiaries of a resident discretionary trust that are presently (or specifically) entitled to non-TAP gains are assessable in Australia on those gains.[35]

The arguments advanced in support are principally the same as those in *Oswal* and *Greensill*, ie that, primarily, a capital gain that a foreign resident beneficiary makes because of the operation of s 115-215(3) ITAA97 is not a capital gain *from* a CGT event that happens to the beneficiary; instead, such an event happens to the trustee.[36] The ATO reasons that, while s 855-10(1) does not expressly provide that the relevant CGT event must happen "to" the foreign resident, this is an inference which may be drawn from the statutory context.[36] This statutory context seems to be the mere existence of s 855-40. In other words, if s 855-10 is sufficient to exclude foreign beneficiaries from tax, why did the drafters feel it necessary to include s 855-40?

The ATO then doubled down on its position in TD 2019/D7,[36] claiming that a foreign beneficiary of a discretionary trust is assessable on non-TAP capital gains, irrespective of whether the gain has an Australian *source* or not.[37]

The combined result of TD 2019/D6 and TD 2019/D7 is the ATO disregarding both "non-TAP status" and "source" to impose tax on foreign beneficiaries of discretionary trusts. At this point, it seems that "fairness" as we understand it vanishes.

The ATO's position has been heavily criticised by practitioners, academics and professional associations. Grouped into areas of "policy" and "technical application", the criticism is summarised below.

Policy

Professional associations have labelled the ATO's interpretation as "unsustainable,"[38] "inconsistent with basic international taxation principles",[39] not "aligned with the overarching policy of the trust tax provisions",[39] and "not a suitable outcome from a policy perspective".[39]

Academics have described TD 2019/D6 as "[t]he ATO simply read[ing] the ambiguous language of a small number of provisions to produce a revenue maximising result without regard to underlying policy", and TD 2019/D7 as "just highlight[ing] how confusing the legislation is without advancing any particular reason for the ATO's preferred analysis".[40]

Despite numerous changes to legislation surrounding the taxation of trusts over the years, the policy intent has remained consistent, that is, the "conduit treatment" of trust income. This treatment effectively requires that a beneficiary should be taxed the same as if they had held the asset or derived the income directly.[39]

While the intended policy behind Div 855 was to "narrow the range of assets on which foreign residents will be liable to Australian CGT",[41] the ATO's interpretation does the opposite.[42]

The ATO has misinterpreted the policy intention of s 115-215. That policy intention is to allow streaming, and not to create a dichotomy between gains from CGT events and gains *from* attribution.[39]

Technical application

The ATO has effectively read words into s 855-10(1) that do not exist (being that nothing expressly excludes beneficiaries).[43]

Although the ATO considers that non-TAP and foreign-sourced capital gains should be caught by Subdiv 115-C and subject to tax, if the same foreign gain were on revenue account, it appears that the gain would not be subject to tax under s 98 ITAA36.[40]

As a matter of proper statutory interpretation, s 6-10 ITAA97 applies to modify Subdiv 115-C when determining how capital gains will be taxed. Although s 6-10(5)(b) provides that a foreign resident's assessable income includes statutory income "on some *basis* other than having an Australian source", it is argued that Subdiv 115-C does not provide a relevant "basis" for including the gain, and, as such, the source limitation in s 6-10(5)(a) applies to restrict the gain from being included in the foreign resident's assessable income.[44]

Finally, Professor Richard Vann has stated that "[i]t is a mystery why the ATO continues to be unwilling to use the various means at its disposal to reach the sensible interpretive and policy outcomes, but instead creates more and more unintended consequences in relation to trusts and CGT".[41]

> *"... it is time for the long-awaited reform of trust taxation ..."*

Why?

To unravel the mystery, in the author's opinion, the ATO's position is not grounded in policy nor proper statutory interpretation. Instead, it is an attempt to protect the integrity of the tax system from avoidance due to the inadequacy of existing provisions within the tax legislation.

CGT events I1 and I2

When an individual, a company or a trust ceases to be a resident,[45] CGT events I1 or I2 will occur. Broadly, the consequence is that the taxpayer is deemed to have disposed of all of its post-CGT assets at the time it ceases to be a resident, with the exception of assets that are TAP, ie assets that remain taxable in Australia irrespective of residency.[46] The capital gain or loss that occurs is determined by reference to the cost base (or reduced cost base) of the asset and its market value at the time of the CGT event.[47]

The effect of these provisions is to capture capital gains that have accrued to taxpayers while they are Australian tax residents. Without CGT events I1 and I2, taxpayers may simply avoid tax in Australia by changing residence and subsequently realising gains on the disposal of non-TAP assets, relying on Div 855 to exclude the assets from taxation.

One issue with CGT events I1 and I2 is that they only apply in relation to CGT assets held by the taxpayer just before the time of cessation.[47] Where a taxpayer owns a non-TAP asset directly, CGT events I1 and I2 apply without issue. Where a taxpayer owns a non-TAP asset indirectly via an interest in a fixed trust, it is the interest in the fixed trust itself that is the relevant CGT asset (s 108-5 ITAA97), and similarly, the provisions apply without issue. However, where a taxpayer is a mere object of a discretionary trust, until the beneficiary is made entitled,[48] the taxpayer has no CGT asset that may be recognised for CGT events I1 and I2.[49] This is because mere objects of discretionary trusts do not ordinarily have the necessary interest in the trust (or its assets) prior to the exercise of discretion in their favour.[49]

Accordingly, if Div 855 applied to non-TAP gains distributed from discretionary trusts, it seems that tax may be avoided by trustees holding off on realising capital gains on the disposal of non-TAP assets until beneficiaries (that would have otherwise been assessable on the distributed gain) become non-residents.

Acknowledging that s 115-220 ITAA97 may still assess the trustee on the gain under s 98 ITAA36, the question then arises as to whether, as the Commissioner contends, s 115-220 does not test whether the beneficiary's attributable gain satisfies the conditions in s 98, but rather it increases the amount assessable to the trustee under s 98 without regard to those conditions,[50] or alternatively, whether s 115-220 only applies to amounts which satisfy the requirements of s 98.[39]

The difference here is significant, as the former does away with source and residency (the trustee being taxed on the full gain), and the latter makes taxation contingent on the gain being "attributable to a period when the beneficiary was a resident" or "attributable to sources in Australia" (s 98(2A)(c) and (d) ITAA36).

Under the latter interpretation, the following questions are posed:

– When is a capital gain included in net income, and when is it attributable to a period when the beneficiary was a resident? Does this capture unrealised gains that have accrued while the beneficiary was a resident, or does it only capture gains that are realised while the beneficiary *is* a resident (thus excluding gains realised *after* the beneficiary ceases to be a resident)?

– If the source of the capital gain is the relevant factor, do we arrive at the taxation of gains that were otherwise exempt as non-TAP assets (eg ASX listed shares), and is the 100+ year old case law determining *source* even relevant in a global society where intangible assets and instruments are so disconnected from geography?

Notwithstanding the above, a conclusion that Div 855 applies to discretionary trusts would seemingly also result in increased s 100A ITAA36 or Pt IVA ITAA36 activity, such as distributions (on paper) of non-TAP gains to foreign resident beneficiaries, only for the proceeds to be gifted or loaned back to Australian residents.

If Australia's tax system can be so easily undermined, those with means will seek to exploit it, resulting in outcomes that most Australians would hardly consider "fair".

Conclusion

Despite the foundations of a sound tax system being built on efficiency, equity and simplicity, when it comes to the interaction between CGT, residency and trusts, it is arguable that our current system falls short of all three objectives. In the author's opinion, the solution is *not* for the ATO to deviate from policy objectives, read words into the legislation, or stretch the scope of provisions to address gaps that they were not intended to cover. Instead, it is time for the long-awaited reform of trust taxation[51] and a re-write into the ITAA97. Only then can we hope to achieve a tax system that is moving towards efficiency, equity and simplicity.

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3 Either through their lesser use of public facilities and infrastructure (as they live and reside elsewhere), or their exclusion from the social security system (typically being ineligible for Medicare, Centrelink etc).

