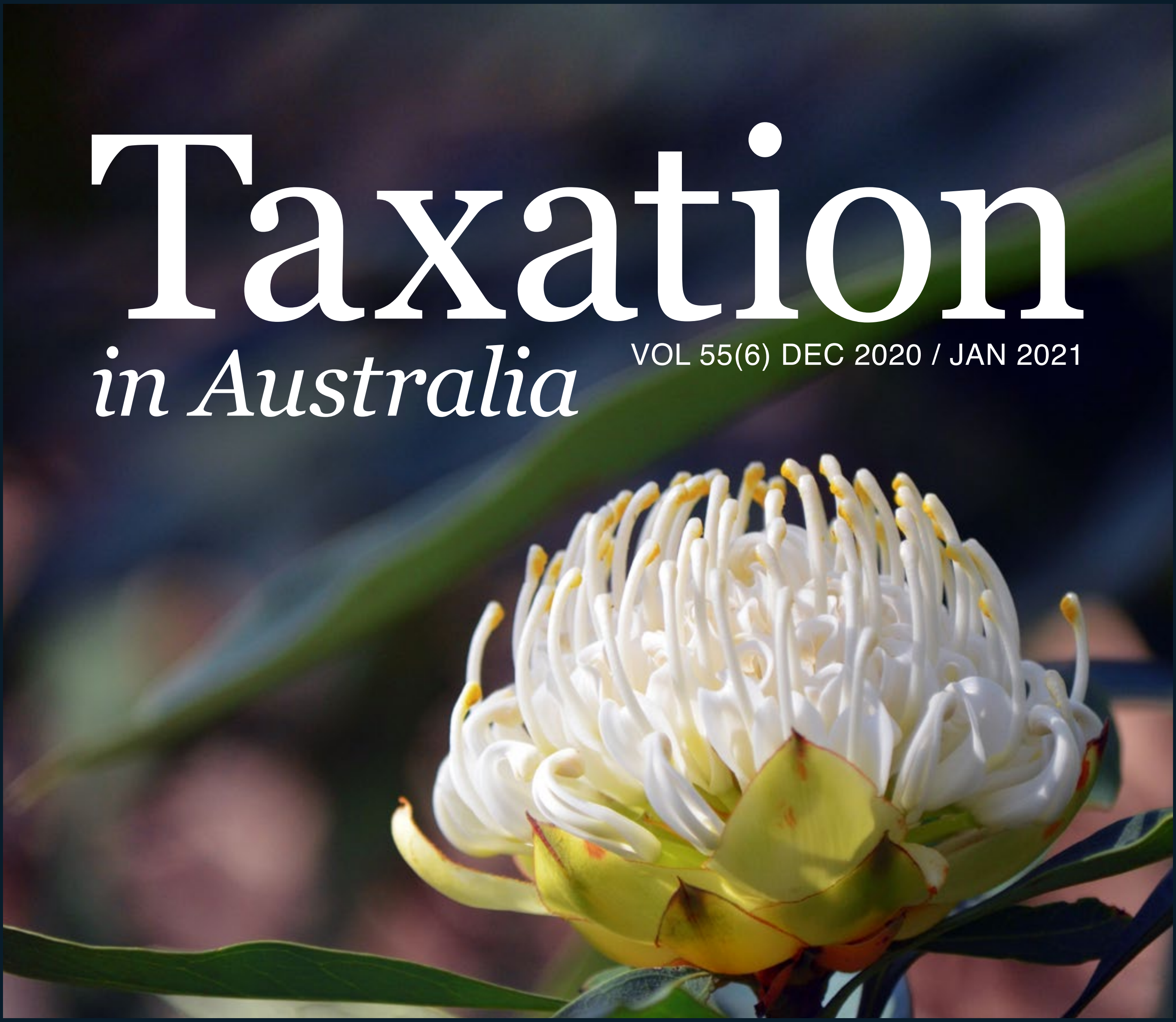
THE JOURNAL FOR MEMBERS OF THE TAX INSTITUTE



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THE TAX INSTITUTE

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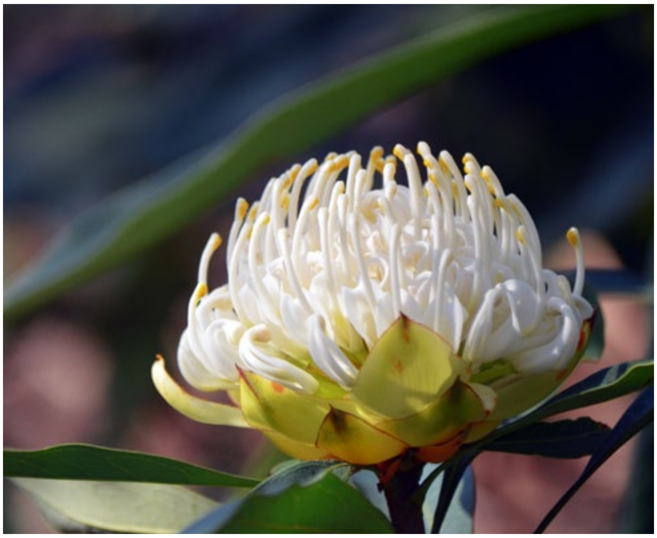

Invitation to write

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

For details about submitting articles, please see Guidelines for Publication on our website taxinstitute.com.au, or contact publisher@taxinstitute.com.au.

Tax News – at a glance

by TaxCounsel Pty Ltd

November – what happened in tax?

The following points highlight important federal tax developments that occurred during November 2020. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 279 (at the item number indicated).

Exposure draft of technical amendments

The Treasury has released an exposure draft Bill, regulations, an instrument and supporting explanatory materials in relation to proposed minor and technical amendments to the Treasury portfolio laws. **See item 1.**

CGT withholding variation

The Commissioner has made a legislative instrument under the *Taxation Administration Act 1953* (Cth) that varies to nil the amount of withholding required under the CGT foreign resident withholding rules in certain circumstances where there is a mortgagee sale (Variation 2020/1). **See item 2.**

Administrative penalties and SMSFs

The Commissioner has released a law administration practice statement that provides guidelines to ATO officers as to the administration of the penalties imposed under s 166(1) of the *Superannuation Industry (Supervision) Act 1993* (Cth) for contraventions in relation to self-managed superannuation funds (PS LA 2020/3). **See item 3.**

Ordinary income and non-cash benefits

The Full Federal Court (Logan, Colvin and Thawley JJ) has unanimously reversed in part a decision of Moshinsky J at first instance and held that the amount of a non-cash business benefit that was potentially assessable under s 21A ITAA36 was, in the circumstances, nil (*Victoria Power Networks Pty Ltd v FCT* [2020] FCAFC 169). **See item 4.**

Expenditure on capital account

The Full Federal Court (Jagot, Moshinsky and Colvin JJ) has unanimously reversed a decision of Perram J at first instance and held that lump sum payments made by the taxpayer company to doctors in respect of contracts to conduct for a certain period their practices at medical centres operated by the taxpayer were capital in nature and, so, not allowable as general deductions (*FCT v Healius Ltd* [2020] FCAFC 173). **See item 5.**

Joint venture issues

The Federal Court (Davies J) has considered a number of issues that arose out of a joint venture agreement and also the construction of the provisions of a discretionary trust deed relating to the changing of a trustee (*Advanced Holdings Pty Ltd as trustee for The Demian Trust v FCT* [2020] FCA 1479). **See item 6.**

GST input tax credits and incapacitated entities

The AAT has held that, where an entity that accounts for GST on an accruals basis becomes an incapacitated entity and the representative of the incapacitated entity accounts for GST on a cash basis, an input tax credit in respect of a creditable acquisition made by the entity before it became incapacitated but paid for by the representative is claimable by the entity and not the representative (*Richard Albarran, Brent Kijurina and Cameron Shaw as Joint Administrators of Cooper & Oxley Builders Pty Ltd as trustee for the Cooper & Oxley Builders Unit Trust and FCT* [2020] AATA 4325). **See item 7.**

President's Report

by Peter Godber, CTA

Closing on one of the most challenging years

While challenging, 2020 will not hold us back as an organisation and a community.

It's certainly hard to contemplate a more challenging year for us all.

At The Tax Institute, we have weathered the pandemic and the economic slump by being agile and quickly responding to the external influences that have changed the way we do things. We always had in mind the need to engage closely with our members in 2020, and the times we are living through have made that an even greater necessity. We have embraced a strong sense of community and that is seeing us through and giving us motivation to look ahead to 2021. As they say, the greater the challenges, the greater the opportunities.

I have been pleased this year to be able to introduce new members of our team who are already embedded in the delivery of our services. These include Andrew Mills, CTA (Life), Robyn Jacobson, CTA, Julie Abdalla, FTI, Michelle Ma, ATI, and most recently, Scott Treatt, CTA. I haven't yet had the chance to publicly welcome Scott, but having known him over a long period of time in the profession and through The Tax Institute, it gives me great pleasure to know that Scott will be working with us, hopefully for a very long time. All of these wonderful people bring new skills and depth to our technical, advocacy and knowledge-based services.

Let me also sincerely thank our leadership team, and all of those in our membership engagement, events, education, marketing, finance, and other support teams who have worked so hard this year.

We have continued to deliver our events, publications, education programs and advocacy services that I know members value so highly. From a busy start to the year and reaching The Tax Summit 2020 in March, to moving to online delivery, dealing with Zoom and the like, and long days out of the office, it has been challenging.

But these are the types of challenges that all of our members have been going through. Support for what our members do is the key to our vision at The Tax Institute. One of the most pleasing things for me this year has been to hear from members, even when I am stopped in the street, who say that the Institute has really stepped up and delivered some meaningful things –- be it vital publications, timely lunchtime webcasts, help with JobKeeper, answers to technical questions, or thought-provoking ideas. Thank you for the feedback. We have learned a lot this year about what our members find valuable and we will continue to deliver these resources and experiences.

We are finishing the year with some valuable CPD events and by wrapping up the final stage of The Tax Summit: Project Reform. The Virtual Summit event, where all of the hard work and insights from this project came together, was successfully held last week.

That project has been a wonderful and important reminder of the role that The Tax Institute plays as the leading forum for the tax community in Australia. Participating has been enjoyable, and hearing from the long and varied list of speakers and contributors has been a fantastic learning experience. My thanks go out to all involved, including our speakers, facilitators, volunteers, committee members and delegates.

This all plays into the very important constitutional objectives of the Institute — the advancement of public knowledge and understanding of taxation laws (including how they are administered and the attitudes of the governments which make them), advancing study and education in taxation, and encouraging research into reform of the taxation law. I would say that we have thoroughly delivered on many of our key objectives in 2020.

2021 will offer us more opportunities to be relevant to and supportive of our members. We will do this with acceptance of new technologies, an urgency to bring important technical updates to members, continued development of our structured education programs and pathways to advancement in membership status, help at all stages of a member's career development, recognition of our communities, and, maybe most importantly, care for the health and wellbeing of our members.

I do hope that you get some time away from your work during the summer festive season. May you get together with family (which for many has not been easily achievable this year), celebrate the good things, care for others, and be ready to go again in 2021.

Thanks for all of your support during 2020. It has been my great pleasure to represent The Tax Institute as president. I, too, look forward to 2021 at the Institute.

CEO's Report

by Giles Hurst

Revitalisation and rebirth: looking ahead

Leading the way on change in our tax system and embracing the digital future at the Institute.

Well, that's a wrap folks. As we near the end of a challenging year, I am penning my last report to you for 2020 in the wake of one of our most ambitious undertakings — The Tax Summit: Project Reform has now come to a close.

We held the Virtual Summit event on 24 to 25 November and it was two half-days full of some of the most constructive and inspiring discussions we have ever seen at the Institute. We heard from some key players, including Jeremy Hirschhorn, CTA, Second Commissioner at the ATO, and the Rt Hon Sir Bill English, former Prime Minister of New Zealand, on some important topics for our profession.

This project was not only ambitious in its scope, but also in the fact that the program was delivered solely online. While this was both a challenge and a necessity, it was also an opportunity for us to extend the invitation to members in every corner of the country. And you responded to the call.

On behalf of the Institute, I would like to thank anyone who attended any of the focus sessions, keynotes or roundtables from the program, which have been taking place since September. When we set out to define the path of potential reform for our tax system, we knew that our members' voices would be vital to capturing truly meaningful insights. Thank you for your contributions, they will be given serious consideration as we move forward.

I would also encourage you to continue contributing your reform opinions on Community and engaging with your fellow members on issues that are important to the profession.

Although the event part of this project has now finished, there is still work to be done. Our Tax Policy and Advocacy team is working to put together our case for change, a comprehensive submission to Treasury which lays out our priorities for significant tax reform. And as a result of this extensive and ambitious project, I can say with confidence that *our* priorities are *your* priorities.

Our case for change is built on the actual, everyday needs of practitioners like you and the overall vision that will make practical solutions possible. True reform may not happen quickly but, rest assured, the Institute will continue to lead the way on a revitalised tax system for Australia.

The Institute website: reborn in 2021

Although we are coming to the end of the year, things are certainly not slowing down at the Institute. I am thrilled to share with you that we have embarked on an exciting new project to refresh and rebuild The Tax Institute's website.

Our current website is built on technology that is over a decade old, so we are certainly due for a refresh. And there has never been a more appropriate time for it — as we all know, life has taken a sharp turn towards all things digital this year.

Our online environment is more important for members than ever. We aim to create a website which allows you to more easily find the resources, tools and information you need to excel in your profession and that better fosters your connection with other members and with the Institute.

Our members are the best and brightest of the tax profession — from seasoned experts, to up-and-coming new faces. And I believe that the Institute is a worthy home for that talent and passion. In 2021, we will have a website which reflects that.

Practically speaking, this is a huge undertaking and will not be a quick project. But have no fear, we have an incredible team working behind the scenes to deliver a website that we can all be proud of. When we get closer to rolling out the changes, we will be in touch with more information about what you can expect.

I will share a glimpse into the project so far by telling you that it has been dubbed "Project Phoenix" internally. I for one cannot wait to see our site reborn better than ever before.

This is my last report to you until February 2021, so let me end by saying this: we have navigated an unprecedented year in 2020 and you have done a phenomenal job in supporting Australian communities and businesses through it. As I have said, there is more work to be done, but know that you do not shoulder that work alone. You have the Institute's unending support.

So, this holiday season, I urge you to take the time to be proud of your achievements and triumphs in 2020, and to take a breath, reconnect with your loved ones, rejuvenate and refresh yourself for the year ahead.

My warmest wishes to you and yours for safe and happy holidays.

Tax Counsel's Report

by Angie Ananda, CTA

A year no one will forget …

As we move towards 2021, it is a good time to reflect on the positives from 2020 and to refocus our attention on the future.

At this time last year, I wrote a column about re-examining the Australian tax base to ensure that Australia would have a strong tax system in the future. I had no idea what challenges 2020 would bring. As it turned out, 2020 has been a year of unimaginable challenges, many of which people would like to forget. Rather than focusing on the future of the tax system, our focus became dealing with the reality of a global pandemic. As we move towards 2021, it is a good time to reflect on the positives from 2020 and to refocus our attention on the future.

Starting at the Summit

2020 started off with a bang for The Tax Institute with The Tax Summit in March. The theme of the Summit was "Now & When" to highlight the need to look forward.

At the time of the Summit, the Institute made this statement:

> "The industry faces enormous challenges — but also remarkable opportunities. What does the future hold? What can you do to grasp those opportunities? What skills and tools will you need?"

Little did we know that, within days of the Summit in March, we would face challenges never before seen in our lifetimes. The full implications of the global pandemic started to become apparent — offices closed around the country and lockdowns would soon follow. In 2020, the need to stand up to challenges, take new approaches and grasp new opportunities has never been needed more.

Dealing with new challenges

The global pandemic imposed challenges on businesses and individuals like no others. The government acted quickly and introduced many tax measures to attempt to mitigate these challenges.

The Institute in turn responded quickly and advocated on behalf of our members on a number of issues, including significant policy matters relating to the various stimulus packages. The Institute fought for relevant tax deferrals to allow our members to cope with the challenges imposed by the pandemic.

The Institute also worked closely with many other professional associations to drive outcomes on significant policy matters that have come back into focus as a result of the COVID-19 crisis. We prepared more than a dozen joint submissions with other professional bodies representing the tax profession on numerous matters related to the stimulus package measures and issues that members were facing as a result of the COVID-19 crisis.

The Institute was in constant contact with the ATO Communications Team to ensure that website guidance and communications with tax agents and taxpayers was clear and updated as required.

We supported our members by ensuring that guidance from the government about measures in the stimulus packages had been disseminated properly. A special COVID-19 webpage was developed by the Institute to provide as much information to our members as possible. We also offered free events for members about the stimulus package measures.

Back to the Summit and beyond

After advocating for our members in relation to the stimulus package measures for a large part of 2020, it is time for the Institute to look to the future. Nothing highlights the Institute's commitment to the future of the tax system more than the Tax Reform Project headed by Andrew Mills (Director of Tax Policy and Technical). The objective of the Institute's Tax Reform Project is to position the Institute as the leader of the tax reform debate.

After a year when we have all faced challenges we could never have imagined, the Institute finished where it started … back at the Summit! This time the focus of the Summit was tax reform, with sessions highlighting tax reform options and priorities. The global pandemic has highlighted the need for tax reform so that we can develop a robust and adaptable tax system to take us into the future.

The November Summit was different to the March Summit. Like all businesses, we have needed to adapt and adjust. As such, the November Summit was a virtual Summit. Although there was no shaking hands and mingling with colleagues, this Summit offered amazing opportunities for our members and the broader tax community to come together virtually and to start considering the case for change. If this year has taught us nothing else, it has taught us the importance of being able to adapt and deal with change.

Tax News – the details

by TaxCounsel Pty Ltd

November – what happened in tax?

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

Government initiatives

1. Exposure draft of technical amendments

The Treasury has released an exposure draft Bill, regulations, an instrument and supporting explanatory materials in relation to proposed minor and technical amendments to the Treasury portfolio laws.

The proposed amendments seek to ensure that the law operates as intended by correcting technical or drafting defects, removing anomalies, and addressing unintended outcomes. The amendments are part of the government's commitment to the ongoing care and maintenance of Treasury laws.

The proposed amendments address technical deficiencies and legislative uncertainties in various Treasury portfolio laws by:

- correcting spelling and typographical errors;
- fixing incorrect legislative references;
- reducing unnecessary red tape;
- addressing unintended outcomes;
- adopting modern drafting practices;
- enhancing readability and administrative efficiency; and
- repealing redundant and inoperative provisions.

The Commissioner's perspective

2. CGT withholding variation

The Commissioner has made a legislative instrument under the *Taxation Administration Act 1953* (Cth) (TAA53) that varies to nil the amount of withholding required under the CGT foreign resident withholding rules in certain circumstances where there is a mortgagee sale (variation 2020/1).

More particularly, the effect of the instrument is to vary to nil the amount that would otherwise have to be paid to the Commissioner (under s 14-200, Sch 1 TAA53) when land is acquired in the following circumstances:

- there is a transaction where a mortgagee exercises a power of sale over the land and the mortgagee is also an authorised deposit-taking institution (under s 5 of the *Banking Act 1959* (Cth));
- the mortgagee has determined that the residue from the sale proceeds will be zero or less than zero; and
- the mortgagee has provided the transferee with a written declaration stating that the amount to withhold is varied to nil under legislative instrument variation 2020/1.

The legislative instrument commenced on 10 October 2020, the day after its registration on the Federal Register of Legislation.

3. Administrative penalties and SMSFs

The Commissioner has released a law administration practice statement that provides guidelines to ATO officers as to the administration of the penalties imposed under s 166(1) of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA93) for contraventions in relation to self-managed superannuation funds (PS LA 2020/3).

The purpose of the practice statement is to provide guidance on:

- when an entity becomes liable to one or more administrative penalties under the SISA93;
- which entities are liable to pay the administrative penalty;
- the Commissioner's remission considerations; and
- the objection, review and appeal rights relating to a remission decision.

If a trustee of an SMSF contravenes a provision of the SISA93 listed in s 166, an administrative penalty is imposed. Administrative penalties apply to contraventions which occur on or after 1 July 2014. Contraventions which occurred before 1 July 2014 may constitute an offence which has criminal or civil consequences.

PS LA 2020/3 points out that a contravention occurs at a point in time. There is no one continuing contravention which carries over successive financial years. There may, however, be circumstances when a contravention remains unrectified at the end of a financial year. For some contraventions, this causes an additional, separate contravention at the start of the following financial year.

The SISA93 sets out who is liable to the penalty and provides that the liability cannot be reimbursed from the SMSF. The penalty is imposed on the following persons:

- a trustee of an SMSF (including an individual trustee or a corporate trustee); or
- a director of a body corporate that is a trustee of an SMSF.

Under s 298-20, Sch 1 TAA53, the Commissioner has the discretion to remit an administrative penalty imposed under s 166.

The practice statement makes these points in relation to the making of a remission decision:

- the relevant ATO officer may decide that full remission, partial remission or no remission of the penalty is appropriate based on the individual circumstances of the case;
- the penalties, in conjunction with other compliance treatments under the SISA93, give the ATO effective, flexible and cost-effective mechanisms for applying appropriate sanctions; and

- depending on the circumstances of a particular case, one or more compliance treatments may be applied within the one case.

The other compliance treatments include: issuing a direction to educate; accepting an enforceable undertaking; issuing a direction to rectify; disqualifying an individual and prohibiting them from acting as a trustee of a superannuation fund or as a responsible officer of a corporate trustee; or seeking civil and/or criminal penalties.

PS LA 2020/3 sets out a number of considerations that are relevant when administering the penalties (including in any review process undertaken).

Recent case decisions

4. Ordinary income and non-cash benefits

The Full Federal Court (Logan, Colvin and Thawley JJ) has unanimously reversed in part a decision of Moshinsky J at first instance and held that the amount of a non-cash business benefit that was potentially assessable under s 21A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) was, in the circumstances, nil (*Victoria Power Networks Pty Ltd v FCT*[1]).

The taxpayer, Victoria Power Networks Pty Ltd (VPN), was, during the relevant income years, the head company of a consolidated tax group. Powercor Australia Ltd (Powercor) and CitiPower Pty Ltd (as trustee for the CitiPower Trust) (CitiPower) were subsidiary members of that group. Each of Powercor and CitiPower (the distributors) held a distribution licence under the *Electricity Industry Act 2000* (Vic) and carried on the business of distributing electricity to customers in Victoria.

