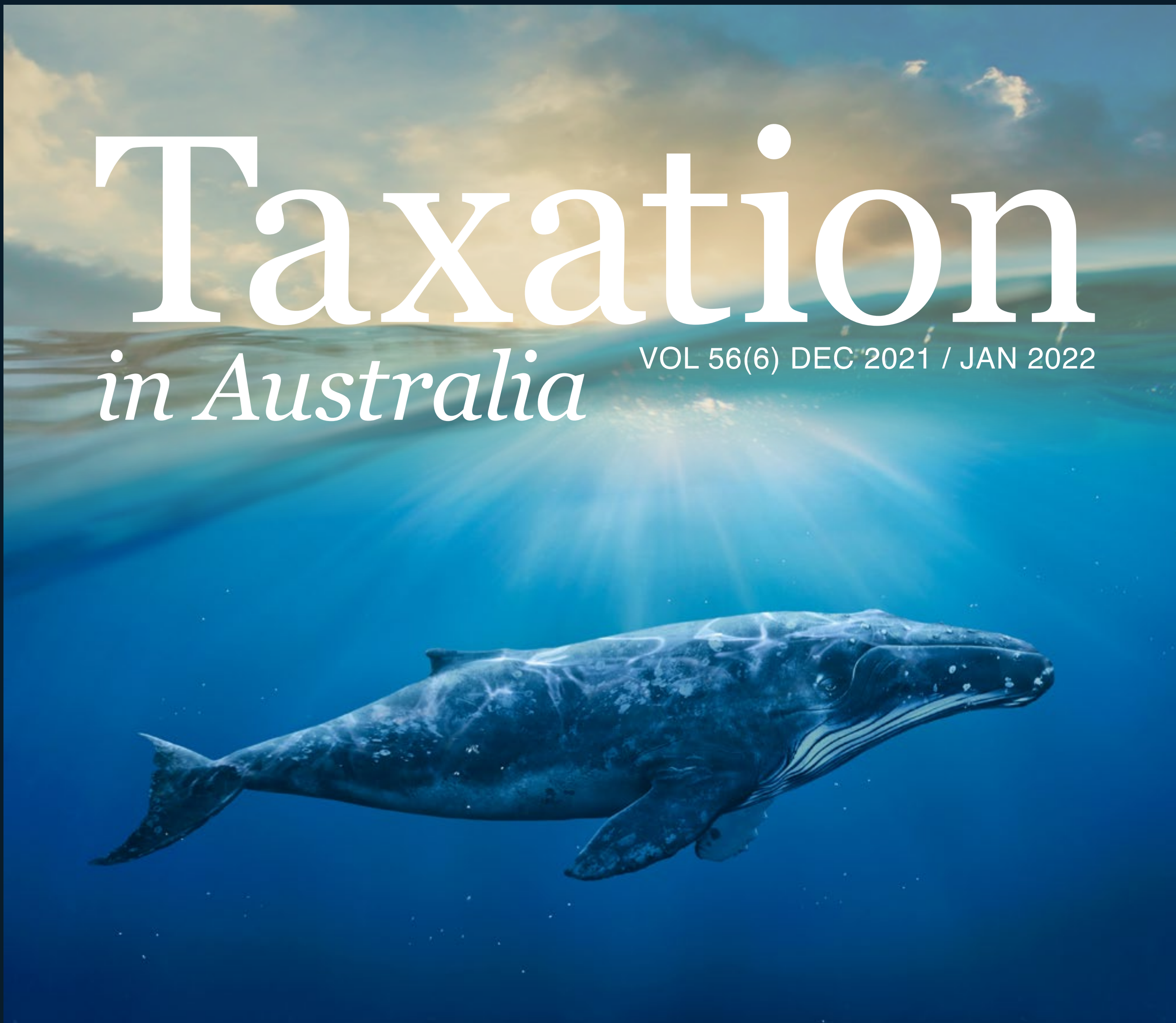
THE JOURNAL FOR MEMBERS OF THE TAX INSTITUTE