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6 Item 2, s 855-15 ITAA97.

7 S 855-25 ITAA97.

8 S 855-20 ITAA97.

9 Item 3, s 855-15 ITAA97.

10 Item 4, s 855-15 ITAA97.

11 Item 5, s 855-15 ITAA97.

12 S 104-165(3) ITAA97.

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14 S 995-1 ITAA97 ("resident trust for CGT purposes").

15 S 95(1) ITAA36 (broadly, total assessable income less allowable deductions).

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19 ID 2010/54.

20 *Nathan v FCT* [1918] HCA 45.

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23 S 115-215(3) ITAA97.

24 S 115-215(4A) ITAA97.

25 Ss 115-227(a) and 115-228 ITAA97.

26 S 115-227(b) ITAA97.

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A Matter of Trusts

by Philippa Briglia, Sladen Legal

SMSFs and the use of bare trusts

Self-managed superannuation funds and bare trusts — investment in the underlying asset or in-house asset issue?

Self-managed superannuation funds (SMSFs) are known for their use of bare trusts in the context of limited recourse borrowing arrangements (LRBAs), but there are other ways in which SMSFs could use bare trusts as part of their asset structure. This article looks at the use of non-LRBA bare trusts by SMSFs, and whether that could cause issues from an in-house asset perspective.

What is a bare trust?

"Bare trusts" or "holding trusts" are commonly used as part of LRBAs, with s 67A of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA) providing an exception to the general prohibition against borrowing by SMSF trustees. Under s 67A, an SMSF trustee may borrow money where that money is applied for the acquisition of a single acquirable asset, and where the acquirable asset is held on trust so that the SMSF trustee acquires a beneficial interest in the asset.

While not defined in the SISA, a bare trust is generally understood to exhibit the following characteristics:[1]

- the trustee holds property without any interest therein, other than that existing by reason of the office and the legal title as trustee; and
- the trustee has no discretion and no active duties, other than to convey the trust property on demand to the beneficiary or beneficiaries or as directed by them.

Section 67A does not strictly require a bare trust relationship. It could, for example, include a fixed trust that is not a bare trust. However, many LRBA trusts are established as bare trusts.

In addition, there are other ways in which an SMSF might invest via a bare trust, which are outside of an LRBA context. This could be, for example, to protect the SMSF from claims (asset protection), for commercial efficiency reasons, or for privacy reasons.

In-house asset rules

An SMSF is typically restricted to investing no more than 5% of the market value of the SMSF's assets in "in-house assets". "In-house asset" is defined in s 71(1) SISA as:

> "… an asset of the fund that is a loan to, or an investment in, a related party of the fund, *an investment in a related trust of the fund*, or an asset of the fund subject to a lease or lease arrangement between a trustee of the fund and a related party of the fund …" (emphasis added)

For the purposes of the in-house asset provisions, a related trust includes a trust where the SMSF has an entitlement to the majority of the income from the trust.

Bare trust = related trust?

A trust under an LRBA is typically a related trust of the SMSF because the SMSF trustee has an entitlement to all of the income from the trust. The interest of the SMSF in the LRBA trust therefore represents an investment in that trust for the purposes of the in-house asset rules. An express legislative carve-out is contained in s 71(8) and (9) SISA which provide that an SMSF's investment in the LRBA trust is not an in-house asset, provided that certain conditions are satisfied (including that the LRBA meets all of the requirements set out under s 67A SISA).

However, the operation of s 71(8) and (9) is limited to trusts used as part of LRBAs which meet the requirements set out under s 67A SISA. These provisions do not apply more broadly to trusts (including bare trusts).

A similar carve-out for instalment trusts is provided in s 10(1) SISA which defines "related trust" as:

> "… a trust that a member or a standard employer-sponsor of the fund controls (within the meaning of section 70E), *other than an excluded instalment trust of the fund*." (emphasis added)

"Excluded instalment trust" is defined in s 10(1) SISA as a trust which arises when the fund trustee makes an investment under which a listed security, being the only trust property, is held in trust until the purchase price of the underlying security is fully paid, and where the investment in the underlying security held in trust would not be an in-house asset of the fund.

These two examples appear to be the only exceptions expressly provided for by the SISA. The SISA does not contemplate a scenario where an SMSF has an interest in a bare trust, where that bare trust is not part of an LRBA.

In that instance, would the SMSF's interest in the bare trust count as an investment in a related trust for the purposes of the in-house asset provisions? Or, given the "bare" nature of the trust, should the SMSF's interest in the bare trust be more properly characterised as an interest in the underlying asset? That is, should the bare trust be "looked through" for the purposes of the in-house asset provisions?

SMSFR 2009/4 discusses the Commissioner's view on the meaning of "investment in" for the purposes of the in-house asset provisions but does not specifically discuss investment in a non-LRBA bare trust.

Bare trusts and look-through treatment

There is a widespread taxpayer practice where bare trusts are not recognised for income tax purposes, ie the bare trust is generally looked through or disregarded. Beneficiaries are taken to derive income and incur losses directly as though no trust exists. However, this practice is not expressly supported by Div 6 of Pt III of the *Income Tax Assessment Act 1936* (Cth) for most types of bare trusts, in that Div 6 does not express a distinction between bare trusts and other trusts. The practice is arguably only maintained by an ongoing administrative approach from the Commissioner.[2]

In its June 2017 report to the Minister for Revenue and Financial Services,[3] the Board of Taxation expressed concern that this general taxpayer practice appears not to be supported at law, which inevitably gives rise to uncertain outcomes. The Board made a number of recommendations, arguing that the current administrative approach be given express legislative support. However, these recommendations have not yet translated to legislative reform.

The *Income Tax Assessment Act 1997* (Cth) (ITAA97) provides express legislative support for the look-through approach in certain circumstances, including:

- s 106-50 ITAA97: a beneficiary will be treated for CGT purposes as if it owns a CGT asset to which it is absolutely entitled as against the trustee (the concept of "absolute entitlement" in this context was examined in TR 2004/D25);
- s 235-820 ITAA97: if an entity (the investor) has a beneficial interest in an instalment trust asset under an instalment trust, the asset is treated as being the investor's asset (instead of being an asset of the trust); and
- s 235-840 ITAA97: the look-through treatment in s 235-820 applies to bare trusts used as part of SMSF LRBAs.

The "look-through" approach to bare trusts is also reflected in the ATO's administration of the tax system, for example:

- GSTR 2008/3 permits registration at the beneficiary level rather than the bare trustee level, therefore allowing for the beneficiary to account for the GST; and
- PS LA 2000/2 exempts bare trusts that are "transparent trusts" from lodging tax returns, permitting the income and expenses of the bare trust to be accounted for at the beneficiary level.

Absolute entitlement = look-through treatment?

In TR 2004/D25, the look-through treatment of bare trusts in the context of the CGT provisions turned largely on the concept of "absolute entitlement".

The Commissioner's view in TR 2004/D25 is that absolute entitlement to an asset as against a trustee is the ability of a beneficiary to call for a trust asset to be transferred to them at their discretion where the beneficiary has a vested and indefeasible interest in the entire asset.

The Commissioner further confirmed that the most straightforward application of the core principle of "absolutely entitled" is one where a single beneficiary has all of the interests in the trust asset.

Arguably then, if the SMSF trustee is the sole beneficiary under a bare trust and has all of the interests in the trust asset, the SMSF trustee is absolutely entitled to the asset in the same way that a beneficiary is as described under s 106-50 ITAA97. It follows that the "look-through" treatment described in TR 2005/D25 should also apply to this scenario.

This argument is bolstered by the fact that s 235-840 ITAA97 recognises look-through treatment specifically in the context of bare trusts in LRBAs. By analogy, this treatment should also apply to SMSFs and non-LRBA bare trusts, where the SMSF trustee is the sole beneficiary and has all of the interests in the trust asset.