The consequences of the statutory regime of the *Electricity Industry Act 2000* included:

- the taxpayer had to connect a “customer” to the electricity network even where the “incremental cost” of the connection exceeded the “incremental revenue” anticipated from the connection. These connections were conveniently labelled “uneconomic” from the perspective of the taxpayer. The amount by which the anticipated cost of construction exceeded the anticipated revenue was referred to as the “shortfall”; and
- although the taxpayer had no choice but to connect the customer, the customer wanting an uneconomic connection had to bear the shortfall whether or not the taxpayer (option 1) or the customer (option 2) undertook the relevant “contestable works” required for the connection.

If a customer wanted an uneconomic connection and chose option 1, the taxpayer paid the full amount of the construction costs, the customer paid to the taxpayer a “customer cash contribution” representing the shortfall, and the taxpayer always owned the assets.

If a customer wanted an uneconomic connection and chose option 2, the customer paid for the works, the customer arranged for third parties to undertake the works, the taxpayer paid the customer a “rebate” such that the customer only ultimately bore the shortfall (economically equivalent to the customer’s position under option 1), and the assets were transferred by the customer to the taxpayer.

At first instance, Moshinsky J held, in relation to option 1, that the customer cash contributions were derived by the taxpayer under transactions that occurred as an ordinary incident of their electricity distribution business and were assessable as ordinary income. In relation to option 2, his Honour held that there was no derivation of income according to ordinary concepts but that the assets that were transferred under option 2 constituted a non-cash business benefit of the taxpayer for the purposes of s 21A ITAA36, the arm’s length value of which, for the purposes of s 21A(5), was the estimated cost of construction.

On the appeal by the taxpayer, the Full Federal Court unanimously held that Moshinsky J was correct to conclude that the customer cash contributions received by the taxpayer under option 1 were ordinary income.

The Full Court also held, as had Moshinsky J, that under option 2 there was no derivation by the taxpayer of ordinary income but that s 21A ITAA36 applied. However, the Full Court, differing from Moshinsky J, held that the amount assessable under that section was nil. The arm’s length value under option 2 was the estimated cost of the contestable works less the shortfall. Then, under s 21A(2)(a), the arm’s length value was to be reduced by the recipient’s contribution, if any. In the case of option 2, the recipient’s contribution (that is, the taxpayer’s contribution) was the amount of the rebate. That meant that the non-cash business benefit to the taxpayer under option 2 was nil.

5. Expenditure on capital account

A Full Federal Court (Jagot, Moshinsky and Colvin JJ) has unanimously reversed a decision of Perram J at first instance and held that lump sum payments made by the taxpayer company to doctors in respect of contracts to conduct for a certain period their practices at medical centres operated by the taxpayer were capital in nature and, so, not allowable as general deductions (*FCT v Healius Ltd*[2]).

The taxpayer was in the business of developing and operating medical centres (centres). Medical practitioners at the centres conducted their own practice, but all of the facilities and support services that they required for their practice, including reception and billing services, were provided by the taxpayer. A range of health services was provided at the centres.

As at 1 July 2002, there were 17 centres. By 30 June 2007, there were 35 centres. During that period (being the five income years before the court), the taxpayer entered into a considerable number of arrangements with medical practitioners, most of whom were general practitioners, concerning the conduct of their practices at the centres. The balance of the arrangements was made with specialist medical practitioners and dentists.

One type of arrangement made by the taxpayer concerning the centres involved the entry into of a sale of practice deed and an agreement for the provision of services. Practitioners entering into such arrangements agreed to conduct their medical practice from a centre for an agreed period, usually five years. Practitioners were also paid a lump sum by the taxpayer of the order of several hundreds of thousands of dollars (lump sum). In total, 505 lump sum amounts were paid under such arrangements during the relevant five-year period. Under the arrangements, the taxpayer earned ongoing revenues that were determined on the basis of a percentage (usually 50%) of the fees rendered by medical practitioners conducting practices at its centres. The lump sums for the income years in question were: $31,012,599 (2003); $15,514,000 (2004); $20,488,023 (2005); $36,706,780 (2006); and $40,104,463 (2007).

At first instance, Perram J held that each of the lump sum payments was made on revenue, not capital, account for income tax purposes and, so, was allowable under s 8-1 of the *Income Tax Assessment Act 1997* (Cth) as a general deduction.[3] As indicated above, the Full Federal Court has now reversed the decision of Perram J.

In a joint judgment, the Full Court said that it was common ground that, in almost all instances, the documents recording the arrangement reached between the taxpayer and the practitioner provided for the practitioner to sell an existing medical practice to the taxpayer as a going concern and then for the practitioner to conduct their practice at a centre. Further, the practitioner agreed not to practise elsewhere during the term of the agreement, and also agreed to accept a restraint of trade that prevented the practitioner from conducting a medical practice within a specified radius and for a specified time while conducting, and after ceasing to conduct, a practice at the centre.

Significantly, the practitioners also agreed to accept a particular mode of providing medical services at the centre, including the adoption of bulk billing. The practitioners were also required to be available to support rosters that allowed for the operation of the centre on the basis that it may be open seven days a week and 365 days of the year without the need to make an appointment to see a doctor. All services required by the practitioner in order to conduct the medical practice were to be provided by the taxpayer, including a central reception that handled patient inquiries for all practitioners. The taxpayer also assumed responsibility for the rendering and banking of fees and the promotion of the centre as a place where a range of medical services could be obtained from a single location.

The Full Court pointed out that the chief, if not critical, factor in determining the character of a particular payment was the advantage that the taxpayer sought to secure by making the payment.

The Full Court said that the lump sum payments were capital outgoings principally because they were not simply payments to secure medical practitioners as customers who would then pay to use the facilities and support services provided by the centre. Rather, they were payments made for the practitioner: (1) to cease operating an existing practice (or to cease practising independently of the centre); (2) to commence trading as part of the centre by adopting the taxpayer's required mode of practice; and (3) during the arrangements, as well as thereafter, to accept a restraint on establishing a medical practice that would compete with the centre.

The arrangements enabled the taxpayer to earn ongoing revenues that were determined on the basis of a percentage (usually 50%) of the fees rendered by medical practitioners conducting practices at its centres. As such, they were the means by which the taxpayer profited from the adoption of a mode of practice by medical practitioners at its centres that formed an essential part of the taxpayer's business structure, a mode of practice that was instigated and directed by the taxpayer. Also, commitments from the medical practitioners of the requisite character needed to be in place from the outset for each centre to be opened and operated. The connections then developed by the business conducted from the centre with patients who sought medical services at the centre were protected by the restraint. The lump sum amounts were paid to put in place that structure and they thereby created and protected the goodwill in the centres that was associated with the operation of the centres in the manner required by the taxpayer.

The taxpayer is seeking special leave to appeal from the decision of the Full Federal Court in this case to the High Court.

6. Joint venture issues

The Federal Court (Davies J) has considered a number of issues that arose out of a joint venture agreement and also the construction of the provisions of a discretionary trust deed relating to the changing of a trustee (*Advanced Holdings Pty Ltd as trustee for The Demian Trust v FCT*[4]).

The factual situation was somewhat complex and involved a number of entities associated with a Mr Charbel Demian and which carried on a property development business. For present purposes, however, it may be said that the trustee of the Lewisham Estates Trust (Lewisham Estates), which was a unit trust that was established in 2003 and of which Advanced Holdings Pty Ltd (Advanced Holdings) was the sole unitholder, entered into a loan facility agreement on 31 March 2010 with Abacus Funds Management Ltd (Abacus) to refinance its borrowings in respect of the purchase in 2003 and 2004 of several properties, in particular, 62 Old Canterbury Road, Lewisham, 72-76 Old Canterbury Road, Lewisham, 78-90 Old Canterbury Road, Lewisham, and 8 William Street, Lewisham (collectively, the Lewisham properties). With the exception of 8 William Street, the Lewisham properties were sold under contracts entered into during the 2013 income year.

On 1 April 2010, Lewisham Estates, in its personal capacity and in its capacity as trustee of the Lewisham Estates Trust, entered into a call option agreement with Abacus. On 24 June 2010, Abacus exercised its call option so that, on 30 June 2010, Lewisham Estates entered into a joint venture agreement with Abacus (joint venture agreement). The proper construction of the joint venture agreement was one of the key issues in dispute.

Did Abacus have an equitable interest?

In particular, the construction issue that arose out of the joint venture agreement was whether the agreement operated, as contended for by the taxpayers, to create a 50% equitable interest in Abacus in the Lewisham properties, and accordingly the Lewisham Estates Trust only beneficially derived 50% of the proceeds of the sales, with the other 50% being beneficially derived by Abacus. Davies J rejected the taxpayers' contention.

Her Honour said that whether such an interest was created depended on whether an intention to create that interest was explicitly or impliedly expressed in the joint venture agreement, as an express trust does not exist unless the parties so intended. Absent an explicit declaration of such an intention, the court must determine, from a construction of the agreement, whether such an intention should be inferred. Importantly, such an intention cannot be imputed simply from the label "joint venture". As the authorities show, there is no settled common law meaning of the expression "joint venture" and joint ventures can take many forms, with different legal arrangements as between the parties. Davies J considered in some detail the relevant features of the joint venture agreement and other facts and concluded that Abacus did not have a 50% equitable interest in the Lewisham properties.

Repayment of revenue borrowing?

Another issue that arose with respect to the calculation of the net income of the Lewisham Estates Trust for the 2013 income year was whether an amount was to be deducted from the net income of the Lewisham Estates Trust on the basis that it was a repayment of a "revenue borrowing". This issue required determination as to whether the amounts borrowed by Lewisham Estates were on revenue account and whether, as contended by the taxpayers, the amounts paid to discharge the revenue borrowings in excess of the amounts borrowed were allowable as deductions to the Lewisham Estates Trust.

In rejecting the taxpayers' contention, Davies J said that the evidence established that Lewisham Estates borrowed funds which it used to acquire properties for the conduct of its property development business. However, the use to which the borrowed funds were put was not conclusive of the character of the borrowings. Merely because the borrowings were used to acquire the properties did not give the borrowings a revenue character. For the borrowings to be on revenue account would require the finding that the borrowings were an incident of the commercial operations by which Lewisham Estates acquired its trading stock. However, the evidence did not substantiate that the original borrowings were an incident of the process by which Lewisham Estates operated to purchase its trading stock, as distinct from borrowings made by Lewisham Estates to provide funds to enable it to conduct its business enterprise, which was an affair of capital. It followed from this conclusion that the excess amount was not deductible.

Status of Advanced Holdings as unitholder

As indicated earlier, Advanced Holdings was at all relevant times the sole unitholder in the Lewisham Estates Trust. However, an issue arose as to whether Advanced Holdings held the units in the Lewisham Estates Trust in its capacity as trustee of the Demian Trust (as contended by the taxpayers) or (as the Commissioner contended) Advanced Holdings was never validly appointed trustee of the Demian Trust or, if it was, the units in the Lewisham Estates Trust never formed part of the corpus of the Demian Trust. In the result, the Commissioner argued, Advanced Holdings was beneficially entitled to the net income of the Lewisham Estates Trust and was itself assessable on that income.

Davies J upheld the Commissioner's contentions on this point and in doing so considered a number of questions, including the proper construction of the provisions in the deed which established the Demian Trust and which related to the retirement and the appointment of a trustee.

Comment

The decision in this case highlights the need for tax advisers to take care when dealing with trust issues, particularly where trust law or general law questions can impact the position. The case also involved backdating issues which can raise significant difficulties when seeking to contest any action of the Commissioner.

In cases where the operation of commercial agreements is in issue, there is always the possibility of civil litigation to which the Commissioner is not a party.

In the light of the amount of tax involved, it would not be surprising if the taxpayers appealed to the Full Federal Court from the decision of Davies J.

7. GST input tax credits and incapacitated entities

The AAT has held that, where an entity that accounts for GST on an accruals basis becomes an incapacitated entity and the representative of the incapacitated entity accounts for GST on a cash basis, an input tax credit in respect of a creditable acquisition made by the entity before it became incapacitated but paid for by the representative is claimable by the entity and not the representative (*Richard Albarran, Brent Kijurina and Cameron Shaw as Joint Administrators of Cooper & Oxley Builders Pty Ltd as trustee for the Cooper & Oxley Builders Unit Trust and FCT*[5]).

The applicants (the administrators) were appointed as joint administrators of Cooper & Oxley Builders Pty Ltd as trustee for Cooper & Oxley Builders Unit Trust (the company) in February 2018. In that capacity, they were required to lodge an activity statement for March 2018, which they did on 22 June 2018. As they had elected to account for GST on a cash basis, the administrators claimed input tax credits on acquisitions made by the company in January 2018 (the acquisitions), which the administrators had paid for in March 2018.

On 25 May 2018, under the terms of a deed of company arrangement, control of the company was returned to its former directors. On 15 June 2018, the directors caused the company to lodge an activity statement for January 2018. As it accounted for GST on an accruals basis, the company claimed input tax credits for the acquisitions for which it had been invoiced in January 2018.

The Commissioner assessed the administrators' net amount for the March 2018 tax period on the footing that the company, not the administrators, was entitled to the input tax credits. The administrators objected to the assessment. The Commissioner allowed the objection in part but maintained the position that the administrators were not entitled to the input tax credits. The amount of the input tax credits that remained in contention, totalling $329,256, was not in dispute, only whether the administrators were entitled to the input tax credits.

The directly relevant legislative provision was s 58-10 of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GSTA99) which, so far as is relevant, provides:

"(1) A representative of an incapacitated entity:

(a) …; and

(b) is entitled to any input tax credit that the incapacitated entity would, but for this section or section 48-45, be entitled to for a creditable acquisition or a creditable importation; and

(c) …;

to the extent that the making of the supply, importation or acquisition to which the GST, input tax credit or adjustment relates is within the scope of the representative's responsibility or authority for managing the incapacitated entity's affairs."

The AAT said that the Commissioner's construction confining s 58-10 to supplies and acquisitions made by the representative reflected the more natural reading of the provision and was coherent with the scheme of the GSTA99 in relation to GST on taxable supplies and input tax credits on creditable acquisitions and their attribution to tax periods. The practical outcome of this construction — that representatives are only liable for GST on taxable supplies, and entitled to input tax credits on creditable acquisitions, which they actually make, and not on supplies and acquisitions made before their appointment by an entity over which they had no control — was not suggestive of a manifestly absurd, unreasonable or improbable intention to attribute to parliament.

TaxCounsel Pty Ltd
ACN 117 651 420

References

1 [2020] FCAFC 169.
2 [2020] FCAFC 173.
3 *Healius Ltd v FCT* [2019] FCA 2011.
4 [2020] FCA 1479.
5 [2020] AATA 4325.

Tax Tips

by TaxCounsel Pty Ltd

Proving your case

A recent AAT decision illustrates the difficulties that can be encountered where a taxpayer seeks to challenge an assessment and relevant evidence is lacking.

Background

In *San Remo Heights Pty Ltd and FCT*,[1] the Commissioner assessed the taxpayer company (the company) on the basis that the sale by the company in July and August 2018 of two vacant lots that were created by the subdivision of certain land that had been acquired by the company in 1962, were taxable supplies for the purposes of GST.

On review by the AAT, the Commissioner's assessment was upheld. The company simply did not have records going back to 1962 that could be relevant to establishing its case, for example, as to why the company acquired the land in 1962. Somewhat surprisingly, however, some facts that could have been established were not obtained by the company or, if obtained, were not mentioned in the AAT's reasons. For example, there was no indication of the area of land acquired in 1962 or of the areas that were sold off.

As will be seen, the Commissioner expressed the view that, because the company was, quite apart from the activities in relation to the land, carrying on an enterprise for GST purposes, anything that the company did would be potentially subject to GST unless there was some specific provision in the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GSTA99) which provided otherwise.

The facts

The primary facts were not in dispute. The following findings were drawn by the AAT mainly from unchallenged evidence by way of a witness statement provided by Mr John Andrew Keam, a director and secretary of the company since 2014, who was not called to give evidence.

The company acquired a parcel of land (the parent lot) in Bergin Grove, San Remo, Victoria in 1962. Because of the effluxion of time, no one that could be called on to provide evidence could now say what the company's object in acquiring the parent lot was.

The company undertook various subdivisions of the parent lot:

- in April 1987, creating four new lots, each of which were sold that year;
- in November 1987, creating another four lots, one being sold in 1989, another in 1995 and the remaining two in 1998; and
- in June 2000, creating four lots that became known as "3 Bergin Grove", "5 Bergin Grove", "7 Bergin Grove" and "7 Mary Grove" (collectively, the "San Remo vacant lots").

The company sold 7 Bergin Grove in 2002 and 7 Mary Grove in June 2019.

3 Bergin Grove and 5 Bergin Grove (which were the sales that were the subject of the Commissioner's assessment) were also sold as follows:

- 3 Bergin Grove: for $420,000 under a contract that was dated 18 July 2018 and was completed on 15 October 2018; and
- 5 Bergin Grove: for $422,000 under a contract that was dated 7 August 2018 and was completed on 7 November 2018.

When assessing the company's net amount for the December 2018 quarterly tax period, the Commissioner included GST on the sales of 3 Bergin Grove and 5 Bergin Grove. The Commissioner disallowed the company's objection to the assessment and the company applied to the AAT for a review of the objection decision.

In his written statement, Mr Keam stated:

> "The sole objective of San Remo Heights Pty Ltd disposing of the San Remo Vacant [Lots] is to facilitate the closure of the Estates and simplify ongoing affairs of San Remo Heights Pty Ltd."

Since Mr Keam was not cross-examined or his evidence otherwise relevantly impugned, the AAT was prepared to find that the company's sole objective in selling the two lots was as Mr Keam stated. The "estates" were those of deceased relatives who previously held shares in the company. Financial statements for the company indicated an indebtedness to two deceased estates.

Other activities of the company

The company was GST registered as it held various rental properties and operated a sheep grazing business.

The rental properties comprised three commercial and four residential properties at various locations in Victoria. The sheep grazing was conducted on parcels of land in San Remo, Victoria.

The San Remo vacant lots were not contiguous with the grazing land nor were they used for grazing or rental purposes. The company had not claimed income tax deductions or input tax credits for expenses or capital allowances (depreciation) associated with their ownership. Mr Keam was not aware of any occasions on which the company sought to have the San Remo vacant lots rezoned, applied for relevant permits, or previously attempted to sell those lots.

The company's case

The company's submissions included a number of assertions, including:

> "… there is no evidence of any business plan relating to property development or sale, no evidence of the Applicant undertaking land development and sale in a systematic, organised or businesslike manner and the Applicant has not registered any business name related to property development and does not employ any employees related to property development."

The AAT said that, since it bore the burden of proof, it was, of course, for the company to put forward evidence in support of its case. The AAT went on to say:

> "As there is no evidence relating to the existence or otherwise of a business plan or registered business name, I make no findings in that regard. I accept that in the 2017 and 2018 financial years the Company had no employees: the Company's financial statements for the year ended 30 June 2018 record no wage and salary expense for 2018 or in the 2017 comparatives.
>
> Mr Keam's witness statement is silent as to manner in which the subdivisions and sales took place. I therefore make no findings regarding whether that was systematic, organised or businesslike, other than to note that the lands were not treated as trading stock in the Company's 2018 financial statements."

The company accepted that its property rental and grazing activities constituted enterprises and accordingly was registered for GST. However, it contended that it was not liable for GST on the two sales of vacant land because they were not made in the course or furtherance of either of those enterprises or of any other enterprise.

The Commissioner maintained that the company's enterprise was broader than the rental and grazing activities and encompassed the acquisition, subdivision and sale of the subdivided lots. Even if that were not so, the Commissioner contended that the company had not established that the land sales were not made in the course or furtherance of the rental or grazing enterprises.

The categories of enterprise that were potentially relevant were an activity, or series of activities, done:[2]

> "(a) in the form of a business; or
>
> (b) in the form of an adventure or concern in the nature of trade …"

The AAT's decision

The AAT accepted the company's submission that, in order for there to be a taxable supply, it was necessary to identify an enterprise carried on by the company in the course or furtherance of which a supply had been made. That did not mean the character of the enterprise needed to be determined with precision; it was sufficient to identify an enterprise carried on by the company and that the supply was made in the course or furtherance of that enterprise.

If the only enterprises carried by the company were, as the company submitted, the property rental and grazing enterprises, the company would discharge its burden of proof if it proved that the sales were not made in the course or furtherance of those enterprises. On the uncontested evidence, the AAT was satisfied that the sales had no connection with the property rental or grazing enterprises and were not made in the course or furtherance of either or both of those enterprises.

The AAT went on:

> "But that is not the end of the matter. The sales will nevertheless be taxable supplies if they were made in the course or furtherance of another enterprise. Mr Wright, who appeared for the Company, argued that the Company, in acquiring and subdividing the parent lot, and selling the two lots, was not carrying on an activity or series of activities in the form of a business, nor in the form of an adventure or concern in the nature of trade.
>
> There is no evidence that the Company acquired the property other than for commercial purposes, which would be exceptional for a company, nor any evidence of facts from which the Tribunal could draw any such inference. I accept, as Mr Keam's evidence establishes, the sales of the San Remo Vacant Lots were motivated by a desire to finalise the estates of his late relatives to whom the financial statements of the Company indicate the Company remained indebted and simplify the Company's affairs. However, such motivation is not inconsistent with the land being acquired for the commercial purpose of generating a financial gain or the achievement of that goal upon the sales occurring.
>
> The Company's submission that the relatively small scale and long periods between the subdivisions, and other factors identified above, are against the conclusion that the activities are in the form of a business, is not without force. However, the Company did carry out a series of activities — subdivisions and sales — albeit over an extended period, which culminated progressively in the sale of 12 lots. On the evidence I cannot determine those activities were undertaken other than for commercial purposes. There is no evidence of whether sales of subdivided lots at an opportune time was contemplated when the parent lot was acquired, but that could not be excluded on the evidence before the Tribunal. As such, there is a degree of repetition and scale in the activities and there is no evidence that would exclude a conclusion that those activities were carried out for a commercial purpose."

The AAT said that it might be thought that the long periods of apparent inactivity could establish an inference that the parent lot was not acquired with the intention of subdivision and resale at a profit, since what an entity actually does may be evidence of its earlier intention, and the periods of apparent inactivity might point against there being a "series" of activities. On the other hand, it has been said that:[3]

> "The carrying on of 'business', no doubt usually calls from some activity on the part of whoever carries it on, though, depending on the nature of the business, the activity may be intermittent with long intervals of quiescence in between."

Also, the long periods of apparent inactivity were not necessarily inconsistent with the activities being in the form of a business. They might be explained by prevailing market conditions and/or strategic business decisions relating to, for example, other priorities, or other commercial considerations consistent with the land being held for business purposes.