Taxation in Australia

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THE TAX INSTITUTE

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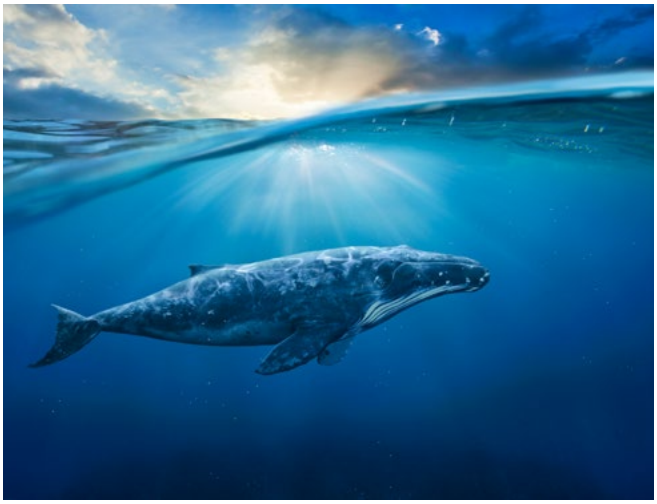

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Invitation to write

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 2021. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 345 (at the item number indicated).

G20 endorses global minimum tax rate

In a media release on 31 October 2021, the Treasurer said that the global economy is one step closer to a minimum corporate tax rate of 15% after the Prime Minister and other G20 leaders endorsed the OECD Inclusive Framework on BEPS proposed tax reforms. **See item 1.**

AGMs and electronic communications

An amending Bill (the Corporations Amendment (Meetings and Documents) Bill 2021), which was introduced into the House on 20 October 2021, contains amendments to modernise the *Corporations Act 2001* (Cth) by permanently allowing companies to use technology to meet regulatory requirements under the legislation. **See item 2.**

The games and sports exemption

The Commissioner has released a draft ruling in relation to societies, associations or clubs seeking to determine whether they are exempt from income tax under item 9.1(c) of the table in s 50-45 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) as a society, association or club established for the encouragement of a game or sport (TR 2021/D6). **See item 3.**

Employee share schemes

The Commissioner has released a draft determination that sets out the principles for working out when an employee share scheme's disposal restrictions are "genuine disposal restrictions" and, if they are, when the employee is no longer genuinely restricted by the scheme for the purposes of determining the employee share scheme's deferred taxing point (TD 2021/D5). **See item 4.**

Luxury car tax: avoidance arrangements

The Commissioner has released a taxpayer alert in relation to arrangements involving sales of both new and second-hand luxury cars between participating entities designed to improperly obtain refunds of luxury car tax (LCT) and evade LCT on the retail sale of the cars (TA 2021/4). **See item 5.**

GST property decision tool

The ATO has released a GST property decision tool that is designed to assist when determining the GST implications for property-related transactions. **See item 6.**

"Connected with"

The Commissioner has released three draft tax determinations to help entities determine whether they are "connected with" another entity for the purposes of working out their aggregated turnover under Subdiv 328-C ITAA97. **See item 7.**

Backpacker tax appeal: High Court

In a unanimous decision handed down on 3 November 2021, the High Court (Keifel CJ, Gageler, Gordon, Edelman and Gleeson JJ) upheld an appeal by the taxpayer from a decision of the Full Federal Court in the so-called "backpacker tax case" and, in doing so, held that the taxpayer was not taxable at the backpacker rates of tax because of the non-discrimination clause in the United Kingdom double tax agreement (*Addy v FCT* [2021] HCA 34). **See item 8.**

Default assessments

In two recent cases, the AAT upheld the Commissioner's objection decisions against assessments made by the Commissioner on the basis of the particular taxpayer's bank account deposits, one case involving income tax assessments and the other GST assessments (*Carvell and FCT* [2121] AATA 3627; *Southern Global Group Pty Ltd and FCT* [2021] AATA 3968). **See item 9.**

President's Report

by Peter Godber, CTA

The year that's gone and the year ahead

Thanks and see you soon, in Peter Godber's last report as President of the Institute.

2021 has been a busy, challenging and hugely successful year for The Tax Institute.