To take it one step further, if the "look-through" treatment applies for tax purposes, could it also apply for in-house asset purposes? That is, the bare trust is looked through or disregarded, and the interest of the SMSF trustee is in the underlying trust asset, rather than an interest in the trust. Accordingly, there would be no "investment in a related trust of the fund" for the purposes of the in-house asset provisions and, so long as the underlying asset does not fall within the definition of in-house asset for other reasons, no issues from an in-house perspective.

While the above reasoning makes practical sense, it is untested and relies on an analogy with non-SMSF provisions and ATO materials. The application of TR 2004/D25 is limited to the CGT provisions, and comments made by the Commissioner in the ruling cannot be applied with certainty in an SMSF context. It is also important to note that the ATO has a broad discretion to deem an SMSF trustee's investment to be an in-house asset, even if it does not constitute an in-house asset under the usual rules.

More specific commentary from the ATO as to how it will interpret and apply the in-house asset provisions in the context of bare trusts under the in-house asset rules will be needed before SMSF trustees can proceed with certainty. In the meantime, SMSF trustees with bare trust arrangements (other than those relating to LRBAs) may have to infer a look-through approach under the SISA by way of the ATO's general administrative practices relating to bare trusts.

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Superannuation

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SMSFs and rent relief due to COVID-19

Self-managed superannuation funds that own business real property are facing the prospect of tenants falling behind in their rent payments due to the economic stress arising from COVID-19.

This article examines the position of self-managed superannuation funds (SMSFs) that lease business real property to an arm's length tenant and to a related party tenant, and provides recommendations to ensure that they minimise downside risk and position themselves with sound legal backing.

Self-managed superannuation funds that own business real property are facing the prospect of tenants falling behind in their rent payments and with regard to other obligations under the lease due to the economic stress arising from COVID-19.

Australian states and territories have put a six-month moratorium on evictions for both residential and commercial tenants during the coronavirus pandemic, Prime Minister Scott Morrison announced on 29 March 2020:

> "Now there is a lot more work to be done here and my message to tenants, particularly commercial tenants and commercial landlords is a very straight forward one: we need you to sit down, talk to each other and work this out."

The National Cabinet Mandatory Code of Conduct — SME Commercial Leasing Principles During COVID-19 (National Code) was released on 3 April 2020. The Code's purpose is to impose a set of good faith leasing principles for application to commercial tenancies (including retail, office and industrial) between owners/operators/other landlords and tenants, where the tenant is an eligible business for the purpose of the Commonwealth Government's JobKeeper program. The National Code is given effect through relevant state and territory legislation or regulations, as appropriate.

Under the National Code, landlords are encouraged to offer tenants proportionate reductions in rent payable in the form of waivers and deferrals of up to 100% of the amount ordinarily payable, on a case-by-case basis, based on the reduction in the tenant's trade during the COVID-19 pandemic period and a subsequent reasonable recovery period. Rental waivers must generally constitute no less than 50% of the total reduction in rent payable, with the balance being deferred and repaid over a prescribed period.

Most states and territories have since enacted legislation and/or regulations following some of the leasing principles in the National Code. Some key points are now discussed in relation to the position in New South Wales and Victoria.

In NSW, the *Retail and Other Commercial Leases (COVID-19) Regulation 2020* (NSW) (Regulation) made under the *Retail Leases Act 1994* (NSW) gives effect to certain aspects of the National Code. For example, the parties must have regard to the economic impacts of the COVID-19 pandemic and the leasing principles in the National Code. However, not all of the principles in the National Code are reflected in the Regulation, such as the proportionate reduction and the rent deferral/waiver principles. Instead, the Regulation relies on the parties negotiating in good faith having regard to the principles in the National Code.

In Victoria, the *COVID-19 Omnibus (Emergency Measures) Act 2020* (Vic) (Victorian Act) applies to "eligible leases". Interestingly, an SMSF that leases commercial property to a related party tenant that is a company is not likely to be covered by the Victorian Act. This is because s 13(3)(c) of the Victorian Act asserts that a retail lease or a non-retail commercial lease or licence will not be an eligible lease where:

> "(c) an entity has a prescribed method of control or influence, through the holding of a prescribed interest, right or power, in relation to acts or decisions relating to the ownership, management or affairs of a tenant under the retail lease or a non-retail commercial lease or licence that is a body corporate."

On 1 May 2020, the Victorian Government passed the *COVID-19 Omnibus (Emergency Measures) (Commercial Leases and Licences) Regulations 2020* (Vic) which give effect to the National Code (with some notable differences).

The ATO has provided a practical approach of, broadly, not applying its resources to determine whether an SMSF is obtaining rent from a related party tenant for FY2020 and FY2021. While this ATO approach is welcome, a properly considered strategy is recommended rather than relying on the ATO's practical compliance approach, given the significant downside risks. In particular, if these matters are not carefully managed and documented, SMSFs and their trustees/directors could potentially face the risk of significant penalties under the *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA) and the *Superannuation Industry (Supervision) Regulations 1994* (Cth) (SISR).

SMSF and arm's length tenants

If the tenant has no direct or indirect relationship with the SMSF trustee (that is, the landlord), the SMSF trustee may be in a position to grant rent relief without contravening the SISA. Under this scenario, the parties probably would be dealing at arm's length and, as outlined below, there may be various factors supporting a rent reduction in whole or in part as being in the best interests of fund members. For example, the following reasons could support rent relief:

- the tenant may have a better chance of successfully trading out of its current predicament; especially as many other landlords are being requested to grant relief due to the economic stress arising from COVID-19;

- the tenant may also be in a position to continue to cover holding costs such as council rates, land tax, regular maintenance of equipment and insurance subject to any applicable law (eg the *Retail Leases Act 2003* (Vic) may preclude a landlord from recovering land tax). Note that a property that has been vacant for some time may not be covered by insurance and having a tenant occupy premises, by itself, can be a significant advantage to a landlord who's otherwise at risk without insurance;
- there may be further risks of having a vacant property such as break-ins and fires and other damage arising while a property remains vacant and not maintained; and
- there may also be little prospect of obtaining another tenant in the near future until the economy recovers after COVID-19 which some predict may take years.

The states and territories arrangements may provide some detail on what changes, if any, are required to be made to a lease agreement as the states and territories have the power to override any lease agreement with a direction or order when a state of emergency is declared. Subject to further developments, a lawyer should be consulted in relation to the terms and conditions in each lease agreement as some may include a "force majeure" clause that allows a party to suspend or terminate the performance of its obligations if certain events occur such as an act of god. Note that since a lease confers a form proprietary interest in relation to the land, the usual contractual law rules such as 'frustration' of a contract may not necessarily apply. This area of law is being well researched and commented on by many property law experts.

SMSF and related party tenants

If the tenant is a related party of the SMSF trustee, it is very easy to contravene the SISA provisions and extreme care is required when handling these situations.

Where an SMSF wants to grant any concession under a lease to a related party tenant, they should, after taking appropriate accounting and legal advice, be careful to follow the appropriate steps and gather relevant evidence.

Some of the key issues that an SMSF dealing with a related party tenant will need to manage include:

- the sole purpose test (s 62 SISA): is the SMSF trustee's purpose to assist a related party, which is to generate retirement benefits in accordance with what an arm's length landlord would do? As noted above, an arm's length landlord may decide to grant a concession to an unrelated tenant where that is in the landlord's best interests;
- the in-house asset test (Pt 8 SISA): non-payment of rent is likely to give rise to a loan by the SMSF to the related party, and if that loan exceeds 5%, an in-house asset contravention may arise. Note also that the terms of the lease may apply a penalty interest rate to the amount owed;
- the prohibition against lending or providing financial assistance to a member or relative (s 65 SISA): if the SMSF is leasing to a member or relative of an SMSF, there is a potential contravention of s 65 if the arrangement is not on arm's length commercial terms; and
- the arm's length test (s 109 SISA): broadly, all investments and transactions involving an SMSF must be made and maintained, on an ongoing basis, on arm's length terms.