On the evidence, the AAT simply had no way of deciding. There were no minutes or other relevant records in evidence other than the 2018 financial statements, nor testimony of any director or other person to shed light on the circumstances prevailing between the subdivisions. Indeed, there was no evidence of whether the *apparent* inactivity was actual inactivity.

In particular, there was no evidence of the purpose of the controlling minds of the company relating to the subdivisions that created the San Remo vacant lots in 2000 or why no sales proceeded for some years after the subdivisions, other than Mr Keam's explanation of the delay between his appointment as a director over a decade later in 2014 and the sales in 2018 "as a result of myself needing time to understand the magnitude and complexity of the Estates". It would be reasonable to infer, or at least it could not be excluded in the absence of contrary evidence, that selling at an opportune time was contemplated when the land was acquired and when the subdivisions were carried out. While there was no positive evidence of these matters, perhaps of more relevance was that there was no evidence excluding commercial or other explanations for the periods of inactivity that would not be inconsistent with the activities being in the form of a business.

Aside from the company's sole objective in selling the San Remo vacant lots being to facilitate winding up the deceased estates and simplifying its affairs, there was little other direct evidence to support the company's position. The company's own choices on the taxation treatment of whatever expenses may have been incurred in owning the land, while not irrelevant, in the AAT's view carried little weight against the objective evidence of the activities undertaken, and there was no evidence of whether deductions were claimed for subdivision costs. The AAT accepted that the company's accounts not treating the lands as trading stock was relevant and consistent with its position.

The AAT then said:

> "In the end, what I am left with is that the Company:
>
> (a) acquired the parent lot for purposes which have not been proved to be other than of a commercial nature;
>
> (b) undertook multiple subdivisions of the parent lot, albeit separated by lengthy periods of apparent inactivity[11] the reasons for which are unexplained;
>
> (c) sold 12 of the subdivided lots for prices that it is not suggested, and certainly has not been proved, did not result in a gain to the Company;
>
> (d) in selling the San Remo Vacant Lots, but not so far as the evidence suggests the other subdivided lots, had as its sole objective facilitation of winding up the deceased estates and simplifying the Company's affairs; and
>
> (e) recorded the land and relevant expenses in the financial records of the Company but not did not treat the San Remo Vacant Lots as trading stock or claim input tax credits or tax deductions in relation to it (there is no evidence regarding the treatment of the lots created in the earlier subdivisions)."

In the view of the AAT, in the absence of significant contrary evidence, those circumstances would not be inconsistent with a conclusion that the company acquired the parent lot with a view to commercial gain, subdivided the parent lot at various times, and realised the contemplated gain by selling the 12 subdivided lots. Particularly in the context of a company, those circumstances were capable of constituting a series of activities in the form of a business. In the AAT's view, the company had not provided sufficient evidence to exclude that conclusion. That may or may not have been because of evidence being now unavailable due to the passage of time, but the AAT could only decide the matter on the evidence before it. As to the issue of whether there was an adventure in the nature of trade, the AAT said:

> "In respect of whether the Company's activities were properly characterised as a series of activities in the form of an adventure or concern in the nature of trade, Mr Wright [for the company] referenced income tax cases[4] in which it was held on the facts of those cases that activities involving the subdivision and sale of property did not constitute an adventure or concern in the nature of trade, or analogous expressions. Those cases concerned a different issue: whether the gain on sale was income and in particular whether the sales in question constituted mere realisation of a capital asset.
>
> The answer to that question is not determinative for current purposes. The GST legislation contemplates that a sale may be taxable supply even though the sale proceeds are of a capital nature. It is also notable that the cases cited were concerned with individual taxpayers rather than companies and each involved circumstances, such as inheritances and gifts, not coloured by a profit-making purpose for the acquisition of the land.
>
> The considerations I have outlined in respect of whether the Company's activities in relation to the land amounted to a business also require the conclusion that the Company has not discharged the burden of proving those activities were not an adventure or concern in the nature of trade.
>
> Having regard to these considerations, I am not satisfied the Company has established that the series of activities outlined did not constitute an enterprise at the relevant times. Once that conclusion is reached, there can be little doubt the sales of the two lots were in the course or furtherance of that series of activities. There is certainly no evidence to suggest otherwise.
>
> For these reasons, I am not satisfied the sales were not in the course or furtherance of an enterprise carried on by the Company. That being so, the Company has not discharged its burden of proving the assessment is excessive."

Some practical points

The following are some practical points that the facts of, and the decision of the AAT in, the *San Remo Heights* case gives rise to.

Scope of an enterprise

The AAT said that the Commissioner's report of his review of the two sales asserted:

> "'The supplies of land in question might be considered to be mere realisation of a capital asset in circumstances where the supplier is not registered.'
>
> The report then sets out s 188 [sic] of the GST Act, and continues:
>
> 'In your situation, you [that is, the Company] are registered for GST and any supplies you make (including capital assets) will be subject to GST unless another provision in the GST Act specifically provides that the supplies are GST-free or input taxed.'"

The AAT said that this suggested that, once a company is registered or required to be registered for GST, any supply that it makes will be in the course or furtherance of an enterprise. The AAT went on to say that that was not correct as a matter of statutory language — s 9-5(b) GSTA99 required determination of whether the particular supply was made in the course or furtherance of an enterprise carried on by the relevant entity, whether a company or otherwise. A company may face a particular challenge in discharging its burden of proving that a supply was not made in the course or furtherance of an enterprise, but that is not say it is an impossible task; it requires an evidentiary foundation on which to do so.

It was the absence of such a foundation that led the AAT to conclude that the company had not discharged its burden of proving the relevant elements of a taxable supply were not satisfied in relation to the two sales. The AAT said that its reasons should not be taken to endorse a process of reasoning that effectively bypasses the requirements of s 9-5(b) where the taxpayer is a company.

In relation to the adventure or concern in the nature of trade concept in the definition of "enterprise", the AAT appears to have taken the view that the income tax cases on this concept were not relevant for the purposes of GST because those cases concerned a different issue: whether the gain on sale was income and, in particular, whether the sales in question constituted the mere realisation of a capital asset. It is suggested that, if this was the view taken by the AAT, that view is not correct and that the income tax cases are relevant. That appears to be the view of the Commissioner.[5]

Margin scheme

It would seem from the facts of the *San Remo Heights* case given by the AAT that, subject to an important qualification, it would have been open to the company, when calculating its GST liability in respect of the two sales, to apply the margin scheme provided for by Div 75 GSTA99. That would mean that the GST would be calculated by reference to the difference between (broadly) the sale proceeds and the market value of the land as at 1 July 2000 (s 75-10 GSTA99).

The important qualification is that, for the margin scheme to be available, both the supplier and the recipient of the supply must have agreed in writing that the margin scheme is to apply (s 75-5(1) GSTA99). The written agreement must be made on or before the making of the supply or within such further period as the Commissioner allows (s 75-5(1A) GSTA99).

Because the Commissioner's discretion is confined to extending the time by which a written agreement for the application of the margin scheme must be made, and assuming that no agreement has been made, the company (if the relevant amendment period for the GST assessment is still running) would need to seek to have each purchaser to now agree for the margin scheme to apply and request the Commissioner to exercise the discretion to extend the time for the making of the written agreement.

Of course, if the acquisition of the property was a creditable acquisition of the purchaser, then the purchaser could request a tax invoice from the company (s 29-70(2) GSTA99) and, subject to any applicable time limitations, obtain an input tax credit.

There may be circumstances where, although a vendor of real property may consider that the supply that will be made on completion of the contract will not be a GST taxable supply, the vendor wishes to limit any GST exposure should the Commissioner take a contrary view. If the supply would be eligible for the margin scheme to be applied, the vendor's exposure could be limited by the contract, providing that, if the supply is a taxable supply, the vendor and purchaser agree that the margin scheme is to apply. The Commissioner accepts that such a conditional agreement is effective (see GSTR 2006/8).

Income tax

An important point is that, if there is an enterprise that is constituted by an activity, or series of activities, done in the form of a business or in the form of an adventure or concern in the nature of trade (s 9-20(1)(a) and (b) GSTA99), inevitably ordinary income tax considerations will arise.

Clearly, in the case of an enterprise constituted by activities done in the form of a business, a supply of either a revenue or a capital asset may potentially be a taxable supply. A capital asset may be involved, for example, where the factory premises in which a business is conducted are disposed of. Where, however, there is an adventure or concern in the nature of trade, there will be an overall gain or loss, or gains or losses, that will be assessable or deductible. It is submitted that there is no reason why the income tax cases would not be relevant in relation to the question of whether particular activities constitute an adventure or a concern in the nature of trade.

Record-keeping

The decision of the AAT in the *San Remo Heights* case also highlights the need for appropriate records to be kept that establish the attributes of a transaction that are relevant for tax purposes. There are various statutory requirements relating to the keeping of records, but each transaction will need to be looked at. Practitioners should, as a general practice, look at each transaction relating to a client and see whether the records that will be kept contain what may be needed later on. Contemporaneous records will serve a more useful function than attempted reconstructions.

TaxCounsel Pty Ltd

References

1 [2020] AATA 4023.

2 S 9-20(1) GSTA99.

3 *American Leaf Blending Co Sdn Bhd v Director-General of Inland Revenue (Malaysia)* [1979] AC 676 at 684.

4 *Statham v FCT* (1988) 20 ATR 228; *Casimaty v FCT* (1997) 37 ATR 358; *FCT v Williams* [1972] HCA 31.

5 See MT 2006/1.

Mid Market Focus

by Daryl Jones, CTA, HLB Mann Judd

Corporate tax residency in a global context

With the recent announcement on the changes to corporate tax residency, it may be the start of the long road of tax reform.

On 6 October 2020, the government announced in its federal Budget[1] that it will make technical amendments to clarify the corporate residency test. The measure will return the treatment of foreign incorporated companies to the position prior to the High Court's 2016 decision in *Bywater Investments Pty Ltd v FCT*.[2]

Existing definition

Under the existing definition of "resident or resident of Australia" in s 6(1) of the *Income Tax Assessment Act 1936* (Cth) (ITAA36), a company that is not incorporated in Australia will be an Australian resident where:

– it carries on business in Australia; and

– has its central management and control in Australia.

Generally referred to as the "central management and control" (CMAC) test, where it applied, foreign incorporated companies would be subject to Australian tax on their worldwide income under s 6-5 of the *Income Tax Assessment Act 1997* (Cth).

A brief history: how we got here

If we recall the observations of Dixon J in *Koitaki Para Rubber Estates Ltd v FCT*,[3] the finding of the company's residence must always be a matter of degree, constituted by a combination of various factors. Of these, one is the place of the "superior or directing authority by means of which the affairs of the company are controlled".

Over time, the application of the CMAC test has allowed many taxpayers in Australia to take advantage of incorporating companies in tax havens and other low-tax jurisdictions (and thus giving rise to our controlled foreign company rules[4]). This typically arose as a result of the board of directors, regardless of whether they were Australian residents, meeting outside Australia or "directors for hire" meeting locally and "rubber stamping" the decisions of those in Australia.

Before *Bywater Investments*, the decision in *Esquire Nominees Ltd v FCT*[5] was generally accepted as the leading authority that where the directors for hire were influenced by Australian parties but were not legally obliged to comply with the instructions, the CMAC of the company would not shift back to Australia.

Briefly, Esquire Nominees Ltd was incorporated in Norfolk Island and had its office located there. All of its directors resided in Norfolk Island and all directors' meetings were held there. The Commissioner of Taxation contended that the directors of Esquire Nominees Ltd merely carried out the directions given to them by the firm of Australian accountants and therefore the actual management and control of the company was in Australia. In holding that the company was a resident of Norfolk Island, Gibbs J stated:[6]

> "It was apparent that it was intended that the appellant should carry on its business of trustee company on Norfolk Island. It was in my opinion managed and controlled there, none the less because the control was exercised in a manner which accorded with the wishes of the interests in Australia."

Prior to the *Bywater Investments* decision, the ATO's views on the CMAC test were contained in TR 2004/15 (now TR 2004/15W). This ruling considered both the "carries on business" test and the CMAC test to be equally important matters of fact when determining corporate tax residency. Where a company has active business operations, such as trading or the provision of services, the business' location would be where the main operating activities were undertaken, which would not necessarily be the same location as CMAC. When a company was involved in passive business activities, the location of CMAC would be where the business operations are undertaken. The tax ruling stated:[7]

> "The reference to *Mitchell v Egyptian Hotels Ltd* (1915) AC 1022 indicates that mere trading is not sufficient and that there also has to be CMAC in order for a company to be resident in Australia under the second statutory test. However, it does not necessarily support the further proposition that if you have CMAC you are also invariably carrying on a business in that jurisdiction."

The issue of directors merely "rubber-stamping" the instructions of the Australian residents was at the heart of *Bywater Investm*ents. Similar to the *Esquire Nominees* decision, all but one of the directors of the (three) appellants were residents of Switzerland and this is where the meetings of directors took place. Bywater Investments Ltd offshore corporations were structured by the Sydney-based accountant, a Mr Gould.

Following assessments issued by the Commissioner in 2010 to tax the appellants as Australian residents on profits derived from the sale of ASX-listed shares, the appellants appealed to the Federal Court.[8] In summary, Perram J found that the real business of the appellants was carried out by Mr Gould in Australia despite the foreign location of the "formal organs" of each company. Therefore, under the CMAC test, the appellants were Australian residents and liable for Australian tax.

On appeal,[9] the Full Federal Court (Robertson, Pagone and Davies JJ) agreed with the decision of Perram J and rejected the appellants' contentions that their CMAC was situated offshore because the meetings of the boards of directors were held offshore. Their Honours stated:[10]

> "His Honour found that the real business of each taxpayer was conducted from Sydney by Mr Gould. His Honour did that by considering the evidence which had been relied upon by the taxpayers in support of their respective contentions that their places of central management and control were at places other than Australia. His Honour had regard to such factors as the place of incorporation of each of the companies, the shareholding of each company, and where relevant, the place of incorporation of shareholders, the location of the directors, the minutes of meetings of the board of directors, the place at which the meetings were held, and the place at which the transactions were entered into constituting the businesses of each of the taxpayers."

By grant of special leave, the appellants appealed to the High Court. Its decision is summarised as follows:[11]

> "The Court held that, as a matter of long-established principle, the residence of a company is a question of fact and degree to be answered according to where the central management and control of the company actually abides, and that is to be determined by reference to the course of the company's business and trading, rather than by reference to the documents establishing its formal structure. The Court held that the fact that the boards of directors were located abroad was insufficient to locate the residence of the appellants abroad in circumstances where, on the findings of the primary judge, the boards of directors had abrogated their decision-making in favour of Mr Gould and only met to mechanically rubber-stamp decisions made by him in Australia. The Court held that the appellants could not escape liability for income tax in Australia on the basis that they were resident abroad. Nor could Bywater Investments, Chemical Trustee or Derrin Brothers Properties rely on applicable double taxation agreements on the basis that their 'place of effective management' was other than in Australia."

The Commissioner accepted the High Court's decision and noted that his approach in TR 2004/15 could no longer be sustained and the tax ruling was withdrawn.[12]

ATO position after Bywater Investments

After the *Bywater Investments* decision, the ATO released TR 2018/5. The ruling outlines the ATO's approach to determining a company's tax residency using the CMAC test. According to the ruling, CMAC considers the high-level control and direction of a company's operations. Although day-to-day management and decision-making are a key part of a business' operations, they will generally not be considered by the CMAC test. High-level decision-making of a company is the key focus of the CMAC test as it guides the overall strategy for a company's operations.

When determining the location of a company's CMAC, the ATO will look at the minutes of the board's meetings. The ATO will seek further evidence on the location of a company's CMAC when:[13]

- no board meeting minutes are kept;
- high-level decision-making occurs outside of board meetings;
- the location where decisions are made is not included in the minutes; and
- the minutes are false (including where a decision is rubber-stamped).

In order to fall within the definition of "resident" in s 6(1) ITAA36, there must be CMAC in Australia *and* business must be carried on in Australia. TR 2018/5 essentially removes the requirement for business to be carried on in Australia as, according to the ruling, CMAC constitutes the business operations.

Board of Taxation Review

In September 2019, the Board of Taxation released its consultation guide titled "Corporate tax residency" following a request by the Treasurer on 5 August 2019 for the Board to conduct a review of the operation of Australia's corporate tax residency rules. Its terms of reference were:[14]

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

Then, in December 2019, the Board of Taxation released a number of reforms following the consultation process, with stakeholders consistently raising challenges largely focused on three factors:[15]

> "– the impact of the *Bywater* case on the interpretation of the CMAC test;
>
> – changes in the way multinational groups operate in today's economy; and
>
> – how the combination of the above two factors has been reflected in the ATO's re-issued written guidance on (and administration of) this test."

Federal Budget 2020-21

In clarifying the corporate residency test, the government announced that it will amend the law to provide that:[1]

> "… a company that is incorporated offshore will be treated as an Australian tax resident if it has a 'significant economic connection to Australia'. This test will be satisfied where both the company's core commercial activities are undertaken in Australia and its central management and control is in Australia."

And further:[1]

> "The ATO's interpretation following the High Court's 2016 decision in *Bywater Investments Ltd v Federal Commissioner of Taxation* departed from the long-held position on the definition of corporate resident. The Government requested the Board of Taxation review the decision on 2019-20. This measure is consistent with the Board's key recommendation in its 2020 report: *Review of Corporate Tax Residency* and will mean the treatment of foreign incorporated companies will reflect the position prior to the 2016 court decision."

Board of Taxation report

On 13 October 2020, the Board of Taxation's report to the Treasurer on the rewrite of the corporate tax residency rules was released following the Budget announcement. The reasons for the rewrite for the test (introduced over 90 years ago) was stated by the Board as follows:[16]

> "The Board has found the rules as they currently apply to foreign incorporated companies are in need of reform. They are out of step with modern business practices, create considerable uncertainty, are susceptible to manipulation and increase the potential for international disputes. As a consequence, many corporates are experiencing a significant increase in financial costs and disruptions to business."

The Board listed six recommendations[17] as follows:

> "**RECOMMENDATION 1**
>
> The 'central management and control test' should be modified to ensure that for a foreign incorporated company to be an Australian tax resident there needs to be a sufficient economic connection to Australia.
>
> Sufficient economic connection to Australia will be best demonstrated where together both the company's core commercial activities are being undertaken in Australia and its central management and control is in Australia. Central management and control in Australia, by itself, will not be sufficient except in very limited circumstances (such as with certain holding companies).
>
> The new rules should apply prospectively and as soon as possible after receiving Royal Assent, but a foreign incorporated company should also have the option to choose for the rules to take effect from the date TR 2014/15 was withdrawn (15 March 2017).
>
> The new rules should be subject to a Government review three years after receiving Royal Assent.
>
> **RECOMMENDATION 2**
>
> Overarching guidance of the circumstances under which the core commercial activities of a company can be said to be conducted in Australia should be provided in the legislation and extrinsic materials.
>
> This should be supplemented with administrative practical guidance that includes the treatment of 'holding companies' and the need for a *de minimis* threshold.
>
> **RECOMMENDATION 3**
>
> The ATO should consider providing additional practical guidance on the meaning of the term 'central management and control in Australia' to provide greater alignment with modern business practices.
>
> **RECOMMENDATION 4**
>
> The 'voting power test' should be retained at this time.
>
> Any change from the wording 'carries on business' to referencing core commercial activities in the 'central management and control test' should likewise be applied to the 'voting power test'.
>
> **RECOMMENDATION 5**
>
> The Board recommends that basing residence solely on a place of incorporation test should not be adopted.
>
> **RECOMMENDATION 6**
>
> The Board does not recommend adopting a corporate residency test based on place of management or place of effective management."

Where to now?

As can be seen from the above discussion, the government has almost adopted the same wording of the Board of Taxation's recommendation. This effectively reinstates the views taken in TR 2004/15 and the decisions of the courts over a long period. We now await further consultation and/or exposure draft material which should provide guidance and interpretative assistance in determining the meaning of "significant economic connection to Australia".

Conclusion

While the measure is welcome in an ever-changing global business environment (in particular, for Australian-based directors), the need now is for the legislation to provide certainty to Australian business and worldwide restructuring to ensure that multinational enterprises are not inappropriately taxed as residents of Australia.

While CMAC remains relevant, there are numerous issues highlighted in the Board of Taxation's report that will need clarification, such as what amounts to "core activities" and the differences and extent of what amounts to "core or ancillary activities". These types of issues will be particularly important where, for example, a company is established to make an offshore investment and the strategic decision-making is effectively the core commercial activity of the company.

As a final point, when the legislation is finally passed, companies will have the option of applying the new measure from 15 March 2017. This may require careful consideration for companies which are members of multinational groups.