It has been my privilege to be President and I have many people to thank for their support of myself and our national endeavours over the past year, or two. That includes National Council with whom I have worked so closely, and all of the state-based volunteers I have been fortunate enough to meet and engage with at Institute events, including many online and virtual interactions in 2020 and 2021!

To Giles, our CEO, and all of our team, well done, congratulations and thank you. Thank you for putting the interests of The Tax Institute and its members at the front of your thinking, for being so adaptable, and for aiming high to make our organisation so strong and valuable — and for helping to create the communities within it that will grow in 2022 and beyond.

I was very pleased to announce at our AGM, well in advance of 2022, that we have elected Jerome Tse and Marg Marshall to be President and Vice-President of The Tax Institute in 2022. I congratulate them and wish them all the best as our national leaders. I also want to especially thank Len Hertzman who completes his time on National Council — he has been a wonderful and productive contributor to our board over the past six years. In the years ahead, we are looking forward to embracing an increasingly diverse and inclusive culture across all aspects of the Institute that will positively impact our operations, our volunteers and our members.

In celebrating our members, it gave me great pleasure at the AGM to award Life Membership to Stephen Heath, a long-serving South Australian member who carries many fond personal memories of events at The Tax Institute. Stephen has contributed significantly to our educational development.

But maybe I could highlight the following in respect of the year that has gone:

- as the 30 June year end passed, The Tax Institute was again able to show its financial stability and sustainability, which is no mean feat in these COVID-affected times;
- at our board level, we have had substantial oversight over our business risks, and I can confidently say that we have in place very comprehensive risk management processes that equip us well for the future;
- we continue our investment in technology which will soon see us with a refreshed website and a modern content management system to support it and our extensive knowledge bank;
- The Tax Institute's brand still represents the mark of expertise in tax. The Chartered Tax Adviser status is held by over 6,000 practitioners, more than half of our membership. It is a mark of excellence that we are proud to facilitate our members in achieving;
- the Institute's education strategy continues to evolve. Our structured education offering will develop with the times and is set to evolve significantly. We have launched The Tax Institute Higher Education brand to bring you our tertiary education offering, the Graduate Diploma in Applied Tax Law. We have worked hard to ensure that the governance and delivery of that program allows an effective and accredited path of structured study. In addition, our future delivery of education will stretch to coverage of online and micro-credentialled education modules, and hopefully more opportunities for learning, as we step into the future of education in tax;
- we have enhanced and developed The Tax Institute's Tax Policy and Advocacy and engagement teams which are now embedded in the delivery of technical support services for our members and external advocacy efforts; and
- we have positively impacted and supported tax policy and tax system improvements. We continue, with the other major professional bodies, to be active in consultation with Treasury, the ATO, the Inspector-General of Taxation and Taxation Ombudsman, the Board of Taxation, and the Tax Practitioners Board (TPB). Our consultancy agendas with the ATO and Treasury are always busy. That covers matters like Treasury's priorities for new law, progressing announced but unenacted tax measures, and, with the ATO, the need for clear interpretative guidance.

The role of the Institute in the tax community is clearly very well positioned.

And we have learned that the health and wellbeing of the tax profession and our members should always have our attention. We evidenced our support for this in several very popular high-profile sessions at our most successful 2021 Tax Summit: Challenge Accepted.

Over the summer, please relax, refresh, reset and look after yourselves. 2022 will be an even bigger and, hopefully, much brighter year for us.

Once again, thank you for your membership and support, and best wishes to you for the year ahead. Of course, my involvement with the Institute doesn't end here, and I'll see you at one or more of our wonderful events.

CEO's Report

by Giles Hurst

Ending the year on a collaborative note

Closing out a year when members have been more active than ever and looking forward to a new year of working together.

What a year 2021 has been. The challenges posed by lockdowns and working from home continue to be very real and immediate for the majority of members. They have changed the way we work and there has been a lot of transformation to adapt to lately. Despite this uncertainty, we have had a year of success and support within our community.

As we close out the year, I would like to thank everyone who has been on the 2021 journey with us, including our wonderful members, volunteers and staff.