As you can appreciate from the above, an SMSF trustee will need to demonstrate that granting any concession is consistent with what arm's length parties would agree to do and in the best interests of the fund and its members. They should also examine all available options and obtain advice from an experienced real estate agent with regard to the prevailing market conditions for that particular lease in that location, and determine if and when another tenant can be found and make appropriate notes.

Additionally, the SMSF trustee should gather any evidence that supports the course of action proposed to be taken and consider other alternatives (assuming the tenant was an arm's length tenant, rather than a related party tenant) in those particular circumstances.

A detailed review of the lease documentation should be undertaken as soon as practicable, and advice taken on what variations may need to be made to the lease to reflect any concession that may be granted. Naturally, any variation to the lease agreement should be prepared by an experienced and qualified lawyer.

Note that, even though the SMSF trustee may gather evidence that the outcome of the concession granted to a related party tenant under the lease reflects arm's length terms, that may not necessarily protect them from contraventions of the SISA occurring if, for instance, there is a loan or financial assistance that invokes s 65 or 109 SISA.

ATO practical approach

The ATO's website states:[1]

> "Question: My SMSF owns real property and wants to give my tenant — who is a related party — a reduction in rent because of the financial effects of COVID-19. Charging a related party a price that is less than market value is usually a contravention. Given the effects of COVID-19, will the ATO take action if I do this?
>
> Answer: Some landlords are giving their tenants rent relief as a rent reduction, waiver or deferral because of the financial effects of COVID-19 and we understand that you may wish to do so as well. Our compliance approach for the 2019-20 and 2020-21 financial years is that we will not take action if an SMSF gives a tenant — even one who is also a related party — a temporary rent reduction, waiver or deferral because of the financial effects of COVID-19 during this period."

Broadly, the ATO will not actively seek out cases where an SMSF gives a related party tenant a temporary rent reduction during the remainder of FY2020 or FY2021. However, the usual position for such practical approaches previously issued by the ATO is that, if the ATO does come across contraventions from other sources, eg via its usual data detections, reviews or auditor contravention reports, the ATO will usually apply the legislation in the normal manner. While the ATO should be congratulated on the practical approach reflected above, SMSF trustees should not rely on this non-binding guidance given the substantial downside consequences, especially in light of the alternatives outlined below.

The authors understand that some SMSF trustees and/or businesses may not have the time or resources to obtain proper advice with regard to related party tenants and may choose to simply rely on the ATO practical approach. However, given the consequences, landlords should seek to place themselves in the best position possible to minimise future risk.

It should also be noted that, in relation to an SMSF that owns property via an interposed non-geared company or unit trust, the ATO website states:[1]

> "If your SMSF holds an interest in an interposed entity such as a non-geared company or unit trust and that interposed entity leases property to a tenant, we will not treat the investment in the interposed entity as an in-house asset for the current and future financial years as a result of a deferral of rent being provided to the tenant due to the financial effects of COVID-19."

Once a contravention of one of the criteria relating to a non-geared company or a non-geared unit trust is triggered under reg 13.22D SISR, the trust is "forever" tainted and the SMSF must dispose of its units in that unit trust to comply with the SISR. In particular, if the lease is not legally enforceable or if rent owing by a related party tenant is deferred and constitutes a loan under the lease, the company or unit trust will cease to comply with the criteria in Div 13.3A SISR. However, the ATO states in this regard:[1]

> "… we will not treat the investment in the interposed entity as an in-house asset for the current and future financial years as a result of a deferral of rent being provided to the tenant due to the financial effects of COVID-19."

Thus, the ATO has confirmed that a COVID-19-related deferral of rent in a non-geared company or a non-geared unit trust will not cause an SMSF investment in that company or unit trust to be an in-house asset in the current or any future financial year. This is important because a deferral of rent typically constitutes a loan (see SMSFR 2009/3), and typically, if a non-geared company or a non-geared unit trust has a loan asset, any investment in that company or unit trust becomes an in-house asset.

SMSFs with LRBAs: further implications

If an SMSF has borrowed money under a limited recourse borrowing arrangement (LRBA) to finance the acquisition of a property (whether residential or business real property), a range of other implications may arise, including:

- similar issues to the potential SISA contraventions raised above also may apply if a related party lender does not act at arm's length in relation to collecting all moneys owing under the LRBA. However, a related party lender would typically not consider taking any such action against the SMSF trustee (borrower), given they are related. Again, appropriate arm's length evidence must be gathered, and accounting and legal advice obtained, to position against the significant penalties that may otherwise be applied; and
- if there is a related party lender, unless the "safe harbour" terms and conditions of the borrowing are consistent with the ATO's criteria in PCG 2016/5 and are continuously complied with (eg regular monthly principal and interest repayments), the ATO has advised that it will typically consider applying non-arm's length income (NALI). The following is a helpful extract from this practical compliance guideline:

  > "The trustees will need to be able to otherwise demonstrate that the arrangement was entered into and maintained on terms consistent with an arm's length dealing. One example of how a trustee may demonstrate this is by maintaining evidence that shows their particular arrangement is established and maintained on terms that replicate the terms of a commercial loan that is available in the same circumstances."

Indeed, if the tenant reduces or stops paying rent, the SMSF's ability to make repayments under the LRBA can easily fall into arrears and into default (with the default interest rate, which is typically at least 2% higher than normal) under the loan agreement, giving rise to a range of further ramifications. If the related party lender provides any relief to the SMSF trustee that is not benchmarked to arm's length terms (that can be justified in these difficult times), based on recent ATO materials (including LCR 2019/D3), the ATO position is that NALI may then apply to any net income and net capital gain, if any, derived from that property for the entire future period of ownership.

However, due to COVID-19, the ATO has also offered this practical approach:[1]

> "Question: My SMSF has a compliant limited recourse borrowing arrangement (LRBA) in place with a related party. Would the non-arm's length income (NALI) provisions apply if the related party offers repayment relief to the SMSF trustees because of COVID-19?
>
> Answer: We understand that temporary repayment relief may be offered in relation to an existing LRBA between an SMSF and a related party due to the financial effects of COVID-19.
>
> If the repayment relief reflects similar terms to what commercial banks are currently offering for real estate investment loans as a result of COVID-19, we will accept the parties are dealing at arm's length and the NALI provisions do not apply. For example, these terms currently include temporary repayment deferrals for most businesses of up to 6 months, with unpaid interest being capitalised on the loan.
>
> The parties to the arrangement must also document the change in terms to the loan agreement and the reasons why those terms have changed. It is also expected that there is evidence that interest continues to accrue on the loan and that the SMSF trustee will catch up any outstanding principal and interest repayments as soon as possible.
>
> Any further repayment relief needed due to the continued effects of COVID-19 should be reviewed at the end of the agreed deferral period and remain in line with what the commercial banks are offering at that time."

Possible consequences of contravening the SISA

Despite the ATO's practical approach outlined above, a range of other contraventions may also occur (or may occur in the near future) in these difficult and stressful economic times if, for example, money is withdrawn without a valid condition of release, or if existing SMSF assets are used as security for a borrowing by a related party. When added to non-compliance by an SMSF trustee or a "connected" unit trust renting property to a related party tenant (eg a non-geared unit trust), SMSF trustees may be widely exposed to a range of penalties and become embroiled in costly and lengthy disputes.

There are a range of potential penalties that the ATO may apply unless these matters are appropriately and properly managed, including:

- in extreme cases, the fund could be rendered non-complying, with 45% tax imposed on the value of its opening account balance in the year it is rendered non-complying;
- contravention of a civil penalty, such as s 62, s 65, Pt 8 and s 109 SISA, can result in a monetary penalty of a maximum amount of $504,000 (ie 2,400 penalty units × $210); and
- an administrative penalty, typically of $12,600 per contravention for s 65 and Pt 8, and the ATO's stated policy is to "automatically" impose an administrative penalty for each and every occasion. An SMSF trustee can seek remission of any penalty, the success of which depends on whether the ATO considers whether remission is appropriate in the circumstances.