Daryl Jones, CTA
Director – Tax Consulting
HLB Mann Judd

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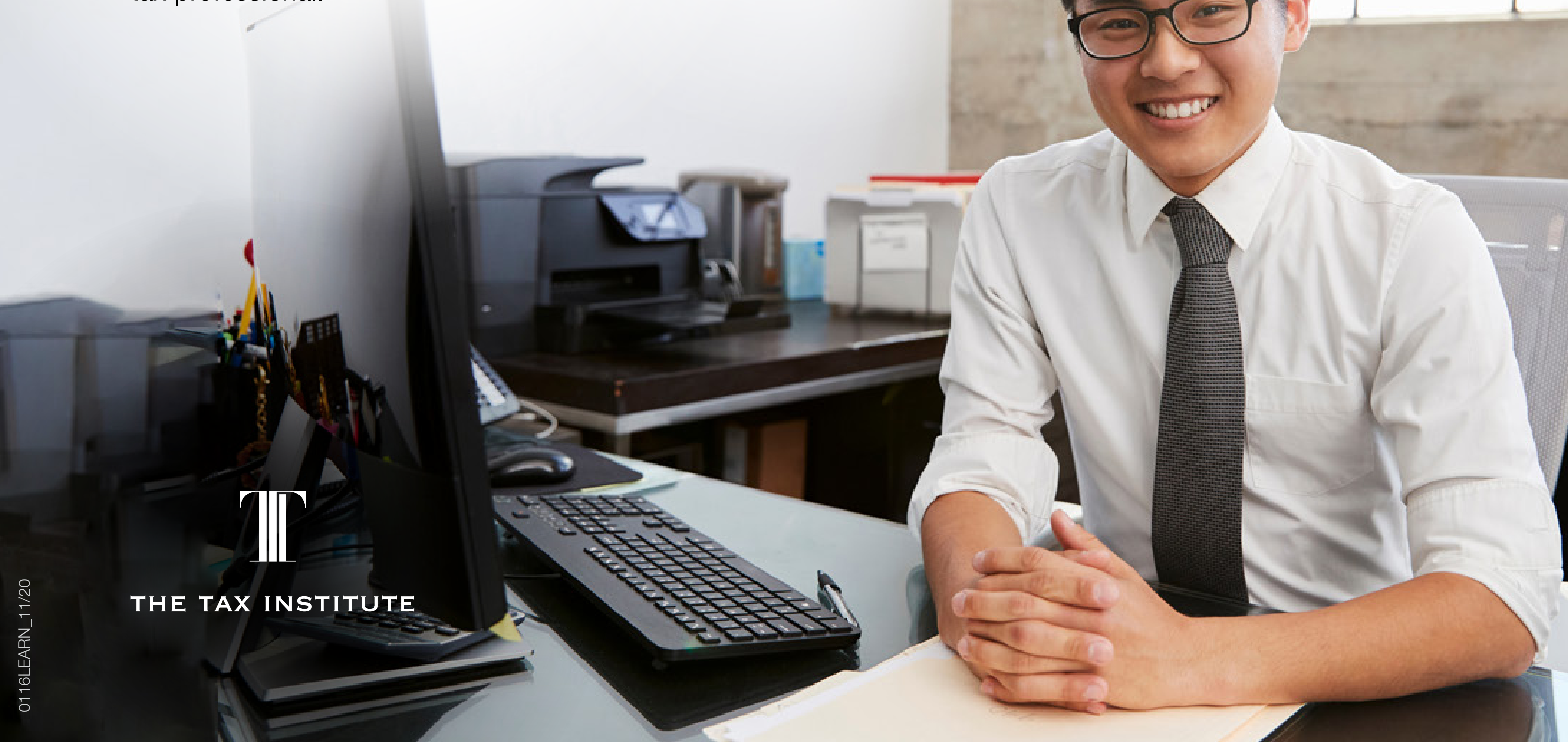

When international tax meets the family trust

by Nolan Sharkey, Winthrop Professor of Law, University of Western Australia

Dealing with the Australian taxation of offshore trusts is very difficult. The scope of the application of the law is highly uncertain and not well known. This is because the tax law uses core definitions that are not exact equivalents of trust law terms. In addition, foreign law uses terms that are not equivalent to Australian trust law usages. The result of this, combined with the statutory complexity, is that it becomes much easier than usual to make an incorrect analysis of tax consequences by relying on an incorrect understanding of a term. This article looks at the issues that arise with basic terms and core starting points in offshore trust taxation.

Overview

The taxation of trusts in Australia is not a simple area of law. The concept of a trust is in many ways an ill fit with the entity/taxpayer approach that is taken in many parts of the law. Once the law is applied to an international situation, its operation can become uncertain, even to specialists, and obscure to tax professionals who do not encounter these situations regularly. This can be a significant problem as "international trusts" arise more regularly with globalisation and immigration. They can fall within the tax jurisdiction unexpectedly. While they may be used by an Australian client to minimise taxation, it will more often be the case that they have been used by another person offshore for a variety of purposes, of which foreign tax minimisation is just one possibility. The purpose of this article is to review a number of areas of uncertainty or pitfalls in the area of international trust taxation. The problem will be discussed, the potential consequences of an error will be explained and, where possible, a solution will be provided. The article is the first of two dealing with fundamental issues in relation to international family trust taxation. It focuses on core concepts as well as problems arising with the transferor trust regime.

What is a trust?

The nature of a trust can be difficult to determine. This gets complicated in international circumstances and where a taxation definition differs from the standard legal definition. This raises two preliminary related problems:

- Problem 1: You think "it" is a trust when it is not.
- Problem 2: You think "it" is not a trust when it is.

The consequence of both of these problems is that you will apply the income tax law fundamentally incorrectly as something needs to be a trust to be covered by the various trust taxation regimes. If you think it is a trust (when it is not) and apply the standard trust provisions and the transferor trust regime, your analysis is built on wrong foundations and the tax consequences determined are likely to differ significantly from those provided by the correct analysis.

On the other hand, if you think something is not a trust when it is, you have the problem in reverse. You will fail to apply the trust taxation and the transferor trust regimes when they should apply.

These problems arise due to a number of factors. First, you have offshore arrangements that are called "trusts" but may fail to meet core indicia of the concept of a trust in Australian law. It is a feature of offshore regimes that they validate by statute things that would invalidate a trust in Australian law. For example, non-charitable purpose trusts. Consider whether a Cayman STAR "trust" is a trust at all. It has been argued by certain commentators that these arrangements should simply not be viewed as trusts. There has been some focus on the "irreducible core of trusteeship" in common law jurisdictions. The issue is whether arrangements that do not meet this core can be said to be trusts at all. At issue are the beneficiaries' rights to enforce, their rights to information, trust documents and letters of wishes, and express exclusions of the "trustee's" accountability as to some property. In *Hayim v Citibank NA*,[1] it was held that, in special circumstances, minimal accountability may subsist for a period, but a general exclusion of accountability is not possible. In *Armitage v Nurse*,[2] however, Jacob J allowed an exclusion for everything except for actual intended fraud.

Thus, the debate about whether something that does not meet the irreducible core of trusteeship is a trust at all is real, if not settled. In addition, there is debate as to what the core is. The relevance to Australian tax is that the foreign "trust" may not be a trust at all.

The counter to this proposition is that something may arise offshore that is not called a trust but might in substance correspond to a trust. In these cases, a trust may arise when one does not expect one. This can occur in a domestic situation. A person who gives something to another person on the understanding that the other person will look after it for the benefit of other people can create a trust. This will happen even if both parties know nothing about trust law. The same applies to the various situations involving constructive trusts and resulting trusts. The trust may exist when a person's conscience is touched in relation to any property. All of these are nonetheless trusts.

In addition, a formal entity created under a foreign law may be able to be found to be a trust notwithstanding that it is not called a trust as such. Possible examples are Dutch foundations and the "bewind" which is an arrangement with significant functional similarities to a trust.

In an international context, these possibilities are significant. The placing of property in another's name with an understanding of obligations is common in Chinese society even though the law there does not traditionally refer to a trust. There is a trust statute[3] in China but it is not concerned with such situations. If such a situation arises in a cross-border situation, the question of whether a trust can be said to exist will raise not only questions about the substantive obligations, but also conflict of laws issues and queries in relation to the proper law. This will be impacted by the situation of relevant property and the parties at the time of the arrangement and later. It may also be impacted by how the foreign law may be used to enforce the understood obligations. Ultimately, it is complex, but it is noted that there is certainly the possibility that a trust may exist for Australian tax purposes when one might not be expected.

The issues around where a trust might arise are further complicated by the fact that "trust" and "trust estate" are not defined in the Income Tax Assessment Acts but must be understood by reference to the definition of "trustee" in s 6(1) of the *Income Tax Assessment Act 1936* (Cth) (ITAA36). This definition goes beyond the standard definition of "trustee", and includes all ordinary trustees and:

> "(a) an executor or administrator, guardian, committee, receiver, or liquidator; and
>
> (b) every person having or taking upon himself the administration or control of income affected by any express or implied trust, or acting in any fiduciary capacity, or having the possession, control or management of the income of a person under any legal or other disability;"

It is clear that this definition can extend beyond trustees as generally understood. Notably, any person acting in any fiduciary capacity can be a trustee. Not all fiduciaries are regarded as trustees. In an international context, this extends the potential for a trust to arise when a person is a fiduciary, or it can be argued that the obligations that they are under is the functional equivalent of a fiduciary.

As "trust" and "trust estate" are not defined in the Tax Acts, we look to their standard definitions. From *FCT v Clark*[4] and the *Registrar of the Accident Compensation Tribunal v FTC*,[5] we may conclude that the trust estate is the property controlled by the trustee. This presumably extends to the trustees for tax purposes even though they are not trustees under general law. It also raises the possibility that the trust estate may be slightly different when a situation involves both a standard trustee and another person who is deemed to be a trustee in relation to some of the property held on trust.

The solution to all of these significant risks is to thoroughly understand what a trust is at law and what it may be for tax purposes. In addition, it is prudent to avoid being led by superficial things such as names when dealing with foreign situations. The issue remains fraught with difficulties. This is of real significance, given the harsh application of the trust regimes — most notably the transferor trust regime.

A final issue to note is the Hague Convention on Trusts.[6] This provides in art 11:

> "A trust created in accordance with the law specified by the preceding Chapter shall be recognised as a trust.
>
> Such recognition shall imply, as a minimum, that the trust property constitutes a separate fund, that the trustee may sue and be sued in his capacity as trustee, and that he may appear or act in this capacity before a notary or any person acting in an official capacity.
>
> In so far as the law applicable to the trust requires or provides, such recognition shall imply, in particular —
>
> a) that personal creditors of the trustee shall have no recourse against the trust assets;
>
> b) that the trust assets shall not form part of the trustee's estate upon his insolvency or bankruptcy;
>
> c) that the trust assets shall not form part of the matrimonial property of the trustee or his spouse nor part of the trustee's estate upon his death;
>
> d) that the trust assets may be recovered when the trustee, in breach of trust, has mingled trust assets with his own property or has alienated trust assets. However, the rights and obligations of any third party holder of the assets shall remain subject to the law determined by the choice of law rules of the forum."

It is uncertain that this will impact when a trust will exist for Australian tax law purposes by causing a non-trust to be a trust. However, based on comparative experiences,[7] the possibility should be considered. In addition, even if it did cover something overseas, this would still need to fit within the convention. Article 18 on public policy should also be noted:

> "The provisions of the Convention may be disregarded when their application would be manifestly incompatible with public policy (*ordre public*)."

Trust residence

The residence of a trust is another concept that is fundamental to its correct tax treatment. If a trust is assumed to be a non-resident when it is in fact a resident for tax purposes, the analysis of its tax situation will be fundamentally faulty. This incorrect analysis is more likely than might be assumed due to the failure of some to appreciate the residence test for a trust, especially in connection with the definition of a "trustee" as noted above.

Section 995-1 of the *Income Tax Assessment Act 1997* (Cth) defines a resident trust for CGT purposes as:

> "…if, at any time during the income year:
>
> for a trust that is not a unit trust, a trustee is an Australian resident or the central management and control of the trust is in Australia"

Section 95(2) ITAA36 likewise specifies:

> "(2) For the purposes of this Division, a trust estate shall be taken to be a resident trust estate in relation to a year of income if:
>
> (a) a trustee of the trust estate was a resident at any time during the year of income; or
>
> (b) the central management and control of the trust estate was in Australia at any time during the year of income."

The first point of note is that central management and control of the trust can determine its residence. The concept is a familiar one to those dealing with international company taxation. However, this raises two notable issues:

1. The nature of company central management and control has been subject to significant testing in the courts. How do these issues carry over when the concept is applied to the trust?

2. There is a distinction between a trustee company's central management and control and the trust's central management and control, but how easy is it to draw the border between the two?

The core issues under (1) above arise where different levels of control exist in a company (as contemplated in *De Beers Consolidated Mines Ltd v Howe*[8]) and the issue of shadow controllers (as contemplated in *Malayan Shipping Co Ltd v FCT*[9] and *Esquire Nominees Ltd v FCT*[10]).

These issues are likely to come up with an offshore trust if it can be said that a person who is neither a trustee nor an officer of the trustee is in fact exercising central management and control of the trust. If that person is in Australia and the argument succeeds, the trust will be a resident trust. It is noteworthy that many offshore arrangements endeavour to give some control to the original settlor or a related person. This can be through the creation of a specific position or it can be informal. The issue is a significant one.

The second major point in relation to trust residence is that the residence of any trustee will cause the trust to be resident. This means that a trust that is almost entirely managed overseas may still be a resident trust. Of relevance here is that a trust can have many trustees, residence rules applicable to individual trustees may have little to do with their physical presence in Australia, and a person may be found to be a trustee under trust law when they do not expect it.

It is noted that internationally there has been significant contemplation as to whether officers such as protectors should be regarded as trustees under trust law. The issue becomes more significant when we reconsider the definition of "trustee" under s 6(1) ITAA36. In addition to deeming certain non-trustees to be trustees (which may cause the residence of non-trust as a trust), it also includes:

> "… every person having or taking upon himself the administration or control of income affected by any express or implied trust …"

It is not uncommon with offshore trusts for another person, often the settlor or a related party, to be given control or administration of the property of the trust, including its investment. It may be argued that such a person falls within the extended definition of "trustee" in s 6(1). If this argument is successfully made, an offshore trust may be said to be a resident trust. The significance of this is clear as all of the income will be subject to worldwide taxation in Australia.

Listed country trusts

An error of a similar type as the residence error is when a person thinks that an offshore trust is a listed country trust when it is not. The relevance of an offshore trust being a listed country trust is that the vast majority of its income is not likely to be attributed under the transferor trust regime. There are seven listed countries. These are the United Kingdom, the United States, France, Germany, Canada, Japan and New Zealand. The issue to be conscious of is what makes a trust a listed country trust. It can be easy for a tax professional to assume that, if everything to do with the trustees and the management of the trust, as well as its deed and governing law, relate to, say, New Zealand, the trust will be a New Zealand trust and therefore a listed country trust. However, the law does not focus on these matters at all.

Section 102AAE ITAA36 essentially requires that, for a trust to be a listed country trust, all items of income or profit must be subject to tax in a listed country or be designated concession income in relation to a listed country. It follows that a Cayman Islands trust can be a listed country trust if all of its income is taxed in a listed country, for example the US. On the other hand, a New Zealand trust may not be a listed country trust if some of its income is not taxed in a listed country (including New Zealand itself) or is not designated concession income in a listed country.

Designated concession income is the amount specified in the regulations.[11] Care needs to be taken to ensure that the amount actually fits with the regulations. For example, capital gains are designated concession income in New Zealand but only when there is a permanent establishment in New Zealand. Therefore, a capital gain in a New Zealand trust may end the trust's listed status if there is no permanent establishment. This detail is easily missed in practice.

The lesson here is that it is critical to work through the complex laws when deciding how the regime operates rather than jumping to tempting conclusions.

"… it is critical to work through the complex laws when deciding how the regime operates rather than jumping to tempting conclusions."

Transferors

The transferor trust regime can cause a number of problems that are unexpected due to its relative obscurity and complexity. Also, it does not always operate in the manner that might be expected based on a rational appreciation of its objectives.

The first problem that can occur is to miss the large scope of the concept of a transferor. The rationale of the regime is to attribute the trust's income to the settlor of the trust. That is, the person that has transferred value to it. However, the scope of the concept of a transferor may catch many people who would not be considered to be a settlor or a major contributor of value to the regime.[12] The law captures all those who transfer any value to a trust other than in some limited circumstances, such as a genuine business transaction conducted at arm's length. This means three critical things:

1. a person can be a transferor even if another person is the main transferor;
2. a person can be a transferor on the back of a minor or incidental transfer of value; and
3. a person can be a transferor without giving something obvious to the trust.

To demonstrate this, consider a situation where a non-resident has transferred $10m to a non-resident trust. At the same time, an Australian resident provided $300 worth of book-keeping services to the trust (assume that they are not in the business of book-keeping). In this case, the Australian resident is a transferor regardless of the incidental nature of their transfer compared to the non-resident. Loaning money to a trust at a less than commercial value may also constitute a transfer. The possibilities are endless. It is clear that there is a significant risk in many trusts that someone unexpected may be a transferor.

The second problem with transferor trusts follows the first. This is that the regime does not initially operate “fairly” by making an apportioned attribution to all transferors that bears some relationship to their transfer. Rather, it attributes all of the attributable income to all transferors. Thus, it attributes to a taxpayer when the trust is really “somebody else’s” trust. Consider the same situation mentioned above where a non-resident has transferred $10m to a non-resident trust and an Australian resident has provided $300 worth of book-keeping services to the trust. The Australian resident is not attributed some portion of the trust’s attributable income. Instead, they are attributed all of the income. In fact, if a second or third Australian resident had also provided similar book-keeping services, *all* of these people will be attributed *all* of the income.[13] The dangers of the regime are quite clear.

The regime is tempered by the later parts of s 102AAZD ITAA36 that allow the Commissioner to reduce the amount attributed when he has full information about the trust’s situation and other transfers. This makes the regime more reasonable, but it must be kept in mind that the initial approach is to attribute all to all transferors. Escaping from this depends on providing the Commissioner with the necessary information and what the Commissioner determines to be reasonable. Two points need to be made in relation to this. First, it must be noted that the Commissioner’s power is quite wide here given that he may take into account “such other matters as the Commissioner considers relevant” under the law. In addition, it is a statutory discretion granted to the Commissioner. It should not be assumed that achieving the preferred outcome would be easy when following this route.

The second point is that it should not be assumed that the impacted taxpayer will be able to provide the necessary information, despite their best efforts. Offshore trustees may be unwilling or unable to provide the information. They may be bound by confidentiality or secrecy and they may not have the duty to provide information that trustees usually are. This is a very common scenario in relation to these trusts.

The lack of available information has further salience in this area. The law allows the attributable income to be calculated by a formula “when the taxpayer could not reasonably be expected to obtain the information required to determine the attributable income of the trust estate”. The outcome of this calculation may be preferable to the actual performance of the trust. However, whether the taxpayer will be able to satisfy the Commissioner that they could not be reasonably be expected to obtain the information should be considered. In addition, it would be risky to assume that a lack of information will protect a taxpayer from an assessment if the Commissioner has a small amount of information that indicates that there may be money in an offshore trust. Consider, for example, if a person’s name came up in the Panama Papers. The Commissioner can rely on his power to issue a default assessment and the taxpayer will be in a very difficult position to counter this. This risk would be significant if the Commissioner had strong suspicions that a wealthy Australian had a stake in an offshore trust.

A final problem with the transferor trust regime is trying to prevent double taxation between taxpayers or on the same taxpayer. In concept, the law does not require that income that has been taxed through attribution be taxed again through the trust regimes. For example, when present entitlement arises. The law works on the tidy assumption that the person who is attributed the income will be the person who actually receives the income. However, this is unlikely to be the case with an offshore discretionary trust. It is clear here that there may also be significant information issues when working out whether income has been previously attributed.

Conclusion

This article has provided a direct and practical analysis of the major problems and dangers inherent in the taxation of the income of offshore family trusts. They have been illustrated directly and can be viewed as an “executive summary” of the issues. More detailed analysis will be published in the next article in this series. What is abundantly clear is that the trust taxation law may operate in an unexpected manner, with dramatic consequences. This is because there is no direct equivalence between the terms used and common understanding in relation to offshore trusts and the definitions used in taxation. Specifically in this article, the scope of “trust” and “resident trust” for tax purposes was considered, as well as the operation of the transferor trust regime. Those who deal with international family trusts should ensure that they make no assumptions about core issues without obtaining certainty first.

Nolan Sharkey
Winthrop Professor of Law
University of Western Australia

Barrister
Frances Burt Chambers, Perth

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Individual residency: the cases just keep coming!

by Robert Deutsch, CTA, Senior Tax Counsel, The Tax Institute

The recent decision of the Full Federal Court in *Pike* sheds some light on important residency issues — what is residence on ordinary concepts, what counts when determining where a habitual abode is, and what are closer personal and economic relations?

The long line of cases dealing with individual residency issues continues to mount and says much about the level of complexity which is involved in interpreting the basic rules. That complexity has been exacerbated by the overlay across the basic rules of Australia's double tax agreements (DTAs) which, in most cases, have superimposed dual residency tie-breaker rules. These additional rules have often been difficult to interpret but a recent case has, to some extent at least, provided some much needed clarity.

The facts in *FCT v Pike*[1] were relatively straightforward.

The taxpayer, Mr Pike, emigrated with his family from Zimbabwe to Australia in 2005. His partner found work in her chosen field in Australia, but the taxpayer could not. He therefore lived and worked in Thailand while his partner and their children lived in Australia in accommodation which was rented in his and his partner's joint names. He remitted money on a regular basis to an Australian bank account which was also in joint names. He returned to Australia four to six times a year, spending approximately 25% of each year in Australia.

The residency rules provide, among other things, that a taxpayer is a resident of Australia if he is so resident based on ordinary concepts. If he is so resident and is also resident in another country with which Australia has a DTA, the DTA will usually have a tie-breaker provision so as to allocate residence to one of the two countries.

Thus, in *Pike*, the two questions for the court were essentially reduced to this:

– Was the taxpayer a resident of Australia based on ordinary concepts?
– As the taxpayer was both a resident of Australia and Thailand under the respective laws of both countries, did the tie-breaker provision in the Australia–Thailand DTA operate so as to confirm residency in one or other of the two countries for the purposes of the DTA?

The first instance judge answered these questions as follows:

– the taxpayer was a resident of Australia based on ordinary concepts; and
– the taxpayer was a dual resident but the DTA operated so as to make him solely a resident of Thailand for the purposes of the DTA.

The Full Court affirmed the decision in respect of both issues. (The judge at first instance had also considered and concluded the domicile test but in view of the Full Court's decision to uphold the finding that the taxpayer was a resident according to ordinary concepts, it was unnecessary for the Full Court to consider whether the taxpayer was also a resident under the domicile test.)

In resolving the first issue, the Full Court confirmed a fundamental critical point, namely, that where a taxpayer rents property in Australia which he uses when in Australia on a regular basis and his family lives in Australia more or less permanently, it would be difficult to conclude that he did not ordinarily reside in Australia. Of course, there can be countervailing factors which reverse this conclusion.[2] Those countervailing factors need to be compelling and, in the author's view, most often will be insufficient.

In resolving the second issue, the Full Court examined two tests which apply under the DTA where dual residency otherwise applies.

First, where a person has a permanent home available in both Australia and Thailand, the person shall be deemed to be a resident solely where the person has a habitual abode.

Second, where a person has a habitual abode in both Australia and Thailand, the person shall be deemed to be a resident solely in that jurisdiction with which the person's personal and economic relations are closer.

The key takeaway regarding habitual abode is that the Full Court makes it clear that it is not simply a contest as to the number of days spent in each of the two jurisdictions. In *Pike*, the taxpayer argued that Thailand was his habitual abode as, even though he had abodes both in Australia and Thailand, he spent more time in Thailand and therefore it followed that Thailand was his habitual abode. This argument was rejected — habitual abode goes to the nature of the abode not just the quantity of the presence, and this view was supported by the relevant OECD commentary. On that basis, the taxpayer had a habitual abode in both Australia and Thailand.