This type of situation highlights the need for making sure that SMSF trustees act in compliance with the law and do not make rash or hasty decisions that they may later regret, especially if the actions were designed to assist a related party without any evidence documenting that the actions were consistent with an arm's length dealing and/or without taking the appropriate steps to implement a lease variation.

This is where a written opinion from an SMSF lawyer, which is subject to legal professional privilege, outlining the law in view of the particular facts is a prudent first step to take. A written opinion that is supported with the right evidence and that is implemented correctly can save on costs that may otherwise arise from needing to respond to the likely auditor or ATO queries, and any auditor contravention report that may be lodged which may give rise to unnecessary inquiries by the ATO.

Sole purpose SMSF corporate trustee

If an SMSF trustee grants a concession to a related party tenant, the administrative penalties on their own can, in these types of circumstances, give rise to hundreds of thousands of dollars as the ATO might argue that each monthly payment of rent not made is subject to an additional penalty.

If the SMSF has, say, two individual trustees, the administrative penalties will be double the amount that would be imposed on two directors of an SMSF corporate trustee, as each individual trustee is subject to the same amount of administrative penalty. For example, if the SMSF has two members who are individual trustees, the typical $12,600 for a single administrative penalty is doubled, ie $25,200. If the SMSF has a corporate trustee, with two members as directors of the corporate trustee, the administrative penalty is $12,600.

Naturally, it is strongly recommended that each SMSF has a sole purpose SMSF corporate trustee to minimise legal risk, given the current economic conditions. Many SMSFs still have individual trustees who remain personally liable for a fund's liabilities, and the administrative penalty system is a big incentive to move to a corporate trustee in these testing times.

It is also recommended that an SMSF should have a sole purpose corporate trustee in these difficult economic times. This is because many "trading" companies that also double up as an SMSF trustee may be facing insolvency. If an administrator, a liquidator, a receiver or some other form of external management "takes over" control of that company, that could make the management of the SMSF assets difficult until that company's external controller is convinced that the SMSF assets are not capable of being applied towards the creditors. This "fight" alone may prove difficult and costly.

Conclusion

Self-managed superannuation fund trustees should obtain expert accounting, financial, valuation, legal and other advice to ensure that any rent relief is properly implemented and legally effective.

Self-managed superannuation fund trustees should also obtain professional advice regarding their options, including how the SMSF trustee can minimise risk to the SMSF from contravening any applicable SISA and/or *Income Tax Assessment Act 1997* (Cth) provision.

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Alternative Assets Insights

by Nick Rogaris and Seán Hanrahan, PwC

COVID-19: real estate and infrastructure tax issues

COVID-19 has acutely impacted the real estate and infrastructure sectors, giving rise to a number of tax implications.

In brief

The federal and state governments have responded swiftly to the economic crisis resulting from measures to limit the spread of the coronavirus (COVID-19). A raft of measures aimed at preserving cashflow, business relationships and jobs has been announced, while the ATO and state revenue offices (SROs) have announced a number of administrative concessions.

It is important to note that some of the announced measures have not yet been enacted, and guidance from the ATO and SROs is being continually updated. Given the speed of developments, impacted businesses and their tax advisers will need to monitor closely (almost on a daily basis) new legislation/regulations and associated guidance published by the ATO and SROs.

While Australian tax issues are highlighted in this article, multinational groups will also need to deal with similar issues in other impacted countries.

In detail

This article first considers the key tax issues for fund vehicles (including investment and trading entities). It then goes on to discuss the key tax issues for property management and other operating entities that are employers.

Fund vehicles (including investment and trading entities)

Recognition of income

National Code of Conduct. While landlords may already have started negotiating rental waivers or deferrals with their tenants, the National Cabinet Mandatory Code of Conduct — SME Commercial Leasing Principles During COVID-19 (National Code) imposes a framework on landlords and eligible tenants to negotiate in good faith amendments to existing leasing arrangements. To apply the National Code, tenants must be eligible for the JobKeeper program and have an annual turnover of up to $50m (referred to as "SME tenants").

Under the National Code (on a case by case basis), landlords must offer tenants a proportionate reduction in rent payable in the form of waivers and deferrals. Where a rent reduction is agreed, 50% of this must be in the form of a waiver and the 50% balance must be in the form of a deferral. Payment of rental deferrals by the tenant must be amortised over the balance of the lease term and for a period of no less than 24 months, whichever is the greater, unless otherwise agreed by the parties. This means that, if a lease has six months to run, the tenant will have 24 months to pay the deferred rent, a period of 18 months beyond the expiry of the lease.

Landlords should consider the tax implications of any agreed rent waiver/deferral and, in particular, the *taxing point* of the portion of rent that is agreed to be deferred (eg is the deferral structured as merely a deferral of cash but still assessable as it has accrued, or is the taxing point also deferred to a later time?).

The agreed rent reduction may also give rise to "trading trust" issues under Div 6C of the *Income Tax Assessment Act 1936* (Cth) (ITAA36), which will be of particular concern to the eligibility of trusts structured as withholding managed investment trusts (MITs)/attribution MITs (AMITs). For example, the safe harbour rule in s 102MB ITAA36 requires that at least 75% of the gross revenue from investments in land for the income year consists of rent (except excluded rent). The 75% threshold may not be met where reductions in rent are negotiated across a landlord's portfolio.

Where a rent reduction is agreed based on the tenant's fall in turnover or profits, this may give rise to concerns over whether the rent that is then payable is "excluded rent" under the definition in s 102M ITAA36. A fall in the landlord's rental income may also mean that the 2% threshold in s 102MC ITAA36 is breached.

Where the above safe harbours cannot be relied on, landlords will need to rely on the basic definition of "eligible investment business" in s 102M that they are investing in land for the purpose, or primarily for the purpose, of deriving rent.

A number of states have announced land tax relief as part of a package of measures to support businesses affected by COVID-19. In some cases, this relief is only available to landlords who provide rent relief to affected tenants and apply the leasing principles under the National Code.

Cross-staple leases. Transitional rules apply to MIT cross-staple arrangement income that is attributable to a facility that existed, or was sufficiently committed to, prior to 27 March 2018, meaning that the existing concessional MIT withholding rate of 15% will apply broadly from the facility's relevant start date for a period of seven years (generally for non-infrastructure assets), or 15 years (if the facility is an economic infrastructure facility).

Any changes to the rental payments made under a cross-staple lease which are not affected under its existing provisions (such as under a rent review or force majeure clause) potentially risks creating a new cross-staple arrangement. Additionally, care should be taken to ensure that any changes to the cross-staple lease arrangement do not cause a failure of the integrity rules that must be continually satisfied by stapled entities to have the concessional 15% MIT withholding rate applied over the transitional period.

Governance arrangements in place between the asset and operating entities should also be considered prior to any variations in rental payments being made.

Guidance from the ATO on these issues can be found in LCR 2019/D2.

Development projects. Where development projects are either put on hold or delayed, and the "estimated profits basis" is used for determining taxable profits under a construction contract, consider adjusting the "notional taxable income" to be allocated to the current financial year (according to expectations existing at the end of the year).

Guidance from the ATO on this issue can be found in TR 2018/3.

Debt deductions

Loan agreements: reduction of interest. Where a lender agrees to defer interest under a loan agreement, the following income tax issues should be considered by lenders and borrowers (as applicable):

- whether the accruals basis can continue to be used as the basis for deriving or deducting interest;
- where the terms of the loan agreement are changed, whether the loan agreement should be retested under the debt/equity classification rules (for example, a new loan arrangement may come into existence);
- whether the commercial debt forgiveness rules apply to any interest that has accrued and is waived; and
- whether the capital gains tax rules apply.

Where the lender is a non-resident, the following additional income tax issues should be considered by the parties:

- the withholding tax implications of interest waivers or deferrals; and
- transfer pricing implications.

Where reducing interest under a related party or cross-staple loan is contemplated, the following issues should also be considered by the parties:

- the value shifting provisions; and
- governance arrangements in place between the asset and operating entities.

The accounting treatment of any deferral or waiver of interest should also be considered by the parties in case this may have a bearing on the income tax treatment.

Thin capitalisation. A reduction in the accounting value of assets or an increase in debt levels may impact reliance on the thin capitalisation safe harbour test. In such cases, affected entities should consider alternative options, such as applying the frequent measurement method for averaging, the arm's length debt test (ALDT) or the worldwide gearing test.

If a trade creditor's terms are extended beyond 100 days, these liabilities may be included as debt in thin capitalisation calculations.

The ATO's website considers the impact of COVID-19 on thin capitalisation, and outlines a pragmatic approach to thin capitalisation requirements for tax years encompassing the February/March 2020 period.[1] In particular, where reliance is placed on the ALDT because the safe harbour test cannot be satisfied, the ATO has indicated that it will not dedicate compliance resources when reviewing the application of the ALDT, provided the requirements listed by the ATO under its "simplified ALDT approach" are met. One requirement in respect of inward-investing entities is that any additional related party funding is provided by way of equity, other than short-term (less than 12 months) debt facilities.

Cash management strategies

Trusts: taxable income greater than cash. Where the trust qualifies as an MIT, the issue of whether it might elect into the AMIT regime for the current income year should be considered. Where the AMIT election is made, the net income of an AMIT is allocated to unitholders on an attribution rather than a present entitlement basis, meaning that the cash distribution can be less than taxable income (with upward adjustments in cost base for investors to ensure that there are no adverse tax outcomes for investors).

Where a trust does not qualify as an AMIT (or does not elect into the AMIT regime), some trusts might consider implementing a distribution reinvestment plan (at the election of unitholders) where this is permitted under the trust deed.

Cross-staple capital reallocations. Consider whether capital reallocations can be made from a passive asset trust to an operating entity via the following methods:

- return of capital from the passive trust to investors which is then mandatorily invested as equity in the operating company; or
- a short-term loan (may be interest or non-interest bearing) to the operating company.

Capital investment

Instant asset write-off. An immediate tax deduction for the cost of a depreciating asset (new or second-hand) that is less than $150,000 is available for small and medium businesses with an aggregated turnover of less than $500m. The asset must first be used (or installed ready for use) from 12 March 2020 to 30 June 2020.

The aggregated turnover test includes the turnover of Australian and non-resident connected and affiliated entities (whether or not the income is assessable in Australia).

Accelerated depreciation deduction. A tax deduction is available for 50% of the cost of an eligible depreciating asset on installation, with existing depreciation rules applying to the balance of the asset's cost. It applies to new assets acquired in the period 12 March to 30 June 2021, and is available for those businesses with an aggregated turnover of less than A$500m. There is no limit on the cost of an asset.

Consider applying the accelerated depreciation deduction where the instant asset write-off is not available.

Foreign Investment Review Board approvals

All foreign investment bids and the establishment of certain types of entities (eg unit trusts) by foreign persons are now subject to Foreign Investment Review Board approval, as thresholds have been lowered to zero for the next six months.

This is likely to increase the time taken to complete transactions and can impact transaction structuring. To the extent that existing entities are utilised in the interim, care should be taken when planning the subsequent conveying of assets/interests to the intended holding structure when Foreign Investment Review Board-approved and established.

Fund manager entities and other operating entities

JobKeeper program

The JobKeeper program has been implemented to enable businesses impacted by coronavirus to access a subsidy from the government to continue paying their employees.

There are a number of tests to determine eligibility, including a turnover test. Under the basic test, businesses with an aggregated turnover of $1b or less will be eligible if their turnover is expected to reduce by 30% or more relative to a comparable period a year ago (of at least a month). Businesses with an aggregated turnover of more than $1b will be eligible if their turnover is expected to reduce by 50% or more relative to a comparable period a year ago (of at least a month). The decline in turnover calculation is broadly based on GST turnover, with some modifications.

Alternative turnover tests are set out in the *Coronavirus Economic Response Package (Payments and Benefits) Alternative Decline in Turnover Test Rules 2020.*

Under the *Coronavirus Economic Response Package (Payments and Benefits) Amendment Rules (No. 2) 2020,* the turnover test has been modified to address the circumstances where group structures use a special purpose entity to employ staff, rather than staff being directly employed by an operating entity. The alternative test can be met by reference to the combined GST turnovers of the group entities using the services of the employer entity.

Cashflow boost for SME employers

Small and medium-sized (SME) employers will receive a temporary cash flow boost (via an automatic credit to be applied on forthcoming activity statements) of at least $20,000 and up to $100,000, based on the extent of PAYG withholding amounts for relevant months. The cash flow boost is available for those businesses which have an aggregated turnover of less than $50m and have employees.

This tax-free cash flow boost is to be delivered automatically through the tax system as a credit applied to eligible businesses

ATO administrative reliefs

There are no blanket concessions or deferrals announced by the ATO in respect of all federal tax obligations, but any business that is having difficulty in meeting its tax obligations is encouraged to reach out to the ATO to seek applicable extensions of time for lodging relevant returns or when paying outstanding tax obligations. A wide range of payment arrangements are available to those struggling to pay their tax liabilities.

State payroll taxes

Different states and territories are providing refunds, waivers, deferrals, increases in thresholds and one-off grants in relation to payroll tax.

Tax residency and permanent establishments

Restrictions on the movement of directors and employees may create tax residency and permanent establishment issues.

The ATO has released guidance that states that, if the only reason for holding board meetings in Australia, or for directors attending board meetings from Australia, is because of impacts of COVID-19, the Commissioner will not apply compliance resources to determine whether the entity's central management and control is in Australia.

Similarly, the ATO has stated that, if a foreign company did not otherwise have a permanent establishment in Australia before the impacts of COVID-19, and the presence of the employees in Australia is because they are temporarily relocated or restricted in their travel as a consequence of COVID-19, the Commissioner will not apply compliance resources to determine whether the foreign company has a permanent establishment in Australia

The takeaway

Property and infrastructure groups will need to consider how they will be impacted by the tax issues highlighted above before the upcoming 30 June year end. In particular, funds will need to consider how they can manage their cashflow in meeting investor expectations as to year-end distributions. Without detailed planning, unexpected adverse tax outcomes may arise in respect of the recognition of income, withholding tax outcomes and the deduction of expenses. Early engagement with the ATO and SROs is recommended where unintended tax consequences arise for particular groups.

Tax advisers can play an important role in navigating clients through the complexity of these new measures and in liaising with the tax authorities.

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1 Australian Taxation Office, *International business frequently asked questions*. Available at www.ato.gov.au/general/covid-19/covid-19-frequently-asked-questions/international-business-frequently-asked-questions.

Successful Succession

by Tim Donlan, ATI, Donlan Lawyers, and Katerina Peiros, ATI, Hartwell Legal

The power, the attorney and the conflict transaction

Where a power of attorney consists of basic proforma provisions without proper tailoring of the scope of the attorney's powers, the potential for disputes increases.

A power of attorney is an important estate planning tool that will be well known to readers.

Basically, a power of attorney is a form of agency relationship where a principal or donor appoints an agent or attorney to manage the affairs of the donor.

The ability to appoint a trusted person to manage one's affairs has existed for centuries at common law. Historically, a general power of attorney would cease to operate in the event of the loss of capacity of the donor. The concept of an "enduring" power of attorney, whereby the authority of the attorney to act on behalf of the donor would survive the donor's loss of mental capacity, is a more recent creation founded in statute in all states and territories of Australia.[1]

Notably, a power of attorney can be said to have three significant features:

1. it is formed via a formal instrument (typically a deed);
2. it is designed to give effect to a relationship whereby one person vests authority in another; and
3. it can be limited in the scope and terms of the power granted.[2]

A power of attorney in a family or private client sense is usually given for no consideration and can be voluntarily revoked by the donor at any time, provided the donor retains the requisite mental capacity to know and understand the effect of doing so. Generally, an attorney, as an agent, is a fiduciary and is fastened with the obligations that attach to fiduciary powers.