Regarding closer personal and economic relations, the Full Court affirmed the first instance decision that the taxpayer's relations were closer to Thailand. Of specific relevance, the Full Court confirms that the test of personal and economic relations is a conjunctive test, and in each case, it will be a matter of fact and degree as to whether a taxpayer's personal and economic relations, viewed as a whole, are closer to one country or the other. Indeed, in this particular case, the court recognised that the judge at first instance expressly concluded that the taxpayer's personal relations were closer to Australia than Thailand, but when considered as a whole having regard to the totality of the personal and economic relations, the facts indicated that the taxpayer's closer connection was to Thailand.

This is yet another case in the ongoing saga that is individual residency. It does, however, add some important new details, particularly around the application of the DTA tie-breaker rules in relation to which there has previously been precious little guidance.

It also underlines how fact-dependent our residency rules are and how uncertain they can be in application. Perhaps that supports an argument for a more objective set of individual residency rules, but there are problems with that approach as well which may well be the subject of further discussion on another day.

Robert Deutsch, CTA
Senior Tax Counsel
The Tax Institute

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Tax effects of COVID-19 cash flow boosts

by Stephen Page, CTA, Partner, Stephen Page & Co

The cash flow boosts should be brought to account as at the dates credited by the Australian Taxation Office. They are tax-free to their direct recipient, but taxable to shareholders when distributed by a company. However, the cash flow boosts are usually tax-free when distributed by a trust or partnership. Although trusts and partnerships can usually distribute the cash flow boosts tax-free, they should be credited to a cash flow boost reserve and not distributed. This both suits the purposes for which they are paid by the government and, in a small way, helps the difficult task of capital formation in small-to-medium enterprises and especially trusts. Although the cash flow boosts are tax-free to their direct recipients, the costs that they fund remain tax deductible in the usual way, unless for capital works.

Scope and introduction

This article is written from a small-to-medium business perspective. It examines how cash flow boosts should be treated for tax and accounting purposes, and examines whether they should be distributed, especially from trusts and companies.

It is well known that cash flow boosts are tax-free to their original recipient. It is less well known that often they should be recorded in the capital section of the balance sheet, not as income. Generally, they should be retained, not distributed, even if, improbably, a capacity to distribute cash exists (the reasons for this are discussed below). Also, it may not be immediately obvious when a distribution to a company shareholder from a cash flow boost may be or not be taxable. This article describes how all of this works.

Cash flow boost tax and accounts treatment

The cash from the boosts will usually have been spent paying wages and operating costs. These costs are recorded in the profit and loss account as expenses. Because the expenses will be incurred when operating the business to derive assessable income, they will also ordinarily be tax deductible.[1] However, the cash flow boost is not a negative expense, but primarily a source of funds.

More typical sources of funds are loans/creditors, income and capital. Loans and capital are not credited to accounts in the profit and loss statement, but to balance sheet accounts, where they carry forward, potentially perpetually, or until they are repaid or otherwise finally dealt with.

In partial contrast, income does offset against expenses to produce a profit or loss. In aggregate, until distributed, this carries forward in the balance sheet, in the same way as loans and capital. However, cash flow boosts are not necessarily income. For trusts, as explained below, they are more akin to capital. Thus, although the cash from the boosts may have been applied to expenses, like other sources of funds that may be similarly applied, the gross cash flow boosts may carry forward perpetually in the balance sheet, or at least until paid out. Later, this is considered in more detail for companies and trusts.

There is a good case to recognise the cash flow boosts on a cash basis, usually the date of the ATO credit. Why this is so derives from the government's announcement of the cash flow boosts' purpose and from accounting standard IAS 20, which mandates how government grants shall be accounted for. While many small-to-medium enterprises (SMEs) are not bound by accounting standards, it is helpful and clearest to follow them and banks' standard loan terms typically require borrowers to use accounting standards, thus requiring SMEs with bank borrowings to apply the accounting standards.

In their joint media release of 22 March, *Supporting Australian workers and business*, the Treasurer Josh Frydenburg and the Prime Minister Scott Morrison stated:

> "The Government is providing up to $100,000 to eligible small and medium sized businesses, and not-for-profits (including charities) that employ people, with a minimum payment of $20,000. These payments will help businesses' and not-for profits' cash flow so they can keep operating, pay their rent, electricity and other bills and retain staff."

IAS 20[2] states:

> "A government grant is recognised only when there is reasonable assurance that (a) the entity will comply with any conditions attached to the grant and (b) the grant will be received. [IAS 20.7]
>
> The grant is recognised as income over the period necessary to match them with the related costs, for which they are intended to compensate, on a systematic basis. [IAS 20.12]"

The joint 22 March media release makes the purpose clear: to pay bills. You can't pay bills from money you haven't yet got. Thus, you recognise the grant as it is received.

Although PAYG(W) liabilities are offset against the cash flow boost credits, many businesses pay PAYG(W) week-by-week or have a liability less than the boost, so they get all or some of the cash flow boosts in cash.

Read as a whole, IAS 20 requires a cash basis of recognition because earlier recognition will not match against costs as required by its para 20.12. It is worth noting that some hold a different view and give either no weight to the government's announcement or no weight to para 20.12 of IAS 20. Thus, BDO Australia states that both the 1st and 2nd cash flow boosts should be accounted for in the year ending 30 June 2020, on the basis that businesses have qualified to receive the 2nd boost by having paid the wages and incurred the PAYG(W) that qualifies for the 1st boost.[3] This conclusion seems incorrect. Although small business is rarely directly bound by accounting standards, as noted above, bank terms frequently require their adoption, so the proper treatment will often matter to small businesses.

According to the ATO:[4]

> "You do not need to pay tax on the amount of the cash flow boost and the cash flow boost is not subject to GST because there is no supply for the payment …
>
> **Passing on the cash flow boost to others**
>
> … if your unit trust distributes all or part of the cash flow boost amount to a unit holder, there will be no tax consequences for the unit holder in receiving that amount. If your company distributes all or part of the cash flow boost amount to a shareholder, the amount will be treated as a dividend, and it will need to be included in the recipient's assessable income for that income year. *We would expect that such distributions will be rare, however, since the cash flow boost is intended to be used to support the business needs of the company or trust.*" (emphasis added)

The ATO's emphasis on an expectation of non-distribution is central. It would look exploitative to the public and would not help business to gain future government support, especially support such as this, which is temporarily or permanently tax-free, depending on its chain of recipients, as discussed in this article, if later government statistics show cash flow boosts were distributed. Distributions should not be attributed to cash flow boosts.

In addition to public perception, there are also strong commercial reasons why cash flow boost payments should not be distributed.

Many trusts create present entitlements and, in order to provide themselves operating capital, fail to pay them. This has tax and commercial risks (discussed later in this article).

The cash flow boosts are an unusual opportunity for a business, especially one operated by a trust, to create/retain some extra permanent capital — something that is always hard to come by.

The cash flow boosts are part of operations, yet, for reasons discussed further below, in most trusts, the cash flow boosts are not income.

To record the cash flow boosts with those conflicting characteristics, and to achieve the capital formation objectives discussed above, while preserving the tax characteristics, requires the following treatment:

> To show 2020 and 2021 operating results, we record the cash flow boost as a specially denominated revenue item in the profit and loss (ie operating) statement. After deriving the operating result, but before arriving at the statutory/trust profit, we transfer the amount to the cash flow boost reserve, reported in the balance sheet's capital area.

Thus, the distributable/trust law profit excludes the cash flow boost.

Companies

For a company, treatment in the balance sheet's capital area is for the directors to decide. This may be demonstrated and achieved by signing accounts recording the cash flow boosts as a reserve in the balance sheet's capital area, ideally supplemented by a resolution included in the minute book to authorise the treatment. For the reasons set out above, the author strongly recommends this treatment. As for a trust, it is also a means of capital formation for a company.

It should be noted that the cash flow boost is part of the company's profit (or loss, if a loss is incurred). The High Court has held, for example, that a dividend paid in part from a gift was paid from profits.[5] In doing so, the court applied the dictum of Fletcher Moulton LJ in *Re Spanish Prospecting Co Ltd*:[6]

> "'Profits' implies a comparison between the state of a business at two specific dates usually separated by an interval of a year. The fundamental meaning is the amount of gain made by the business during the year. This can only be ascertained by a comparison of the assets of the business at the two dates."

However, although the cash flow boosts are part of a company's profit, most small businesses operated by companies are neither bound by accounting standards nor precluded from transferring amounts to reserve. The previous two paragraphs show clearly that transferring to a reserve does not make the amount non-distributable, but it does move it to a special envelope that can be seen more like savings than the owners' ready money.

> *"Nearly all … deeds make the trust income equal taxable income. Thus … the cash flow boost is excluded from the trust income."*

Trusts

Nearly all modern unit and discretionary trust deeds make the trust income equal to taxable income.[7] Thus, unless by financial year end the trustee formally resolves to include the cash flow boost in income, the cash flow boost is excluded from the trust income.[8]

This typical trust income definition is decisive in how you account for the cash flow boost. When, on cash flow boost receipt, you debit cash at bank, the most obvious (but wrong) credit to income is unavailable. The only remaining possibility is a credit to the balance sheet's capital area.[9] This credit should be to cash flow boost reserve.

The name "cash flow boost reserve" strongly hints at the amount's tax character. A working paper should prove it by linking to a PDF of a client tax portal report showing the cash flow boost credit, with a note of the tax law background.[10] This will preserve long-term capacity for its distribution, free of tax.

Accountants' ability to identify and set aside funds of money with particular sources is recognised by the courts, subject of course to any limits placed by law or a constituent document. This recognition is of long standing and is perhaps most prominently given in the High Court's decision in *Archer Brothers Pty Ltd v FCT*,[11] where the majority (Williams ACJ, Kitto and Taylor JJ) stated:

> "By a proper system of book-keeping the liquidator, in the same way as the accountant of a private company which is a going concern, could so keep his accounts that these distributions could be made

> wholly and exclusively out of those particular profits or income, and the shareholders would become entitled to a rebate under s. 107."

Although, in the author's view, this statement was not central to the High Court's decision, it has long been recognised as correct.

Some older trust deeds do not equate trust income to taxable income. In these instances, it remains strongly advisable, subject to power in the trust instrument, to follow the same treatment of the cash flow boost as for more modern trusts.

Trust and company capital

Unit trusts often fund themselves by not paying out unitholders' income entitlements. This is unstable finance. A non-cooperative unitholder, or one needing to pay bills, such as a tax bill, may call for their money. If the money is used in working or fixed capital, as it often is, the trustee will be financially embarrassed when it is called for. It may become a big problem if a unitholder hits strong financial difficulties, eg insolvency. Payment to an individual unitholder, especially a large unitholder, while not paying others, risks dissolving the usual mutual funding cooperation that independent parties can usually bring to their joint endeavours. This can seriously damage the business. Paying all unitholder entitlements, hitherto used to fund operations, may be beyond the trustee's practical capacity. At best, in the author's experience, restoring funding and balance is an annoying and time-consuming distraction from productive activity. A wise trustee will be careful not to distribute the cash flow boost reserve.

The need for most discretionary trusts to distribute all of their income each year makes their capital formation very difficult. Capacity to credit the cash flow boost to a reserve is a "gift from heaven". It builds capital without the risk of beneficiary demands for payment and the threat of s 100A or Div 7A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) if the beneficiaries remain unpaid.

Companies are equally likely, sooner or later, to need capital. Distributing the cash flow boost is tax inefficient, especially if there are no excess franking credits and if the ultimate owners include individuals with material other income. It is better to retain the funds, credited to a reserve.

Ultimate distribution of the cash flow boosts

Trusts

Despite the ATO stating "distributions [of the cash flow boost amount] will be rare", trusts have a finite life (and companies may end when their purpose is over). A day will come, perhaps very far in time, when the entity will be wound up and need to distribute the funds sourced from the cash flow boost. As noted above, this is a funding source that may be carried forward continually in each year's balance sheet, just as are capital, accumulated profits and unpaid liabilities.

The cash flow boost reserve's tax status will be important when the enterprise and entity are dissolved, or the reserve is otherwise distributed.

The tax law background to the ATO's correct[12] view about unit trust distribution quoted under the heading "Passing on the cash flow boost to others" at page 301 of this article (equally applicable to a discretionary trust) is from s 11-55 ITAA97 which provides:

> "The provisions set out in the list make amounts non-assessable non-exempt income."

The list includes:

> "cash flow boost
>
> payments in accordance with the *Boosting Cash Flow for Employers (Coronavirus Economic Response Package) Act 2020* ……… 59-90"

In this list, "59-90" refers to s 59-90 ITAA97 which provides as follows:

> "**Cash flow boost**
>
> A cash flow boost paid in accordance with the *Boosting Cash Flow for Employers (Coronavirus Economic Response Package) Act 2020* is not assessable income and is not exempt income."

Section 104-70 (CGT event E4) broadly provides for non-assessable payments to unitholders to be deducted from the cost base of their units.[13] However, as relevant, s 104-71(1) provides:

> "(1) In working out the non-assessable part referred to in section 104-70, disregard any part of the payment that is:
>
> (a) non-assessable non-exempt income;"[14]

Thus, distribution of the cash flow boost, because it is non-assessable non-exempt income, will not reduce unitholders' cost bases.

Another concern for unitholders is s 99B ITAA36. Section 99B opens adversely:

> "(1) Where, at any time during a year of income, an amount, being property of a trust estate, is paid to, or applied for the benefit of, a beneficiary of the trust estate who was a resident at any time during the year of income, the assessable income of the beneficiary of the year of income shall, subject to subsection (2), include that amount."

This prima facie taxation of everything that a beneficiary gets from a trust is saved by s 99B(2), thus:

> "(2) The amount that, but for this subsection, would be included in the assessable income of a beneficiary of a trust estate under subsection (1) by reason that an amount, being property of the trust estate, was paid to, or applied for the benefit of, the beneficiary shall be reduced by so much (if any) of the amount, as represents: …
>
> (b) an amount that, if it had been derived by a taxpayer being a resident, would not have been included in the assessable income of that taxpayer of a year of income;"

If the cash flow boost is allocated in its own reserve or (slightly less desirably) in a reserve aggregated with other tax-free amounts, and its derivation is supported as described above, it will be readily demonstrated that its ultimate distribution by a trust represents an amount that, if derived by a resident, would not have been included in the assessable income.[15] Thus, the eventual distribution of the cash flow boost to trust beneficiaries will not be taxable to them.

The ATO's view, based on the decision in *Bamford*,[16] is that s 97 ITAA36 proportionally shares tax law income amounts of all characters between the beneficiaries according to their percentage shares of trust law income. Thus, the

ATO's view is that elements of income cannot be streamed unless the item has a specific streaming provision, such as those dealing with franked dividends and capital gains. *Greenhatch*,[17] which preceded the present CGT streaming rules, exemplifies this. The Full Federal Court held that, where the taxpayer had been made entitled to capital gain alone, "what he received in the present case was a proportionate share of amounts having no single character".[18] Although the court was not express in saying so, in context, the quote above referred to the tax, not the trust law, result.

In contrast, when eventually distributed, the cash flow boost reserve may be directed to particular beneficiaries. This is because the reserve is not part of the year's income and so is not affected by the proportioning rule in s 97.

This is also so where a cash flow boost is distributed from its reserve via some other trust to that other trust's beneficiaries, provided that other trust's accounting distinguishes its character. The recipient trust will receive it in its character as non-assessable non-exempt income (from a tax perspective). The issues, consequences and arguments discussed above in relation to receipt by the original trust apply to the recipient trust. Another important issue is whether amounts retain their character on passing through a trust, which this paragraph's first and second sentences take it that they do.

It is inherent in the ATO quote that appears earlier in this article that the cash flow boost retains its character on distribution by a trust and that it is received in the character in which it was distributed, ie as non-assessable non-exempt. That being so, the same applies at a later stage since the amount is received there as non-assessable non-exempt. The best view is therefore that passage through multiple trusts does not affect the result.[19] For example, if a unit trust, eg on winding-up, distributes a share of cash flow boost reserve to a discretionary trust, on that discretionary trust distributing the amount, its beneficiaries will receive the funds as non-assessable non-exempt income. Ideally, however, the discretionary trust will retain the funds to assist its own capital formation and distribute them only on its own winding-up.

Where a discretionary trust makes the distribution, it will ordinarily be open to the trustees, if that suits family circumstances, to select individual beneficiaries, who will receive the amount tax-free. Although company beneficiaries will also receive the amount tax-free, it will not be tax-free on further distribution by the company, except in the limited circumstances discussed under the next heading.

In the minority of instances, where under particular trust deeds the cash flow boosts, as they are derived, unavoidably do form part of trust law income, the distribution of trust law income will include the cash flow boosts, and so beneficiaries' non-assessable non-exempt income will include a share of them.[20]

Companies

The ATO's view that a company's distribution of the cash flow boost is an assessable dividend will almost always be correct, though as discussed below, not inevitably.

Section 6 ITAA36 provides (ignoring preference shares):

> "'dividend' includes:
>
> (a) any distribution made by a company to any of its shareholders, whether in money or other property; and
>
> (b) any amount credited by a company to any of its shareholders as shareholders;
>
> but does not include:
>
> (d) moneys paid or credited by a company to a shareholder or any other property … debited against an amount standing to the credit of the share capital account of the company;"

(Note that some arrangements to credit and then to distribute share capital are excluded.)

Thus, s 6 makes a company's distribution of the cash flow boost to shareholders a dividend. Section 44(1) ITAA36 includes dividends in assessable income. However, circumstances may exist where distribution of funds sourced from the cash flow boosts will not create a tax liability, eg where franking credits accompany the distribution into another company, or where, on winding-up or capital reduction, losses (whether or not from COVID-19) have destroyed capital, but the cash flow boost restored that capital. In that last instance, before winding-up/capital reduction, you would necessarily transfer the cash flow boost reserve to the account in debit, usually accumulated losses. In this way, the distribution will be from capital and by the exclusion in para (d) in the quote above, it will not be a dividend and will not be assessable.

Conclusion

In short, it will be commercially wise for companies and trusts to place the cash flow boosts to the credit of a cash flow boost reserve. Ultimately, trusts may distribute the amount without tax, while company distributions will usually be taxable, although frankable. A partnership might also adopt the strategies described here.

Stephen Page, CTA
Partner
Stephen Page & Co

References

1 Derivation of the cash flow boosts is incidental. The costs are incurred in operating the business and are deductible under s 8-1(1)(b) of the *Income Tax Assessment Act 1997* (Cth) (ITAA97), unless for capital works (eg buildings, in-house software), which will usually be dealt with under the capital allowances rules.

2 IFRS Foundation, *IAS 20 Accounting for government grants and disclosure of government assistance*, April 1983. Available at www.iasplus.com/en/standards/ias/ias20. See also paras 7 and 12 of AASB 120. Available at www.aasb.gov.au/admin/file/content105/c9/AASB120_07-04_COMPsep11_07-12.pdf.

3 BDO Australia, *Accounting for COVID-19 government stimulus measures — Initial and additional cash flow boosts*. Available at www.bdo.com.au/en-au/accounting-news/accounting-news-june-2020/accounting-for-covid-19.

4 Australian Taxation Office, *Accessing the cash flow boosts*. Available at www.ato.gov.au/Business/Business-activity-statements-(BAS)/In-detail/Boosting-cash-flow-for-employers/?page=4#Tax_consequences. Accessed 23 September 2020.

5 *FCT v Slater Holdings Ltd* [1984] HCA 78.

6 [1911] 1 Ch 92.

7 Franking credits are usually excluded, but that is not directly relevant here.

8 As at 30 June 2020, few or no trustees will have resolved to include the cash flow boosts in trust income. The author has yet to encounter a trust that, by 30 June 2020, had resolved on inclusion.

9 For simplicity, this description omits the step of first passing it into and out of the operating statement.

10 This article was written with that purpose for the author's own practice, though responsibility to third parties is not accepted. Readers should satisfy themselves of the correct treatment and not rely on this article.

11 [1953] HCA 23.

12 There may be instances, hopefully rare, where that view will be incorrect. One example might be a superannuation fund in a non-arm's length income (NALI) situation. There are policy reasons why a fund should be taxable in this NALI-like situation, but it is not instantly clear whether this would be the result. Sensibly, the bottled elixir of abstruse knowledge at the bottom of that rabbit hole should be labelled, "Don't drink me".

13 A different regime, with similar effects, applies to publicly offered unit trusts. This is not discussed here.

14 S 6-23 ITAA97 provides it is income that is not assessable income and is not exempt income.

15 The ATO presently requires clear proof of tax-free status of amounts that come to its attention. This makes it critical to have supporting working papers that explain and evidence the amounts and that are carried forward each year.

16 *FCT v Bamford*; *Bamford v FCT* [2010] HCA 10

17 *FCT v Greenhatch* [2012] FCAFC 84.

18 *FCT v Greenhatch* [2012] FCAFC 84 at [31].

19 A short discussion of the flow-through controversy appears at para 3.5 of the Treasury consultation paper, *Modernising the taxation of trust income — options for reform*. Available at https://treasury.gov.au/sites/default/files/2019-03/Consultation_Paper_Modernising_Taxation.pdf.

20 For a fuller discussion of the principles, see ibid, para 3.8.

Death duties again? Really?

by Ian Raspin, CTA, Managing Director, Lyn Freshwater, Senior Tax Consultant, and Mark Morris, FTI, Senior Tax Counsel, BNR Partners

There has been an increasing level of discussion about the feasibility of reintroducing death duties or similar taxes in Australia as a way of bolstering government revenue and addressing growing income and wealth inequality. Death duties have in the past created considerable resentment among affected parties, have been easily avoided by the well-advised, and have not produced significant revenues. International experience suggests that, while some countries have retained them over time, a significant number have removed them, and the case for reintroduction does not suggest international best practice. This article argues that, rather than reintroduce a whole new tax with a whole new set of potential problems and complexities, it may be better to consider broadening the existing tax base, fixing technical issues, and providing greater certainty both in terms of revenue and ease of compliance and administration. In particular, changes could be targeted in the area of estate income and capital gains taxation, or even more broadly in CGT.

Introduction

> "The art of taxation consists of plucking the goose so as to obtain the most feathers with the least hissing."
>
> – Jean-Baptiste Colbert, 1619 to 1683

Murmurings abound at the moment about different ways that the federal government may want to bring in more tax revenue to pay off post-COVID-19 debt, or to better fund aged care in the future, or to do both.

Inevitably, when base broadening and wealth taxes come up, death duties enter (or re-enter) the discussion. Having been part of Australia's tax mix since before Federation at a colonial level, and since 1914 at a federal level, death duties were ditched at both levels by the early 1980s, but that does not stop people advocating for their reintroduction.