In a commercial sense, powers of attorney can be granted for consideration and are more often irrevocable and established for the purpose of giving effect to an obligation of the donor to the attorney, or for securing a benefit for the attorney. These types of powers of attorney are often found in leases or other contractual arrangements and generally survive the death or incapacity of the donor. Such powers of attorney are outside of the scope of this article.

With increasing life expectancies, the potential for loss of mental capacity during one's lifetime has also increased. While there is a growing emphasis on "supported" decision-making for those with impaired capacity rather than the type of "substituted" decision-making associated with the granting of a power of attorney,[3] where substituted decision-making is required, the importance of having a properly drafted power of attorney as part of one's estate or succession planning (as opposed to having an off-the-shelf proforma type document) has been increasingly recognised.

A power of attorney can be tailored to the specific circumstances of the donor and the breadth of the powers to be given to the attorney need to be properly considered. In a modern society, with complex asset structures, increased levels of superannuation and blended families, the previously typical "one-size-fits-all" deeds that can be purchased off-the-shelf will rarely be suitable.

It is incumbent on advisers to explore the intentions of the donor in the event of a loss of capacity and to ensure that, where possible, the powers to be given do, insofar as possible, reflect those intentions.

Equally important is the choice of attorney. In a blended family situation, for example, while it may seem to be a good idea to appoint a spouse together with one or more children from a prior marriage jointly as attorneys (with the intention of promoting harmony and transparency), disputes between the attorneys as to the scope and exercise of powers and actions to be taken (or not taken) by them can frustrate the operation of the power of attorney and the donor's estate plans entirely, and thus needs careful consideration.

Section 7 of the South Australian *Powers of Attorney and Agency Act 1984* provides that:

> "The donee of an enduring power of attorney must, during any period of legal incapacity of the donor, exercise his powers as attorney with reasonable diligence to protect the interests of the donor and, if he fails to do so, shall be liable to compensate the donor for loss occasioned by the failure."

The provisions of the SA Act are not prescriptive as to the scope and limitation of the attorney's powers. However, other states are more prescriptive.

In SA, New South Wales, Tasmania and Western Australia, the scope of an enduring or general power of attorney is limited to property and "financial" matters. In Queensland, Victoria, the Australian Capital Territory and the Northern Territory, the donor may authorise an attorney to make health, lifestyle and other personal decisions.[4]

It is unfortunate that the power of attorney legislation differs in each state and territory. While recognition of each jurisdiction's power of attorney is afforded, difficulties can arise where the donor has interests in multiple jurisdictions and the scope of the powers (including scope as to the nature of permitted transactions) differs within each jurisdiction. The general principal is that a power of attorney from another jurisdiction will be read down in the local jurisdiction to the extent that the powers conferred by it are beyond the permissible powers in the local jurisdiction.

Some jurisdiction's relevant legislation prescribes specific things that an attorney is not authorised to do. In NSW, Tasmania and the ACT, for example, legislation provides that an attorney cannot do anything whereby a benefit is conferred on the attorney unless specifically authorised to do so in the instrument creating the attorney.[5]

The position in Queensland and Victoria is different. For example, the Queensland legislation provides that, for a financial matter, an attorney may enter into a conflict transaction only if the principle authorises the transaction, conflict transactions of that type, or conflict transactions generally.[6]

In Queensland and other jurisdictions, advice and directions can be sought from the Supreme Court or from the Queensland Civil and Administrative Tribunal or other state Administrative Tribunals, and transactions may be pre- or retrospectively authorised.

The Queensland and Victorian legislation provides that an attorney not only has a duty to avoid entering into a transaction in which there is a conflict or potential conflict between the donor and the attorney's interests, but also to avoid any conflict with the interests of the attorney's relatives, business associates or close friends.[7]

In some jurisdictions, gifts are permitted to be made by an attorney but only to a relative or close friend (including the attorney), and only of a "seasonal type" (for example, Christmas) or for a special event, that is the type of donation that the donor made or might reasonably be expected to make if they had capacity to consider such a gift.[8]

The legislation in NSW and other jurisdictions allows an attorney to make gifts and pay expenses for the welfare of the attorney "or any other specified person".[9] Furthermore, a conflict transaction may be authorised (or not be considered to be a prohibited conflict transaction) in circumstances where an attorney deals with an existing interest in property that is jointly owned with a donor, or otherwise obtains a loan or gives a guarantee on behalf of the donor in relation to such interest.[10]

The legislation in jurisdictions that specifically restrict conflict transactions provides for those restrictions to be subject to the terms of the instrument creating the power. The instrument might then be properly crafted to address future transactions.

Given the broad range of powers that an attorney might generally be able to undertake in the absence of specific restrictions arising from "conflict transaction" legislation, it is necessary for a donor to carefully tailor the powers to be given (or not given) to the attorney and to consider how to expand or otherwise restrict the powers granted.

From an estate planning perspective, it is relevant that an attorney's powers have been held to include powers to directly or indirectly:

- execute a binding death benefit nomination on behalf of a donor[11] subject to the limitations on the scope of the power and the terms of the trust deed, as well as the specifics of the case, including any history of prior death benefit nominations made by the member;
- act on behalf of a donor in the capacity as trustee where specifically authorised by the trust deed and the delegation is not prohibited by statute;[12]
- be appointed as a case guardian in Family Court proceedings;[13]
- act on behalf of a donor in the capacity as trustee of a self-managed superannuation fund;[14] and
- act in the donor's personal capacity as appointor of a family trust.[15]

While it is appropriate for donors and their advisers to consider the relevant provisions of the instrument creating the power of attorney from the perspective of limiting the scope for attorney abuse, equally, it is important to ensure that a donor provides and "arms" the attorney with all of the necessary powers intended to be exercised by the attorney free, as far as possible, from legislative restrictions.

Typically, a donor (for example, a husband or a wife) may simply seek to appoint a spouse to be their attorney in the event of their loss of capacity, with the intention that the spouse carries on "business as usual" and is at liberty to financially support the donor, the attorney, and possibly dependent children, free from any legal impediment.

That expectation may be founded in well-intentioned ignorance as it is not as easy as it may seem, given the conflict transaction restrictions and the types of restrictions placed on an attorney to avoid such conflict transactions. Even in circumstances where the applicable legislation provides for support for dependants, such provisions are subject to requirements of reasonableness in the circumstances[16]

The power of attorney document should expressly provide for conflict transactions.

If one considers a common second marriage, blended family scenario, it is typically intended by a donor spouse to appoint a spouse and adult child jointly as their attorneys. The potential for disputes is well known and can result in the child seeking to restrict the scope of the spouse's transactions, including financial support from the donor, based on suggestions of unlawful conflict transactions which are often founded in the child's own self-interest and motivation to preserve the size of the donor's estate to be distributed on death.

A not uncommon scenario may involve a complaint by a step-child that an attorney spouse has used the donor's funds to meet their joint expenses (possibly well in line with the donor's "business as usual" intention) without any express authority in the instrument creating the power. Ultimately, matters such as these can be determined by the courts in their protective jurisdictions. However, such action is typically expensive and emotionally damaging for all concerned. The consideration for the courts will essentially involve a balancing of the interests of the donor in all of the specific circumstances of the case.

In the NSW case of *C v W (No. 2)*,[17] a sister pursued her brothers for alleged breaches of their duties to their mother as her attorneys under a power of attorney. While they were ultimately found to have engaged in some irregularities with respect to their delegation of certain powers and the separation of the donor's funds from their own, their actions were ultimately excused by the court.

In that case, Lindsay J observed that the sister's "adversarial pursuit of her brothers, using her mother as a proxy, went beyond the reasonable".[18] While the court did not make any sanctions against the attorneys, the outcome may be different depending on the court's assessment of the facts and nuances of a particular case.

The most appropriate way to avoid disputes over conflicts involving a power of attorney is to tailor the powers to include those that are considered desirable and appropriate by the donor at the time of creation. A simple standard proforma document will rarely be satisfactory and will not evidence any consideration of a maker's intentions with respect to particular transactions or types of transactions.