On one view, any form of wealth tax, or any new form of tax on capital for that matter, may inappropriately stifle economic recovery following the COVID-19 recession. The creativity, innovation and drive of the small and medium-sized enterprise market will be critical in that phase. But if there has to be a whole new tax on wealth or capital (and, as stated below, the authors do not think that there does have to be), at least a death duty or inheritance tax, properly targeted to inter-generational wealth transfer with decent concessions for active business assets, may be the least of the "evils".

That said, however, any serious proposal to reintroduce death duties (imposed on the estate) or inheritance/succession taxes (imposed on beneficiaries), or any combination of the two, would face significant challenges.

First, there are serious questions as to whether death duties exhibit "good" tax policy credentials — in particular, would they become (like the previous versions) essentially "voluntary taxes" for the well-advised[1] while hitting others particularly hard, and how complex would they be to comply with and for the ATO to administer?

Second, death duties would face considerable "political" opposition and lobbying, doubtless coming, at least in part, from those who supported their removal throughout the 1960s and 1970s, such as farmers and those advocating for newly impoverished widows.

And, if finding a new source of significant revenue is the main requirement, there is the question of whether they would bring in enough tax revenue (or otherwise sufficiently enhance our society and economy) to justify the pain.

But before we look at whether such a "big new tax" is needed, it is important to bear in mind that:

– the income tax law already has a number of features that look and feel like a "death" tax and these could readily be tweaked or expanded if desired without the need for a "whole new tax"; and

– there are many smaller, easily implemented changes to estate taxation that could expand the existing tax base to pick up some of the revenue likely to be generated by a conventional set of death duties.

If significant tax changes in the wealth tax space are in contemplation, the authors believe that all possibilities should be considered, including what have to date been seen as "sacred cows". Loopholes in the existing base could be fixed, the breadth of the base could be adjusted (including exemptions, such as the main residence exemption), and one could also tinker with tax rates that apply to different parts of the base (eg the CGT discount).

This article focuses on changes which could be targeted in the area of death and estate taxation, but the authors acknowledge the possibility of wider and more generic reforms.

Existing aspects of the tax base that look like death duties

Some say that the fact that the legal personal representative (LPR) is liable for tax on the deceased's date of death income tax return (to the extent of assets in the estate) is akin to a "death" duty because it is tax imposed after the taxpayer has died. But there are perhaps better examples.

Superannuation provides one example. The superannuation death benefit is only tax-free if it goes to dependants and financially dependent offspring. If it goes to non-dependent adult beneficiaries, the benefits are generally taxed to the estate. This is similar to a death tax. However, some may argue that tax on superannuation should apply more broadly unless the benefit goes to the surviving spouse.

Now to CGT. Unrealised capital gains to the deceased are not generally taxed at death (although there are exceptions to this) and the LPR or beneficiaries usually inherit the deceased's cost base, exposing them to tax on disposal (again, there are exceptions). So, in a sense, tax on capital gains is "inherited".

If an asset is left to a charity (other than a deductible gift recipient), or if something other than Australian land is left to a non-resident, there is *theoretically* a taxed capital gain under CGT event K3 at death (a "death duty") on the basis that, if unrealised gains are not captured at that time, they will disappear from the tax net after death. The tax is *theoretical* because it will not be collected if the asset passes to the charity or to a non-resident outside the two-year (or sometimes four-year) amendment period for date of death return assessments. This is a big loophole.

Existing aspects that look like a "free kick"

On the other hand, there are CGT concessions that perhaps go too far. A dwelling that was the main residence of the deceased *just before* death, and not used to produce income at that time, can be sold by the LPR or beneficiary completely tax-free within two years of death. This is irrespective of how the dwelling was used before *just before* death or even whether it had been the deceased's main residence for much (if any) of that period. Indeed, there seems to be nothing to prevent the claiming of another dwelling as an *actual* main residence of the deceased for that period. A real double dip! This is a case of an intended compliance cost concession for estates that is poorly targeted and arguably goes "too far".

There are other examples where the CGT base is curiously narrower than good policy would suggest. Pre-CGT dwellings that were never the main residence of the deceased also enjoy a two-year tax-free selling window. Further, the LPR can rent out any dwelling during that two-year period (whether pre-CGT or post-CGT to the deceased) with zero effect on the exemption. This period can be extended with the "okay" of the Commissioner. When CGT began, the window was only 12 months.

The current main residence exemption and death rules also have some drafting deficiencies which may permit (and, in the ATO's view, do indeed permit) taxpayers to "double up" on exemptions, for example, by obtaining a market value cost base on a main residence at death (which eliminates any pre-death capital gain or capital loss) *and* taking account of main residence days *before* death to reduce any capital gain over that market value if the dwelling is not sold within the two-year window.

When one examines examples like this, the existing tax arrangements after death, but as a result of death, reflect different policy considerations and sometimes reveal inconsistencies. Small changes can be made to tidy up the rules for estates and beneficiaries to bring in the tax they should.

Small change approach

A "small change" approach could involve simply fixing loopholes (such as those involving CGT event K3 and the main residence exemption as outlined above) and making minor policy changes or clarifications where necessary.

For example, it has never been clear whether the death roll-over in ss 128-10 and 128-15 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) is meant to come to an end once an estate asset passes to a testamentary (often discretionary) trust, or whether it is meant to continue until the asset finally reaches the hands of an individual beneficiary from a testamentary trust (and perhaps other intervening trusts). Literally, the law exempts only an LPR, and *not* a trustee of a testamentary trust. The ATO's administrative approach (see PS LA 2003/12) exempts transfers from testamentary trusts (including discretionary testamentary trusts). However, if the beneficiary is the trustee of another trust, the practice does not extend to a transfer to any beneficiary of *that* trust.

Curiously, a foreign resident deceased would not be eligible for the CGT discount if they sold Australian land, but the CGT discount is available if their estate has an Australian resident LPR who sells the asset.

On the flipside, a resident deceased person whose estate has a non-resident LPR can avoid CGT on non-Australian land assets even though CGT event K3 should apply.

A more recently observed phenomenon is the concept of "multiple" estates for the one deceased person whereby foreign-sited assets are kept out of the hands of the Australian resident trust rules.

An approach that treated the deceased and their estate as a continuing entity, thereby removing the estate from the trust assessing rules, might overcome some of the anomalous outcomes where the LPR is a resident of a different country from that of the deceased.

Bigger change approach

The full range of tax concessions which are currently enjoyed by deceased estates could be reviewed, including the concessional tax rates that are available to estates under s 99 of the *Income Tax Assessment Act 1936* (Cth) (ITAA36), assuming that "sacred cows" are no longer "sacred".

It appears that people are already trying to subvert the recent amendments to restrict the "excepted income" concession for minors in Div 6AA ITAA36 (broadly, to income from the deceased's own assets and superannuation proceeds etc) by trying to divert income from discretionary trusts through the deceased estate itself. While the Commissioner may seek to apply s 99A ITAA36 to such arrangements, it is a blunt instrument. There is a broader question about the need for a policy rethink because the nature of deceased estate planning has changed from relatively simple trust arrangements for surviving spouses and minor children to highly intricate succession plans involving (in the main) discretionary trusts, including multi-generational arrangements.

When CGT was introduced with effect from 20 September 1985, the federal government was keen to avoid the impression that it was, in any sense, a reintroduction of death duties by stealth. Hence, as mentioned above, the death roll-over in ss 128-10 and 128-15 usually defers recognition of any capital gain or loss until an LPR or beneficiary sells the deceased's assets.

Of course, it would be relatively simple in terms of drafting to remove the roll-over either fully or partly. The impact of such a change, would, however, be considerable in terms of the sheer number and cost of valuations required at death (noting that this was probably one of the reasons why Australia introduced a pre-CGT/post-CGT regime rather than the United Kingdom's original 1965 valuation date approach). This change could also generate real cash flow issues where illiquid assets are concerned.

Notwithstanding the problems, this sort of change would be a de facto death duties regime — without the need for a new and separate piece of legislation while avoiding interactions between CGT and death duties that may otherwise have to be addressed. Unlike a real death duty that would tax the value of assets rather than accrued gains on assets, this approach would just bring CGT collection forward, but that may be more palatable than a duty on estate value and capital gains tax to those who realise estate assets with accrued gains.

Serious consideration could then be given to what assets should be taxed at death and what are not taxed at death. A case would no doubt also be made to continue to defer CGT on agricultural land and small business assets. There would also be a good argument for leaving a concession for spousal transfers of all (or some) assets (such as a main residence).

Some may query at this point whether the fact that the deceased who resided in the property should remain relevant if the property passes to beneficiaries who do not also live there.

In fact, a bigger change approach, beyond death duties, would be to consider whether the main residence exemption should continue at all. It is a very costly exclusion (to government revenue) from the CGT base. For example, it was estimated to cost the budget $74b in the 2017-18 forecast, and $327.5b over the forward estimates.[2] The removal of the exemption for non-residents is estimated to result in a revenue saving of $155m in 2020-21.[3]

No doubt, removal of the main residence exemption would be politically difficult and raise concerns over "lock-in" and further decreases in housing availability (and affordability). But the main residence has become an important (if not *the* most important) store of wealth for many individuals under all but the highest wealth brackets, and so may well feature in any wealth tax that is introduced.

Partial removal of the main residence exemption might also be considered, but the difficulty there has always been fairly balancing the treatment of individuals in different housing markets (that is, Sydney and Melbourne as opposed to the rest of Australia).

If all of this looks just too hard, the 50% CGT discount, which was originally to be a replacement for cost base indexation, has become much more than that in low inflationary times. It is extraordinarily generous and encourages saving and investment to generate capital rather than income returns which are subject to progressive income tax.

Some advocate the return of indexation (but, please, not the rounded to 3 decimal place indexation factors), and this would take trusts and companies back to a neutral playing field. However, a better option may be to reduce the discount rate to a smaller percentage, say, 5% or 10%. Or, as applied in other jurisdictions, the discount rate could increase on a "stepped" basis the longer the asset is held. A lesser change might involve removing or reducing the CGT discount for assets which taxpayers have negatively geared.

The "big bang" – reintroduce death duties or a similar wealth tax

If none of the above appeals, and the government really does want to "bite the bullet", what can be said about a reintroduction of death duties/inheritance taxes?

The first thing of interest is, as previously mentioned, that Australia had got rid of death duties by the early 1980s, notwithstanding the fact that countries with similar taxing regimes retained them (and some, like the United States and the UK continue to have them (at about 40%). The OECD average rate is 15%.

The US has a very high threshold (currently US$11.4m (inflation adjusted) but returning to US$5m in 2026) and the UK reasonably high (GB£325,000 or thereabouts).

However, 15 countries have no taxes on property passing to lineal heirs, and 13 countries repealed them between 2000 and 2015. New Zealand repealed its estate duties in 1992, and its gift duties in 2011.

Prior to the 1980s, Australia's duties were at both a state and federal level, full of complexity, with a combination of relatively low exemptions, moderate to high rates, and, except towards the end, not much in the way of concession for spousal transfers. Death duties were extremely unpopular.

Strong inflationary pressures in the late 1960s and early 1970s had brought ever smaller estates into the net, increasing the overall costs of administration and compliance. Death duties were relatively easy to avoid with the use of trusts, especially discretionary trusts, so high wealth individuals in the main did avoid the duties, but duties fell harshly on business people who died unexpectedly and on people who operated through partnerships and owned assets in their own names. Impoverished widows ended up relying on state pensions, and farmers, who had high value but low income-producing and hard to sell assets, were often worst hit of all. The duties did not produce much government revenue for all of the pain.

These factors would surely have to be addressed in any possible reintroduction.

What are some of the other issues?

Federal or state (or, God forbid, both)?

It seems highly unlikely that the previous arrangement of both state and federal duties would come to pass, although that does remain the approach in the US. In Australia, it would presumably be at a federal level only (if at all).

Estate tax or inheritance tax (or a bit of both)?

Should duties be levied on the estate or on those who inherit (or a bit of both)? Don't laugh — Western Australia previously assessed some duties on the estate and some on successors!

The Henry review[4] pointed to the possibility of introducing an estate tax, an inheritance tax or an accessions tax.

Broadly, an estate tax would apply to the whole of an individual's estate, regardless of how many recipients there were. It could be modified to favour bequests to spouses or to other categories of dependent recipient, as such bequests could be concessionally valued or be subject to a flat percentage discount.

By contrast, an inheritance tax would apply separately to each inheritance received by an individual, which would typically be levied at progressive tax rates.

An accessions tax would essentially tax gifts and inheritances received by a particular person on a cumulative basis. It would take into account the fact that some recipients receive a number of substantial inheritances over the course of their lives and that they should be taxed cumulatively on the value of those amounts. Ireland has such a system (capital acquisitions tax, or CAT), with a hefty 33% tax applying once the threshold is reached, and the record-keeping required for a lifetime system may present some challenges.

Prima facie, an inheritance tax is more aligned with the progressive income tax system as it taxes the bequest in the hands of the recipient rather than the estate of the donor. However, it would provide tax planning opportunities as the deceased may be able to reduce the overall tax burden by allocating the inheritance differentially among such beneficiaries, compared to the total tax that would be payable on the entire estate under an estate's tax. This is in the same way, broadly, that discretionary trusts are now used to split tax liability for income tax, or for CGT purposes, where, to avoid CGT event K3, cash or pre-CGT assets are given to non-residents, with residents taking the bulk of other assets.

Regardless of whether an estate tax or an inheritance tax was implemented, there would need to be rules for gifts. For example, the former Commonwealth estate duty aggregated gifts made within three years of the deceased's death with the value of the estate for the purposes of that tax.

The Henry review concluded that, while there were arguments in favour of both an estate tax and an inheritance tax, an estate tax would be the best model for Australia if a bequest tax was to be introduced.

In reaching that conclusion, the Henry review noted[5] that an estate tax would avoid the lifetime complexity of the accessions tax and be simpler to administer than an inheritance tax. It also accords with the tax system structure under which income savings are subject to relatively uniform low rates of tax, and it removes incentives for donors to split up their estates to minimise the tax payable.

Such an outcome is consistent with the reforms proposed under ch 24 of the Asprey report in 1975 which similarly concluded that there were merits to taxing under both proposals but that an estate tax would be administratively simpler and would more easily control tax avoidance.

Interestingly, discretionary trusts were much less prevalent in the mid-1970s than they are today (today, there are approximately one million such trusts, split roughly 50/50 investment and business), so an estate tax may possibly be used as a lever against discretionary trusts.

Recommendation 25 of the Henry review stated that, while no recommendation was made on the possible introduction of a tax on bequest, the Commonwealth Government should nonetheless promote further study and community discussion on the options available.

Nonetheless, the Henry review's findings that the preferred form of any reform should be in the nature of an estate tax is clearly influenced by the detailed findings of the Asprey report.

What assets?

The Asprey report suggested that the tax base of an estate duty should at least include the real and personal property owned by the deceased at the time of their death, which then becomes part of the estate administered by the LPR. However, the report also proposed that the base on which estate duty is levied should also include property that the deceased had power to acquire at the time of their death. Thus, it would include property the subject of a power of appointment which the deceased had at the time of their death, which could have been exercised in their own favour. While not directly referred to, this would appear to place a constraint on the use of discretionary trusts as a possible means of avoiding duty as was the experience under the former estate duty regime.

The Asprey report also suggested that, in relation to certain illiquid assets (such as farming land), LPRs should have an option to spread the payment of duty over a number of years to minimise the cash-flow effect of the duty.

Threshold, rate and revenue potential?

Now we get to the nitty gritty!

The Henry review pointed out that raising revenue should be done to cause the least harm to economic efficiency, provide equity (horizontal, vertical and intergenerational), and minimise complexity.

The Henry review also pointed out[6] that no OECD country regards wealth transfer taxes as a major source of revenue and that, on average, OECD countries only raised 0.41% of their total tax revenue from such taxes.

If the tax has a large threshold, and therefore fewer cases, a high rate is needed to ensure a reasonable revenue take. This is broadly the current approach federally in the US. But a high rate means that there are big incentives to get around the impost.

Too small a threshold, even with a smaller rate, could bring too many small estates into the net and lead to an increase in administration, compliance complexity and costs, as was the case with the old death duties in Australia.

That seems to leave a large threshold so only large estates are caught, and a low rate to minimise efficiency distortions and discourage avoidance. But will this produce much revenue?

The Henry review recommended that the merits of introducing a bequest tax should be considered and that, if it was introduced, it should only be levied at a low flat rate and be designed to affect only large bequests.

It seems that the only way in which an estate or inheritance tax could generate a significant amount of revenue in Australia is where it is imposed on a broad base at a low rate of tax. Currently, there is no modelling which indicates what level of revenue would be generated by the introduction of such a tax (which would also be contrary to international trends). However, an interesting article published by the Australian Institute for Business and Economics of the University of Queensland does discuss the economic merits of such a broad-based proposal.[7]

One of the arguments is that, even if significant revenue is not generated, a death duty or inheritance tax may address wealth inequality to some extent. As people are now living longer, assets are increasingly left to financially secure spouses and children, causing wealth inequality (and the economic and social disadvantages that that creates) to increase. A tax may help to reduce these effects.

Any revenue raised from the tax could also be used to increase opportunities, for example, with spending on education and scholarships, and the tax may be reasonably efficient. It may not "distort" the behaviour of the deceased to the extent that bequests are from assets that the testator kept for a "rainy day" but, in the end, were not needed, or where the deceased died unexpectedly. Even if testators decide to spend rather than save in order to leave to others, there may be a positive effect on demand, as well as helping to break down stores of wealth. To the extent that the tax did discourage some saving and investment by living people, at least the actual impost is deferred until after death.

Spousal transfer exemption?

Politically, duties with a spousal transfer exemption would be easier to sell, as there would then be a clear focus on the *inter-generational* transfer of wealth. This would be essentially a deferral of tax in relation to many spousal transfers, as is the case in the UK (which also allows any unused threshold to be passed to surviving spouses). The Asprey report suggested, however, that there should be a monetary limit on a spousal transfer exemption.

Complexity, structuring and costs

One of the major concerns about the reintroduction of inheritance taxes is that they become very complex and encourage advisers to design structures to get around the tax, for example, by using chains of trusts to separate the assets from the true owners. One of the key issues is that these structures will have an impact on the effectiveness of other taxes, which is unlikely to be desirable from either a compliance cost or administration perspective.

Practitioners would be concerned about the effect that the tax would have on the scale of compliance work needed to get estate (and sometimes beneficiary) tax issues satisfactorily sorted, in a reasonable time frame.

International dimension

Would any new tax be like income tax and assess residents on worldwide wealth, and non-residents on Australian assets? If so, similar complexities would arise, for example:

- How would the ATO track overseas gifts that were relevant for a resident's tax-free concession?
- What structuring would be entered into by non-residents to ensure that they were not sufficiently "connected" to Australian assets?

There would also be the question of foreign tax credits and the need to amend the scope of treaties. Treaty interactions would inevitably be complex because of the different ways that countries levy death duties and inheritance taxes. More cases would also arise because, pre-COVID-19 at least, there have been significant increases in the international mobility of income and capital.

Interaction with other taxes

It goes without saying that interactions with other taxes and duties would be needed, especially CGT and stamp duties.

> *"... a death duty or inheritance tax may address wealth inequality to some extent."*

Other considerations

The Henry review noted[8] that any option for taxing bequests and gifts would require consideration of the following:

- the cash-flow implications for estates that are held predominantly in the form of liquid assets;
- the treatment of bequests to charities, which are concessionally taxed in many countries;
- how any such tax would interact with CGT;
- how the tax would interact with the taxation of superannuation benefits on death;
- the treatment of non-resident donors and property located outside Australia; and
- the design of the gift tax to accompany the request tax.

Other wealth taxes

Of course, death duties are not the only "wealth tax" around. There are many others.

Land holdings have sometimes been targeted because they can easily be identified and (usually) valued, but clearly that is highly distortional and inequitable.

In the OECD's report, *The role and design of net wealth taxes in the OECD*,[9] it was observed that there had been a renewed interest in wealth taxation for collection and wealth redistribution purposes, although fewer OECD countries then levied them than in the past.

The report observed that repeal had often been because of administrative and efficiency concerns, redistributive goals had not been met, and the revenue collected had been very low. However, the report argued that there was a strong case for addressing wealth inequality through the tax system — that it is far greater than income inequality and tends to be self-reinforcing. The question was whether a wealth tax was the most effective way of addressing wealth inequality.

Australia already has progressive income tax and a CGT regime where net capital gains are taxed essentially as income (thus progressively), but as noted above, CGT contains some very significant exemptions and rate concessions that weaken its potential effect on addressing wealth inequality. For example, non-assessable distributions from discretionary trusts are not taxed as income or as capital gains.

It may well be that, if there is a desire to reduce wealth inequality, instead of imposing a new wealth tax via a death duty or something similar, fixing base and rate erosion in CGT may provide much of the answer.

It must be remembered too that wealth taxes tend to be very complicated in nature, and this leaves them open to abuse and avoidance. Even former prime minister Paul Keating's recent proposal in the aged care royal commission for an alternative basis to fund aged care (a repayable loan system, like HECS, after death) was met with a question from Commissioner Tony Pagone QC (a noted former tax lawyer and judge) as to whether the proposal could be seen as a death tax. Mr Pagone observed that, putting on his former tax lawyer hat, he could see many people trying to make sure that there would be no assets left to repay the loan.

Conclusion

Many significant impediments would be faced by any serious proposal to reintroduce death duties. A better approach may lie in making smaller policy and technical changes to the existing tax base, especially the CGT rules that apply to deceased estates. If this is done well, a greater degree of progressivity could be achieved on "capital" income, with a consequent effect on wealth inequality.

Ian Raspin, CTA
Managing Director
BNR Partners

Lyn Freshwater
Senior Tax Consultant
BNR Partners

Mark Morris, FTI
Senior Tax Counsel
BNR Partners

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Section 353 notices: powers to obtain information

by Tania Waterhouse, Partner, Waterhouse Lawyers, and Pat Zappia QC, Barrister, Aickin Chambers and PG Hely Chambers

A recent decision of the Queensland Court of Appeal canvasses the use of information obtained during a compulsory interview under provisions such as s 353-10, Sch 1 TAA53 or former s 264 ITAA36. The Full Court found that relying on the transcript to formulate charges abrogates the common law fundamental right to a fair criminal trial. The decision in *R v Leach* affects any taxpayer that was convicted as a result of the Director of Public Prosecutions relying on an ATO compulsory interview. Given the decision, it is unlikely that the ATO will allow this to occur again. The case also throws open the issue of what remedies are available where an ATO officer breaches the disclosure provisions. In particular, is there a remedy available to the taxpayer/defendant?

The law

The non-disclosure provisions in Div 355 of Sch 1 to the *Taxation Administration Act 1953* (Cth) (TAA53) apply to protected information.

Protected information is defined to mean information that is disclosed or obtained under or for the purposes of a taxation law (other than the *Tax Agent Services Act 2009* (Cth)), which relates to the affairs of an entity (including but not limited to the entity's tax affairs), and which identifies, or is reasonably capable of being used to identify, that entity.

Section 353-10, Sch 1 TAA53 confers power on the Commissioner of Taxation to compel a person to give evidence on oath "for the purpose of the administration or operation of a taxation law". A person who is compelled to give evidence under the section may not invoke the privilege against self-incrimination.[1]

Section 355-50, Sch 1 TAA53 carves out exceptions to this prohibition. It permits disclosure of such information to "any entity, court or tribunal … for the purpose of criminal … proceedings … that are related to a taxation law".

Sections 355-25 and 355-30, Sch 1 TAA53 make it an offence for a taxation officer to disclose information obtained at a compulsory examination. The non-disclosure provisions are commonly referred to as "the secrecy provisions".

The basic facts

Philip Leach, a solicitor, lodged numerous BASs on behalf of two trusts, resulting in GST refunds of $1,311,761. The refunds were transferred to bank accounts controlled by him. He also asserted that those trusts had incurred expenses that he knew had not been incurred.

During an audit of his taxation affairs, the ATO issued a notice under s 353-10, Sch 1 TAA53 to Mr Leach, requiring him to attend and give evidence under oath or affirmation and to produce documents on 18 March 2010. The audit concluded in August 2010 and the matter was referred to the serious non-compliance area of the ATO for further investigation.

In September 2011, the matter was referred for prosecution by the ATO investigator. The brief of evidence provided to the Commonwealth Director of Public Prosecutions (CDPP) included a transcript of the compulsory interview conducted on 18 March 2010.

The matter was heard in the District Court at Brisbane on 24 April 2017. During the trial, the interview transcript was tendered and a recording of the interview was played for the jury.[2] In particular, the CDPP sought to establish that Mr Leach had lied at the interview and that those lies evidenced his consciousness of guilt.[3]

The defendant was convicted of all charges on 15 May 2017. He received eight years imprisonment, with a non-parole period of four years.

The Court of Appeal decision

The Court of Appeal of the Queensland Supreme Court held (by a majority)[4] that the use of the transcript of interview by the prosecution constituted a miscarriage of justice.[5]

The issue before the Court of Appeal

The issue before the Court of Appeal was whether the relevant provisions of the TAA53 permitted the disclosure of a compulsory examination to the prosecuting authorities for use in charging and prosecuting Mr Leach.

As stated by Sofronoff P:[6]

> "The question is whether the legislation implicitly authorizes the disclosure to and use by the DPP of the content of a s 353-10 Sch 1 examination for the purpose of a consideration of charges against the examinee, for the purpose of the formulation of such charges, for use in the prosecution case in relation to such charges and as evidence at a criminal trial to prove the guilt of the examinee."

The reasoning in the Court of Appeal

The leading judgment in the Court of Appeal was given by Sofronoff P. His Honour construed the relevant provisions of the TAA53 by applying the principle of legality which holds that the legislature should not be presumed to abrogate fundamental principles or rights or to depart from the general system of law without expressing its intention with irresistible clearness.[7] Such an alteration can only be made if it is made clearly by express words or necessary intendment.[8]

At issue in this case was whether the provisions of the TAA53 abrogated two fundamental principles underpinning the accusatorial nature of the common law criminal justice system. First, the principle that the onus of proving criminal guilt rests on the prosecution. Second, that the prosecution, in discharging that onus, cannot compel the accused to assist it at any stage of the accusatorial process which commences with the investigation of crime and culminates in the trial of the offence.[9]

It would plainly be a departure from these fundamental principles of the criminal justice system for the prosecution to be armed with evidence of an accused person obtained under compulsion when considering, formulating and prosecuting criminal charges against that person.[10]

Sofronoff P held that the relevant provisions of the TAA53, including s 355-50, Sch 1 TAA53 which permitted disclosure of the compulsory examination to "any entity, court or tribunal … for the purpose of criminal … proceedings … that are related to a taxation law", did not manifest an intention by the legislature to abrogate these two fundamental principles.

As such, those provisions did not *impliedly* authorise the disclosure of the transcript of interview to the CDPP for the purpose of considering whether to charge Mr Leach, formulating those charges and proving them at trial.

In reaching this view, Sofronoff P made several pertinent observations about the legislation:

1. the objects of the legislation do not expressly include the alteration of the fundamental principles of the criminal justice system that were at stake;[11]
2. the focus of the provisions in question are to define the scope of criminal responsibility for the disclosure of protected information by tax officers. Section 355-25, Sch 1 TAA53 creates an offence in respect of such disclosure and s 355-50, Sch 1 TAA53 provided for exceptions;[11]
3. the provisions in question say nothing about the propriety of the "use" of the protected information by its recipient;[11]
4. there is nothing in the legislation which expressly authorises "disclosure" of the interview to prosecutors;[12] and
5. the purposes of the TAA53 would not be frustrated to any degree if the transcript of interview could not be disclosed to the prosecution.

In respect of whether the purposes of the TAA53 would be frustrated if the transcript of interview could not be disclosed, his Honour stated:[13]

> "Information obtained from people under compulsion may be used in many ways in pursuit of statutory objects even if an examinee remains immune from its use in criminal proceedings. Information obtained by compulsory interrogation may be used in order to recover unpaid tax by demand and by civil process even if the defendant is the examinee. Interrogation may dig into the commission of serious offences by an examinee alone or in conjunction with others. Such information may be disclosed to aid the DPP's prosecution of offenders other than the examinee."

Subsequent proceedings: the decision of Smith DCJA

Following the appeal, Mr Leach made application to the Queensland District Court[14] for the criminal proceedings against him to be permanently stayed or for the charges which had been laid to be quashed.

Mr Leach submitted that any criminal proceedings against him would be irreparably tainted by the unauthorised disclosure of the compulsory examination to the prosecution which had already occurred, and that it would be impossible for him to obtain a fair trial in accordance with the fundamental principles of the criminal justice system described by the Court of Appeal.

The CDPP resisted the application on the basis that, since the Court of Appeal decision, a new prosecution team had been assembled which had been quarantined from the transcript of interview and the CDPP would not rely on the transcript of interview when preparing and adducing evidence at the trial.

> *"… use of the transcript of interview by the prosecution constituted a miscarriage of justice."*

Findings

The matter was heard by Smith DCJA of the Queensland District Court. The court quashed Mr Leach's convictions.[15] His Honour found on the evidence before him that the complaint and charges presented on the indictment had been in part drawn by the CDPP based on the record of interview and, as found by the Court of Appeal, the provisions of the TAA53 did not authorise the disclosure and use of a compulsory examination for such purpose.[16] That reasoning was plainly correct.

However, Smith DCJA refused to permanently stay the criminal proceedings.[17] He ordered that the charges against Mr Leach be quashed. This left it open to the possibility of new charges being laid.[18]

Use of derivative evidence

In the course of the application before Smith DCJA, a question arose as to whether it was open to the CDPP to use evidence which was derived from information provided by the examinee at the interview (derivative evidence).

His Honour concluded that the use of derivative evidence did not necessarily prejudice a fair trial and its use by the prosecution depended on the nature of the evidence and whether it was available from other sources.[19] Consistently with this approach, His Honour found that it was permissible for the prosecution to rely on the evidence of witnesses who were identified from information provided by Mr Leach in the compulsory examination.[20]

Smith DCJA's conclusion creates a tension with the reasoning of the Court of Appeal. That court had determined that the provisions of the TAA53 concerning compulsory examinations had not in any sense abrogated the twin fundamental principles of the criminal justice system, namely, that the onus of proving criminal guilt rests on the prosecution and the prosecution, in discharging that onus, cannot compel the accused to assist it at any stage of the accusatorial process. Once that conclusion was reached, it would appear to follow that no information provided by Mr Leach could be used in prosecuting him, whether directly or indirectly.

An indirect use of information obtained under compulsion would constitute as much of an infringement to the twin principles underlying the accusatorial process as a direct use. And the infringement arises notwithstanding that such evidence may have been available from other sources. It is not inevitable that the indirect evidence (even though otherwise available) would have been pursued in the absence of the compulsory examination. The prohibition against the use of the compulsory examination to assist in proof of the prosecution case was not confined by the Court of Appeal to the use of the transcript itself.

Smith DCJA referred to the reasons for judgment of French CJ and Crennan J in *X7*, in support of his conclusion.[21] However, French CJ and Crennan J were in the minority. Hayne and Bell JJ, with whom Kiefel J agreed, did not distinguish between a direct and an indirect use of evidence obtained from an accused at a compulsory examination as constituting a fundamental departure from the twin principles underlying the accusatorial nature of the criminal justice system.[22]

Smith DCJA also relied on the reasons for judgment of Bathurst CJ in *R v Seller*.[23] The judgment of Bathurst CJ was carefully considered by Sofronoff P in the appeal and his Honour did not construe it as authority for permitting the use of the transcript of interview to obtain indirect evidence for use in the prosecution of Mr Leach. In any event, the legislation in *R v Seller*, as construed by Bathurst CJ, was found to have abrogated by necessary implication the prohibition against the use of evidence indirectly obtained from the compulsory examination by the prosecuting authorities.[24] The same could not be said of the provisions of the TAA53.

A permanent stay

As correctly noted by Smith DCJA, the grant of an order permanently staying a criminal proceeding because of an infringement of the principles underpinning the accusatorial process is an exceptional remedy.[25] So much was established in *Strickland v DPP*,[26] where it was said that:

> "… a permanent stay of prosecution should only ever be granted where there is such a fundamental defect in the process leading to trial that nothing by way of reconstitution of the prosecutorial team or trial directions or other such arrangements can sufficiently relieve against the consequences of the defect as to afford those charged with a fair trial."

A further observation made in *Strickland* was that the forensic disadvantage suffered by the accused by the wrongful disclosure and use of the compulsory examination is not inevitably overcome by the appointment of new prosecutors who know nothing of the examinations where there has already been a wide-ranging undocumented dissemination of the examination.[27]

In the Court of Appeal, Sofronoff P made the observation that the examination of Mr Leach had been disseminated to numerous officers within the office of the CDPP.[28] His Honour also held that the examination could not be used by the CDPP "for the purpose of a consideration of charges"[29] (ie whether to prosecute). In the context of these matters, it was relevant when considering whether to grant a permanent stay for Smith DCJA to ascertain whether the extent of the dissemination which had occurred within the office of the CDPP no longer made it possible for the prejudice to Mr Leach to be overcome by the appointment of a new prosecution team.

Further, it was also arguable that the decision to prosecute Mr Leach (based partially on the wrongful disclosure of the transcript of interview) could not readily be dismissed as an incurable forensic prejudice. At the very least, it would be difficult for a court to conclude with any degree of confidence that a new prosecution team could truly consider afresh whether to charge and prosecute Mr Leach without being influenced, at least in part, by the fact that the CDPP had previously proceeded with an indictment. Both matters required consideration when determining whether a permanent stay should be ordered.

Remedies

The following remedies may be available to a taxpayer where the secrecy provisions have been breached by an ATO officer.

Pre-conviction

If charges have been laid and the matter has not been heard, a taxpayer who is the subject of a breach of the secrecy provisions can challenge the charges and seek to have them set aside (relying on *Leach*).

The taxpayer, or their legal representatives, can initially make a submission to the CDPP to withdraw the charges.

It is of course open to the CDPP to withdraw the charges and to appoint a new case team to investigate and prepare charges without any reference to the compulsory interview.

Post-conviction

Where the charges have been heard and the taxpayer has been convicted, the taxpayer may be able to challenge the conviction on the basis that the use of the transcript of interview by the prosecution constituted a miscarriage of justice. This was the successful option taken by the defendant in *Leach*

Compensation

There are no compensatory remedies available to the taxpayer under the legislation. However, depending on the particular circumstances, the taxpayer may be able to:

- pursue a negligence claim against the Commissioner;[30] and/or
- seek compensation from the ATO for detriment arising from defective administration.[31]

Action against staff member who disclosed the "secret"

Breach of the secrecy provisions is a criminal matter and a staff member who improperly discloses the record of interview can be prosecuted. The authors are not aware of any instances where this has occurred.

Conclusion

Leach is a salutary lesson to the Commissioner of inherent risks where ATO officers do not strictly observe the secrecy provisions.

Tania Waterhouse
Partner
Waterhouse Lawyers

Pat Zappia QC
Barrister
Aickin Chambers and PG Hely Chambers

References

1 This was established in *FCT v De Vonk* [1995] FCA 994 and *Binetter v DCT* [2012] FCAFC 126 and follows by implication from ss 8C and 8D TAA53.

2 *R v Leach* [2018] QCA 131 at [15].

3 Ibid at [13], [18]-[27].

4 Per Sofronoff P with whom Philippides JA agreed; Applegarth J dissenting.

5 *R v Leach* [2018] QCA 131 at [105].

6 Ibid at [39].

7 *X7 v Australian Crime Commission* [2013] HCA 29 at [158].

8 Ibid at [119].

9 *R v Leach* [2018] QCA 131 at [45], [97] and [101]; *X7 v Australian Crime Commission* [2013] HCA 29 at [99]-[102]. See also *Strickland v DPP* [2018] HCA 53 at [77].

10 *R v Leach* [2018] QCA 131 at [97].

11 Ibid at [36].

12 Ibid at [38].

13 Ibid at [89].

14 *Commonwealth Director of Public Prosecutions v Leach (No. 3)* [2020] QDC 42.

15 *R v Leach* [2018] QCA 131 at [105].

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17 Ibid at [331].

18 Ibid at [333].

19 Ibid at [288].

20 Ibid at [293]-[295], [301]-[306].

21 Ibid at [276].

22 See, for example, *X7 v Australian Crime Commission* [2013] HCA 29 at [124] per Hayne and Bell JJ.

23 *Commonwealth Director of Public Prosecutions v Leach (No. 3)* [2020] QDC 42 at [277].

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26 [2018] HCA 53 at [106].

27 Ibid at [80].

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31 Australian Taxation Office, *Applying for compensation*. Available at www.ato.gov.au/Forms/Applying-for-compensation.

A Matter of Trusts

by Magdalena Njokos, Sladen Legal

Changes to the taxation of testamentary trusts

Legislation passed on 17 June 2020 has amended the ITAA36 to change the taxation treatment of distributions of income from testamentary trusts to minors.

Taxation of unearned income of minors

Trust estates are taxed under Div 6 of Pt III of the *Income Tax Assessment Act 1936* (Cth) (ITAA36). While taxpayers often seek to establish testamentary trusts in their wills with the objective of achieving asset protection for beneficiaries who are exposed to business/creditor risks or family law risks (such as marital or relationship breakdown), an ancillary tax benefit that arises from establishing a testamentary trust is the effect on the taxation of distributions to persons who are under 18 years of age.

Division 6AA ITAA36 provides special rules for determining the tax payable on the eligible assessable income of a minor. The special rules provide that a lower tax-free threshold and special rates of tax apply to the taxable income (other than excepted income) derived by the minor.

For the purposes of Div 6AA, a "minor" is defined as a person who is under 18 years of age on the last day of the year of income and who is not an excepted person in relation to the year of income (s 102AC). "Eligible assessable income" is defined in s 102AE and generally includes so much of the assessable income as is not excepted income. The special rules apply to the minor beneficiary's share of the income of a trust that is not excepted trust income (s 102AG(1)). The types of excepted trust income are listed in s 102AG.

Under the *Income Tax Rates Act 1986* (Cth) and Div 6AA ITAA36, the eligible assessable income of a minor (other than excepted income) is taxed as per Table 1.

Table 1. Tax on eligible assessable income of a minor

Distribution	Tax rate
$0–$416	Nil
$417–$1,307	$0.66 per dollar
$1,308+	$0.45 per dollar

Under s 102AG(2)(a)(i) ITAA36, one of the types of excepted income is assessable income of a trust estate that resulted from a will, codicil or intestacy. Therefore, the income of a testamentary trust (a trust estate that resulted from a will) is excepted income and the special rules in Div 6AA outlined above will not apply to income distributed by the testamentary trust to a minor beneficiary. The minor beneficiary will be taxed on income received from the testamentary trust at normal adult marginal rates, with the benefit of the higher tax-free threshold. In addition, the low-income tax offset and the low and middle-income tax offset will reduce tax payable on the minor's excepted income if the minor is eligible for the offsets.

Later acquisition of assets and Furse's case

Historically (and subject to the anti-avoidance provisions discussed below), the tax benefit of a testamentary trust (as described above) was not limited to assets that are passed directly from the estate of the deceased to the testamentary trust and could be derived from assets that were later acquired by the testamentary trust.

This was specifically addressed in *Trustee for the Estate of the late AW Furse (No. 5) Will Trust v FCT* [1] where Hill J stated:

> "The tribunal held that upon its true construction s.102AG(2)(a)(i) merely required that the trust estate should arise under or by virtue of a will. It was submitted for the Commissioner, however, that for the subsection to operate, it was necessary that the assessable income of the trust estate itself be sourced in the will or property of the deceased. With respect, I do not accept the Commissioner's submission. It requires that the words in s.102AG(2)(a) 'that resulted from' refer to the assessable income rather than to the words in subsection (i) 'a will' etc. or in subsection (ii) 'an intestacy' etc. In my opinion all that is necessary to fall within s.102AG(2)(a) is that the assessable income be assessable income of the trust estate, that trust estate being one of the forms of trust estate referred to in s.102AG(2)(a)(i) or (ii) (that is to say not an inter vivos trust)."

Anti-avoidance provisions

An important part of considering the application of s 102AG(2) is the existing anti-avoidance integrity measures that are set out at s 102(AG)(4) and (5) (the anti-avoidance provisions).

Section 102AG(4) and (5) state:

> "(4) Subsection (2) does not apply in relation to assessable income derived by a trustee directly or indirectly under or as a result of an agreement that was entered into or carried out by any person (whether before or after the commencement of this subsection) for the purpose, or for purposes that included the purpose, of securing that that assessable income would be excepted trust income.
>
> (5) In determining whether subsection (4) applies in relation to an agreement, no regard shall be had to a purpose that is a merely incidental purpose."

This is also emphasised in the explanatory memorandum to the Income Tax Assessment Amendment Bill (No. 6) 1979 (the Bill that introduced the provisions) where it stated that s 102AG(4):

> "… is designed as a safeguard against arrangements of any kind that might be entered into with the purpose of exploiting the exclusions of particular income [from the application of Div 6AA].
>
> Subsection 102AG(5) qualifies subsection 102AG(4) by excluding from operation of the latter subsection the circumstances where the purpose of securing the excepted trust income status is a 'merely incidental purpose' of the transaction."

Treasury Laws Amendment (2019 Measures No. 3) Act 2020

In the 2018-19 Budget, the government announced its intention to "implement an integrity measure to improve the taxation of testamentary trusts". Despite the pre-existing anti-avoidance provisions, the government sought to close the "loophole" of taxpayers inappropriately obtaining tax concessions on assets that are unrelated to the deceased estate and are later injected into the testamentary trust.

The *Treasury Laws Amendment (2019 Measures No. 3) Act 2020* (the amendment Act) amended Div 6AA to clarify that minors will be taxed at adult marginal tax rates only in respect of income that a testamentary trust generates from assets of the deceased estate, or the proceeds of the disposal or investment of those assets.

The amendment Act inserted subs (2AA) which narrows the definition of "assessable income" in s 102AG(2)(a) as follows:

> "For the purposes of paragraph (2)(a), assessable income of a trust estate is of a kind covered by this subsection if:
>
> (a) the assessable income is derived by the trustee of the trust estate from property; and
>
> (b) the property satisfies any of the following requirements:
>
> (i) the property was transferred to the trustee of the trust estate to benefit the beneficiary from the estate of the deceased person concerned, as a result of the will, codicil, intestacy or order of a court mentioned in paragraph (2)(a);
>
> *(ii)* the property represents accumulations of income or capital from property that satisfies the requirement in subparagraph (i);
>
> *(iii)* the property represents accumulations of income or capital from property that satisfies the requirement in subparagraph (ii), or (because of a previous operation of this subparagraph) the requirement in this subparagraph."

The explanatory memorandum to the amendment Bill provides a useful example of the manner in which this provision operates:

> "**Example 1.1 Injected asset**
>
> On 1 July 2019, testamentary trust ABC is established under a will of which a minor is a beneficiary. Pursuant to the will, $100,000 is transferred to the trustee from the estate of the deceased. Shortly after the testamentary trust is established, a related family trust makes a capital distribution of $1,000,000 to the testamentary trust. The resulting $1,100,000 is invested in ASX listed shares on the same day. Dividend income of $110,000 is derived for the 2019-20 income year. The net income of the trust is $110,000 and the minor is presently entitled to 50 per cent of the amount of net income.
>
> The minor's share of the net income of the trust is $55,000. $50,000 is attributable to assets unrelated to the deceased estate and not excepted trust income. $5,000 is excepted trust income on the basis that it is assessable income of the trust estate that resulted from a testamentary trust, derived from property transferred from the deceased estate.
>
> **Example 1.2 Income from retained excepted trust income**
>
> Following on from example 1.1, the minor's share of the net income of the trust (being $55,000, comprising $5,000 excepted trust income and $50,000 not excepted trust income) is not paid to the minor by the trustee but is invested for their benefit in ASX listed shares shortly after the commencement of the 2020-21 income year. For the 2020-21 income year, that investment derives income of $5,500, and the minor is presently entitled to the entire amount.
>
> $5,000 is attributable to assets unrelated to the deceased estate and not excepted trust income. $500 is excepted trust income on the basis that it is assessable income of the trust estate that resulted from a testamentary trust, derived from income that was previously excepted trust income."

The amendment Act took effect on 1 July 2019 and applies to property acquired by or transferred to the testamentary trust on or after that date.

Administrative burden

The amendment Act produces a significant administrative burden by creating a requirement for the duplication of testamentary trusts within a common family scenario.

For example, parent A and parent B have two children. Under their wills, parent A and parent B wish to provide their children's inheritance via testamentary trusts (one testamentary trust per child). On the death of parent A, two testamentary trusts are established. On the death of parent B, a further two testamentary trusts are required to be established to ensure that s 102A(2) applies. Each child is now managing and administering two testamentary trusts, adding unnecessary complexity and costs.