Relevant considerations when tailoring powers for an attorney include:

– the timing of commencement of the powers;
– the appointment of one or multiple attorneys and whether they may act jointly or severally;
– include substitute attorneys in the event that the first attorney is unable to act;
– whether the attorney can enter into specified transactions such as borrowing or providing guarantees, and if so, those transactions should be specifically permitted;
– whether or not the attorney can withdraw the donor's superannuation funds or make, renew or revoke a superannuation death benefit nomination;
– whether an attorney can exercise power as trustee or appointor of a trust;[19] and
– whether an attorney can enter into conflict transactions generally, notwithstanding their particular interest.

Obviously, the choice of attorney, and the relationship between the attorneys where more than one is to be appointed, also need proper consideration.

Only when a donor is able to give properly informed instructions as to the potential scope of the power of attorney, how the laws operate in relation to powers, and what can go wrong if the power is not properly prepared and implemented can the donor be confident that a power of attorney will assist, rather than hinder, their personal and estate planning objectives.

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References

1 *Powers of Attorney and Agency Act 1984* (SA); *Powers of Attorney Act 2003* (NSW)*; Powers of Attorney Act 2014* (Vic); *Powers of Attorney Act 1998* (Qld); *Guardianship and Administration Act 1990* (WA); *Powers of Attorney Act 2000* (Tas); *Powers of Attorney Act 2006* (ACT); *Powers of Attorney Act 1980* (NT).

2 GE Dal Pont, *Powers of attorney*, Lexis Nexis, 2019, p 5.

3 See United Nations, Convention on the Rights of Persons with Disabilities, available at www.un.org/development/desa/disabilities/convention-on-the-rights-of-persons-with-disabilities.html; and Australian Law Reform Commission, *National decision-making principles*, 2014.

4 *Powers of Attorney Act 2014* (Vic); *Powers of Attorney Act 1998* (Qld); *Powers of Attorney Act 2006* (ACT); *Powers of Attorney Act 1980* (NT).

5 S 12 of the *Powers of Attorney Act 2003* (NSW); s 107 of the *Guardianship and Administration Act 1990* (WA); s 32AB of the *Powers of Attorney Act 2000* (Tas); s 34 of the *Powers of Attorney Act 2006* (ACT); s 22(8) of the *Powers of Attorney Act 1980* (NT).

6 S 73 of the *Powers of Attorney Act 1998* (Qld); s 64 of the *Powers of Attorney Act 2014* (Vic).

7 S 64 of the *Powers of Attorney Act 2014* (Vic).

8 S 67 of the *Powers of Attorney Act 2014* (Vic).

9 Ss 11 to 13 of the *Powers of Attorney Act 2003* (NSW).

10 S 64(2) of the *Powers of Attorney Act 2014* (Vic).

11 *Re Narumon Pty Ltd* [2018] QSC 185.

12 S 10 of the *Powers of Attorney Act 2003* (NSW).

13 *Stanford v Stanford* [2012] HCA 52; *Price v Underwood (No. 2)* [2008] FamCA 267.

14 SMSFR 2010/2. Notably, Tasmania is the only jurisdiction in Australia which specifically provides for an attorney to exercise any power of the donor in respect to any superannuation interest of the donor (s 31(2A)(i) of the *Powers of Attorney Act 2000* (Tas)).

15 *Belfield v Belfield* [2012] NSWCA 415.

16 S 89 of the *Powers of Attorney Act 1998* (Qld).

17 *C v W (No. 2)* [2016] NSWSC 945.

18 *C v W (No. 2)* [2016] NSWSC at 945 at [52] per Lindsay J.

19 Interestingly in this case, the NSW Court of Appeal held that a power of appointment over trust property was a power that could be exercised by the attorney of the appointor and the failure to exercise a discretion to appoint property to a claimant under a family provision claim was a "relevant property transaction" for the purposes of notional estate provisions in Pt 3.3 of the *Succession Act 1981* (NSW). Where the notional estate legislation applies, ironically, by restricting an attorney's power to exercise the donor's personal power of appointment, the donor may avoid a claw-back order.

Events Calendar

June/July 2020

EVENT	DATE	CPD
Online		
Barossa Online – SME Tax Technical: Part 3 webinar and live Q&A	9/6/20	3.75
Barossa Online – SME Tax Technical: Corporate tax residency – There's no Australian tax payable … is there? | Session 7 webinar	9/6/20	0.75
Barossa Online – SME Tax Technical: The world's greatest tax admin session! – Issues in taxation administration | Session 8 webinar	9/6/20	0.75
Barossa Online – SME Tax Technical: A practical session for the accidental property developer | Session 9 webinar	9/6/20	1
Barossa Online – SME Tax Technical: Buy-sell agreements as estate and succession planning tools | Session 10 webinar	9/6/20	0.75
Superannuation Series – Part 9: Superannuation planning to meet the unexpected and also the expected	10/6/20	1
Death … and Taxes Online – Part 3: Payment and taxation of death benefits	11/6/20	1
Business Structures Online Tax Symposium – Full series	12/6/20	8
Business Structures Online Tax Symposium – Part 1: Structuring – getting it right from the start	12/6/20	1
Young Tax Professionals Online – Part 2: How to restructure a small business concession	15/6/20	1.5
Trusts Intensive Series – Full Series	16/6/20	6
Trust Intensive Series – Part 1: Entitlement to the income of a trust	16/6/20	1.5
Superannuation Series – Part 10: Superannuation guarantee amnesty	17/6/20	1
Death … and Taxes Online – Part 4: Emerging international issues	18/6/20	1
Breakfast Club Series: Testamentary discretionary trusts	19/6/20	1.5
Business Structures Online Tax Symposium – Part 2: Restructuring – for the 21st century environment	19/6/20	1
Regional Tax Masterclass Series – Full series	22/6/20	6
Trust Intensive Series – Part 2: Capital gains and foreign beneficiaries of Australian trusts	23/6/20	1.5
Private Business Online – Full series	24/6/20	10
Private Business Online – Part 1: Technology, tax and the transformation of the profession	24/6/20	1
Death … and Taxes Online – Part 5: Passing of a life tenant	25/6/20	1
Business Structures Online Tax Symposium – Part 3: Div 7A – everything old is new again	26/6/20	1
Morning Tax Club	1/7/20	1.5
Death … and Taxes Online – Part 6: IGOT inquiry into deceased estates – a range of administrative issues	2/7/20	1
Business Structures Online Tax Symposium – Part 4: The broke trustee	3/7/20	1

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

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TAXATION *in Australia*®
ISSN 0494-8343

Publishing House
The Tax Institute
ABN 45 008 392 372

Level 37, 100 Miller Street
North Sydney, NSW 2060

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Deborah Powell

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Graphic Designers
Mei Lam
Nicole Welch

Typesetter
Midland Typesetters, Australia

Advertising
Wayne Flekser 02 8223 0071

Giving back to the profession

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

Matthew Andruchowycz, CTA
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On the passing of a great tax leader

A message from The Tax Institute's Former President Tim Neilson

Like many others in The Tax Institute I was shocked by the news that Paul Drum, long time General Manager, Policy and Advocacy at CPA Australia, has passed away.

I had the privilege of Paul's company and collaboration over a number of years at the National Tax Liaison Group, being "in lockup" with him during Budget time, and on many other occasions where two or more devotees of tax were gathered together.

Paul was the archetype of a good advocate in tax policy and administration. He had a deep knowledge of the tax system and great empathy and understanding of the needs of those who strive within it. He was resourceful and persistent in pursuit of anything which he saw as a desirable improvement to the Australian tax landscape, but also patient, tactful and understanding with those who were yet to be persuaded by his eloquence on any such matter.

He worked very effectively in an exemplary collegiate way with those of us who were representing the Institute in pursuit of making the tax system as good as it can possibly be.

He was also engaging, warm and genuinely interested in others, not just professionally but personally as well.

I'll very much miss Paul's easy-going charm on social occasions, and the whole Australian tax community will be the poorer for the loss of his truly outstanding contribution to the fabric and the people of the Australian tax system.

Our thoughts are with Paul's family during this time.

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