If it wasn't for the amendment Act, this duplication and requirement for multiple testamentary trusts to be created could be avoided where parent B could instead dispose of parent B's estate to the testamentary trusts established by parent A's will. Based on the *Furse* case and the purpose of not breaching the existing anti-avoidance provisions, the same tax outcome could have been achieved without the added burden.

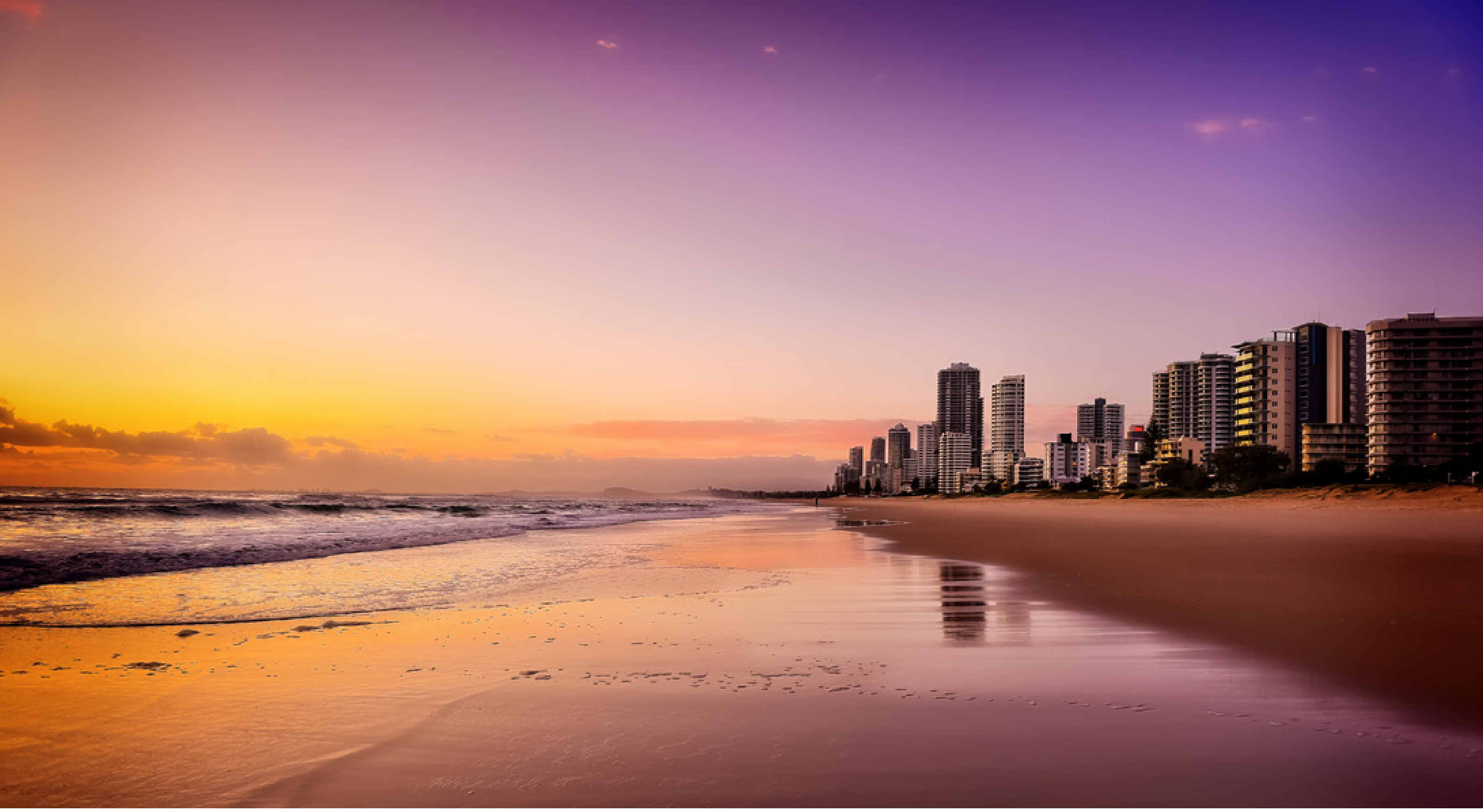
Magdalena Njokos
Senior Associate
Sladen Legal

Acknowledgment

The author would like to acknowledge Daniel Smedley, Principal at Sladen Legal, for his assistance in the preparation of this article.

Reference

1 [1990] FCA 470 at [57].



Superannuation

by Daniel Butler, CTA, and Bryce Figot, CTA, DBA Lawyers

How administrative penalties are applied to SMSFs

Self-managed superannuation fund trustees must play by the rules or suffer the consequences. Trustees should obtain advice before implementing any strategy, embarking on any significant transaction, or where there is any doubt.

Introduction

The ATO recently published PS LA 2020/3 to guide ATO staff on how to apply administrative penalties. The practice statement provides the methodology on how ATO case officers make determinations on imposing and remitting penalties in relation to self-managed superannuation funds for contraventions under s 166 of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA93).

The ATO's view is that a contravention is taken to occur at a point in time and, for the most part, does not continue or carry over to the following financial year. However, it believes that, if a contravention remains unrectified by the end of a financial year, this can cause an additional and separate contravention at the start of the next financial year.

If a contravention is reported or detected by the ATO, there are four steps that the ATO case officer should apply when administering penalties:

1. determine whether a penalty is imposed by law;
2. determine who is liable to the penalty;
3. determine whether remission is appropriate; and
4. notify each trustee and/or each director of the corporate trustee of the liability to pay the penalty.

In addition to imposing penalties, the ATO has the power to apply one or more of the following compliance treatments:

– issue an education direction;
– accept an enforceable undertaking;
– issue a direction to rectify;
– disqualify a trustee;
– issue a notice of non-compliance; and/or
– seek civil and criminal penalties.

This article focuses on how the administrative penalty system applies to SMSFs. For simplicity, the authors refer to the term "trustee" as including a director of a corporate trustee.

Administrative penalties

Under s 166 SISA93, the ATO can impose administrative penalties on SMSFs in respect of certain rules, including the following:

– s 65(1): generally, no lending to members or relatives: 60 penalty units;
– s 67(1): generally, no borrowing: 60 penalty units;
– s 84(1): must comply with in-house asset rules: 60 penalty units;
– s 103(1): must keep minutes: 10 penalty units; and
– s 104(1): must keep records of changes of trustee: 10 penalty units.

A penalty unit is currently $222 and is subject to increases with the consumer price index. The penalty unit amount is indexed each third 1 July and will increase again on 1 July 2023 (as defined in s 4AA of the *Crimes Act 1914* (Cth)). Indexation of the penalty unit was introduced in July 2017 when each penalty unit was $180. Thus, there has been a substantial (23%) increase in the amount of each penalty in the past three years.

An administrative penalty cannot be paid using SMSF resources. Accordingly, it is either the individual trustees or directors of a corporate trustee who are personally liable. Directors of corporate trustees are jointly and severally liable to the penalty, whereas individual trustees are each liable to the penalties imposed on each trustee. This means that a corporate trustee with two directors will receive one administrative penalty overall, but two individual trustees will get one administrative penalty each. This is one of the many reasons why corporate trustees are far superior to individual trustees. Indeed, all SMSFs should have a corporate trustee to minimise the risk of these penalties as all people commit sins and make mistakes, and God may forgive them but will the ATO?

Remission of penalties

When applying administrative penalties, the ATO has an unfettered discretion to remit all, part or none of a penalty imposed under s 166 SISA93. When deciding whether remission is appropriate, the ATO considers the following:

– the purpose of the penalty provision;
– the trustee's behaviour and circumstances;
– the seriousness of the contravention;
– any unintended or unjust results;
– multiple penalties; and
– multiple breaches of the same or different provisions.

The main objectives of the penalty provisions are to encourage voluntary compliance, promote consistent treatment, and shift the behaviour of the trustee to not contravene again. The ATO considers the specific circumstances that resulted in a contravention before determining any remission.

Once the total penalty amount has been determined, the case officer must give written notice to each trustee of their liability and the reasons for this, and an explanation on any remission.

If a trustee is dissatisfied with a decision to refuse to remit, in full or in part, they may object to the Commissioner. If they are not satisfied with the Commissioner's decision, they may apply to the Administrative Appeals Tribunal or to the Federal Court for review.

Trustees' behaviour and circumstances

When considering whether remission is appropriate, a case officer should consider the factors that support remission and weigh them against the factors that do not support remission. The ATO states that some factors in favour of remission include:

- good compliance history;
- rectification prior to ATO contact;
- voluntary disclosures; and
- circumstances beyond the trustees' control.

The above factors would be weighed against the factors that are not in support of remission, which the ATO states include:

- poor compliance history;
- awareness of obligations;
- repeated bad behaviour;
- multiple contraventions;
- seriousness of contraventions; and
- direct benefit gained through deliberate acts.

The important takeaway for trustees is that having a good compliance history and taking swift action to rectify a contravention will work in their favour. The ATO appears to welcome trustees who take initiative, and this may help avoid more serious outcomes.

When seeking to rectify a contravention, trustees should demonstrate to the ATO their voluntary compliance, the rectification action that has been taken (or the proposed rectification action), and how they will avoid contravention in the future. Trustees can give an enforceable undertaking to the ATO to demonstrate how they intend to rectify the contravention and any other action that they may take, such as participating in SMSF education courses.

Hints on remission from examples in PS LA 2020/3

PS LA 2020/3 outlines the ATO methodology for its case officers to follow in respect of imposing and remitting penalties in 12 practical and typical examples.

Example 1 involves an SMSF providing a loan to a member where the trustee failed to seek repayment on six different occasions over two financial years. Each such failure was treated as a contravention that is subject to 60 penalty units (ie six multiplied by 60 penalty units multiplied by $222 per penalty unit, ie 360 penalty units × $222 = $79,920). Since there were two individual trustees, the combined penalty was $159,840 (ie 2 × $79,920). However, as this example involved a single course of conduct, the ATO case officer could remit the penalty to $13,320 for each trustee (ie 60 × $222), as one penalty is appropriate for a contravention that relates to a single course of conduct.

Example 7 involves two individual trustees who deliberately withdrew $50,000 to buy a new car. There were two contraventions: s 34 SISA93 for paying a benefit early; and s 65 SISA93 for providing financial assistance to members. As there were two contraventions, the ATO case officer could remit the penalty to the amount applicable for the primary contravention because imposing a penalty for multiple contraventions for the one event may not be fair and just. Fortunately, in this example, the penalty under s 34 was $4,440, rather than $13,320, for each trustee.

Example 8 is based on similar facts to those in example 7 but the two trustees withdraw 10 separate amounts of $5,000 to buy the new car worth $50,000 in the same financial year (ie 10 × $5,000). Based on the facts in example 8, the ATO case officer could remit:

- the multiple penalties for the same primary contravention, so only impose a single penalty for s 34; and
- the multiple penalties (× 10) for the secondary (s 65) contravention.

This would result in the ATO imposing a single penalty of $4,440 on each trustee rather than imposing a $44,400 penalty (ie 10 × 20 = 200 penalty units per trustee) for the multiple contraventions of the primary contravention. Thus, a potential $288,000 penalty in this example could be remitted to $8,880 (note that the penalty units were lower in FY2016).

Example 9 provides an example of how the ATO may treat a primary and secondary contravention in relation to a loan that resulted in a contravention of s 65 (loan to a member) and Pt 8 SISA93 (in-house assets) over two distinct financial years resulting from two separate loan agreements. The case officer decided that the primary penalty for s 65 should apply for two financial years, ie $13,320 × 2 = $26,640 for each trustee.

Note that, in example 8, the 10 × $5,000 separate withdrawals were all made in the same financial year and were considered a single course of conduct. However, in example 9, there were two separate loan agreements made in two separate financial years that were treated as separate contraventions. Another important factor reflected in example 9 was that, even though Mr Smith was the active trustee who made all of the decisions, the fact that Mrs Smith was a passive trustee who was aware of the loans did not result in any additional remission for her, ie passive trustees should not remain passive and should seek involvement and accountability.

Conclusion

Self-managed superannuation fund trustees must play by the rules or suffer the consequences. Trustees should obtain advice before implementing any strategy, embarking on any significant transaction, or where there is any doubt. Where there is a contravention, timely action should be taken to minimise any adverse consequences as administrative penalties can result in substantial penalties.

When an SMSF trustee lodges a formal objection, they must cover each relevant ground of objection in appropriate detail. If the objection is unsuccessful, the trustee may wish to seek a review of the objection by the AAT or, if it involves a question of law, appeal to the Federal Court.

Daniel Butler, CTA
Director
DBA Lawyers

Bryce Figot, CTA
Special Counsel
DBA Lawyers

Alternative Assets Insights

by Jonathan Malone, CTA, Sarah Saville, ATI, and Joanne Murray, FTI, PwC

Aggregated turnover threshold

How an entity's aggregated turnover is calculated is critical when determining whether it can access the recently enacted temporary loss carry-back and super-charged instant asset write-off measures.

On 6 October 2020, Treasurer Josh Frydenberg handed down the 2020-21 federal Budget. From a tax perspective, there were a range of measures to stimulate business investment and jobs growth, such as a temporary loss carry-back for companies and a new and improved instant asset write-off.

As the loss carry-back and super-charged instant asset write-off measures are only available to entities that have an annual "aggregated turnover" of less than $5b, how an entity's "aggregated turnover" is calculated and tested is an important concept. It should be noted that the Treasurer recently announced an alternate test on 23 November 2020 in relation to the instant asset write-off measure for those corporate taxpayers who do not fall within the $5b aggregated turnover threshold. This article only looks at what is meant by the term "aggregated turnover" and does not address the alternate test.

The reliance on the aggregated turnover test has elevated the importance of a concept that many large taxpayers (particularly multinational corporations) would not have needed to focus on before as the concept has historically applied to measures which applied at a much lower threshold. This article considers how the relevant rules are to be applied.

Aggregated turnover

An entity's "aggregated turnover" is defined as the sum of the following relevant annual turnovers:

– your annual turnover for the income year;
– the annual turnover for the income year of any entity (a relevant entity) that is *connected with* you at any time during the income year; and
– the annual turnover for the income year of any entity (a relevant entity) that is an *affiliate* of yours at any time during the income year.

It should be noted that aggregated turnover for an income year does not include income that is derived by an entity from dealings with affiliates or entities that are connected with it. This ensures that income is not double counted, ie effectively, a consolidated view of the relevant entities is taken. It is also important to note that connected or affiliate entities do not need to be Australian residents for tax purposes to be included, and that the concept of a connected entity or affiliate is not the same as an "associate".

Any ordinary income that was derived by an entity during a period when it was not connected with, or an affiliate of, the test entity is also excluded from the calculation of annual turnover.

Note: While the loss carry-back rules are only available to companies, for the purposes of the aggregated turnover test, it will be important to consider the annual turnover of all types of entities (trust, partnership etc) that are regarded as affiliates of, or connected with, the company.

Relevant income years for the calculation

The amending legislation to give effect to the instant asset write-off and temporary loss carry-back measure (the *Treasury Laws Amendment (A Tax Plan for the COVID-19 Economic Recovery) Act 2020)* adopts definitions from Subdiv 328-C of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) that inform the relevant income years for calculating the aggregated turnover for the purposes of eligibility. Under these provisions, the aggregated turnover test should be calculated based on your turnover (and your connected and affiliate entities) for the prior income year(s) *or* based on your (and your connected and affiliate entities) likely turnover for the current year.

Note: The aggregated turnover tests are relevant in many other areas of tax (including the application of the taxation of financial arrangements rules, and access to the lower company tax rate and other special tax concessions). Care should be taken when determining the relevant periods that are used based on the relevant provision.

Annual turnover

Annual turnover is defined as the "total ordinary income that the entity derives in the income year in the ordinary course of carrying on a business", but specifically excludes ordinary income that is derived from the sale of retail fuel.

As "ordinary income" is income of a kind that is regularly or customarily derived by an entity in the course of its business (or is a direct result of the normal activities of the business), statutory income (eg capital gains) should be excluded from the calculation of an entity's annual turnover. Further, this concept is not limited to income that is assessable in Australia. This means that the annual turnover of a connected or affiliate foreign entity includes all of its ordinary income, irrespective of the source. As a result, there may be practical difficulties in determining the annual turnover of those non-Australian entities.

Special rules apply if a relevant entity has dealings with associates and those dealings are not at arm's length, and if the entity does not carry on a business for the whole income year.

Entity "connected with" an entity

For an entity to be regarded as connected with another entity, the element of "control" must exist. In particular, one of the entities must control the other entity, or both entities must be controlled by the same third entity (s 328-125 ITAA97). Such control can be both direct and indirect. Importantly, these terms are defined in the legislation (which distinguishes between discretionary trusts and other entities) and typically have a lower control threshold than large businesses are familiar with, such as accounting control or significant global entity definitions.

Indirect control may exist between an entity (first entity) and another entity that is controlled by a second entity, where the second entity is also controlled by the first entity. However, there are certain exceptions, for example, indirect control will not apply if the second entity (ie an interposed entity) is a certain widely held entity (including a publicly traded unit trust and listed company).

Affiliates

An individual or a company is an affiliate of an entity where that individual or company "acts, or could reasonably be expected to act, in accordance with your directions or wishes, or in concert with you, in relation to the affairs of the business of the individual or company" (s 328-130 ITAA97).

However, an individual or a company is not an affiliate merely because of the nature of the business relationship that you and the individual or company share. An example in the provision explains that this exclusion could be relevant to partners in a partnership, and to company directors. However, the full scope of the exclusion is unclear.

Some factors which are indicative of parties acting in concert may include family or close relationships between parties, financial relationships or dependencies, relationships created through common links (eg directors, partners or shareholders), and/or degree of consultation on business matters, to name a few.

Practical issues

As taxpayers consider these rules and how they might apply to their Australian entities, there are a number of practical issues that may need to be considered:

- where an entity has a different year end to its connected and affiliate entities, consideration may need to be given to how the annual turnover can be calculated for the relevant period for each connected and affiliate entity;
- as the aggregated turnover threshold is quoted in Australian dollars, the annual turnovers for any foreign connected or affiliate entities will need to be converted into Australian dollars before being summed to calculate aggregated turnover. Depending on the foreign exchange movements over the relevant periods, this may lead to drastically different outcomes;
- where taxpayers join or leave a group or an ownership structure during the year, specific consideration will need to be given to which entities may be considered "connected" and "affiliate" entities for each relevant income year, and which income is included in the calculation of aggregated turnover;
- taxpayers with corporate limited partnerships and fund structures, and/or incorporated joint ventures, will need to consider whether certain entities are aggregated for these purposes;
- taxpayers that have non-share equity arrangements (eg profit-participating loans) in their global structure may need to consider whether those arrangements could also give rise to control under the "connected with" test;
- where an entity is required to include the annual turnover of entities that are not members of a wholly owned group (eg in fund structures that have a single investor that holds an interest of greater than 40%), difficulties may arise in trying to obtain the relevant information to determine the relevant annual turnovers. This difficulty will be exacerbated where, for example, that 40% interest is held by a foreign parent that is a connected entity; and
- the definition of "affiliate" involves concepts that may be new to larger businesses and can involve difficult questions of fact and degree. They are concepts that are perhaps more easily applied to private and family groups, and examples in existing ATO materials mainly focus on family dealings. An example of an arrangement that might seem unclear is the relationship between franchisor and franchisee. Careful consideration may be needed for these and similar relationships.

The takeaway

The aggregated turnover provisions are relevant to a range of existing and new measures in the Australian tax regime. Under the new 2020-21 federal Budget measures, taxpayers will need to calculate their "aggregated turnover" to determine their eligibility for the loss carry-back and new instant asset write-off provisions.

As these reliefs are now available to taxpayers, it is important for taxpayers to consider their eligibility early. Particular care should be taken where taxpayers need to consider whether an entity has an ability to "control" another entity, eg regarding joint venture arrangements, consortium arrangements, fund ownership and other indirect common ownership.

Jonathan Malone, CTA
Partner
PwC

Sarah Saville, ATI
Partner
PwC

Joanne Murray, FTI
Partner
PwC

Thank you

The Tax Institute would like to extend a warm and sincere thank you to the many presenters and members from across the profession for their contribution to our 2020 CPD calendar of events.

2020 saw a new way of delivering events for The Tax Institute, and with it, a very different presenter and delegate experience with a transition of our events to the online arena.

In the midst of the challenges 2020 has presented, we're thrilled to have successfully delivered more than 200 CPD events with a total of 330 CPD hours throughout the year. This is an effort otherwise unachievable if not for the countless volunteer committee members and expert presenters who contribute their time.

We look forward to the opportunities of the new year, and to bringing you a new 2021 calendar of events very soon.

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Cumulative Index

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General Manager, Knowledge and Learning
Alexandra Wilson

Managing Editor
Deborah Powell

Content Consultant
Bob Deutsch

Graphic Designers
Mei Lam
Nicole Welch

Typesetter
Midland Typesetters, Australia

Advertising
Business Relationship Manager
Brian Martin 08 6165 6600

Giving back to the profession

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

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Todd Want, CTA
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Neil Warren
Liz Westover, FTI
Damien Williams
Ben Wilson, CTA
Cristina Wolters, CTA
David Wood, CTA
Sandra Wood
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Joanne Wynne, CTA

Contacts

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Todd Want, CTA

National Office

CEO: Giles Hurst

Level 37, 100 Miller Street
North Sydney, NSW 2060

Tel: 02 8223 0000
Email: ceo@taxinstitute.com.au

State Offices

New South Wales and ACT

Chair: Rae Ni Corraidh, CTA

Level 37, 100 Miller Street
North Sydney, NSW 2060

Tel: 02 8223 0031
Email: nsw@taxinstitute.com.au

Victoria

Chair: Fiona Knight, CTA

Level 3, 530 Collins Street
Melbourne, VIC 3000

Tel: 03 9603 2000
Email: vic@taxinstitute.com.au

Queensland

Chair: John Ioannou, CTA

Level 11, Emirates Building
167 Eagle Street
Brisbane, QLD 4000

Tel: 07 3225 5200
Email: qld@taxinstitute.com.au

Western Australia

Chair: Bill Keays, CTA

Level 10, Parmelia House
191 St Georges Terrace
Perth, WA 6000

Tel: 08 6165 6600
Email: wa@taxinstitute.com.au

South Australia and Northern Territory

Chair: Peter Slegers, CTA

Ground Floor, 5-7 King William Road
Unley, SA 5061

Tel: 08 8463 9444
Email: sa@taxinstitute.com.au

Tasmania

Chair: Ian Heywood, CTA

Level 3, 530 Collins Street
Melbourne, VIC 3000

Tel: 1800 620 222
Email: tas@taxinstitute.com.au

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