Special thanks and congratulations also go to our outgoing President, Peter Godber, who is wrapping up his time as President at the end of the year. When Peter began his presidency at the start of 2020, we could never have anticipated the challenges that lay ahead. Peter has guided our activities and plans throughout this period with the considered hand of a true leader.

To Jerome Tse and Marg Marshall, who have been elected President and Vice-President of the Institute for 2022, a hearty congratulations. Jerome and Marg have long been active members of the Institute and were instrumental in some of our more recent successes, including the wonderful experience of The Tax Summit this October.

I also echo Peter in thanking Len Hertzman, who is wrapping up an outstanding six years on National Council, and congratulating Stephen Heath, who has made such an impact on our educational development and has this year been awarded Life Membership.

In mentioning the valuable contributions of all these people, I have to say that one of the things I am most proud of this year is the increased collaboration between the Institute, members and committees. Peter has outlined some of our major achievements for the year in his President's Report, so I won't repeat them. But I will say that many of the greatest achievements were made possible by the generous contributions of committee members and individual Institute members who shared their time and efforts.

The *Case for Change*, our Federal Budget report, our many and varied professional development events, our evolving education offerings — these were all fuelled by collaboration with our volunteers. You may have also noticed an uptick in topical resources and advocacy pieces being penned by members and experts from our various committees. This is something you can expect to see (and be involved in) more in the future.

We are building closer ties within our community with each of these activities. A diverse and inclusive culture means we can better represent our membership. And that allows us to be better advocates, to develop better resources and, ultimately, to lead our profession in a way that is meaningful and makes sense for those within it.

We have come through a challenging year and put ourselves in a strong position for the future by leveraging our strength as a community. Members have access to high-quality resources and development opportunities and are being represented by active advocacy. In turn, The Tax Institute is benefitting from the insight and strength of a broad and generous membership.

Next year, we will be looking for further opportunities to collaborate and to shine a spotlight on our talented members and volunteers. I encourage you to reflect on ways you might like to be more involved, take up opportunities that come your way, and suggest your own ideas to our team.

We will also be continuing with major projects currently in the works, including the upgrade to a new website experience which you can expect in early 2022, continuing the development of our learning offerings for increased flexibility, and advocacy around topical matters.

As I sign off for 2021, a final thank you for being part of the Institute this year and trusting us to help you navigate challenging times. I hope you are planning a relaxing break over the holiday season and that you are looking forward to further successes and collaboration in the coming year, just as we are.

Tax Counsel's Report

by Julie Abdalla, FTI

Reflections on 2021 and the path forward

2021 was a momentous year for The Tax Institute, our members, and the broader tax profession. Reflections on the past, and hope for the future.

As we approach the end of the year, it is timely to reflect on 2021 and the year that was. In many ways a continuation of the ordeals of 2020, this year had more than its fair share of tribulations. But while it presented many challenges to the tax profession, 2021 also brought a number of new opportunities.

Ongoing commitment to our members and the tax community

Over the past year, tax practitioners across the industry have continued to tackle new challenges head on, and provide frontline support throughout the delivery of various government COVID-19 stimulus and support measures. It would be an understatement to call them trying times and yet, through it all, tax practitioners have shown a remarkable level of resilience and dedication.

You have played a pivotal role in keeping your clients and the broader economy afloat, and the Tax Policy and Advocacy (TPA) team has been proud to support you through this period by delivering several timely products, including webinars, information fact sheets and blogs. These materials provided unique insights and practical guidance to The Tax Institute's members in navigating the different measures and the seemingly constant changes in rules and government messaging. In addition, we have kept lines of communication open, with direct engagement with government and, of course, our members through various channels, including the Institute's Community and the TPA mailbox.

Initiating the journey towards genuine tax reform

If our experience of navigating piecemeal measures over the past two years of events devastating our economy has taught us anything, it is that we need a better tax system, underpinned by sound tax policy. A significant milestone this year was the launch of the Institute's landmark paper, the *Case for Change*. Following on from the 2020 Tax Summit: Project Reform, our continued engagement throughout 2021 has brought together the profession to spark debate and drive new ideas for tax reform as never before.

The resoundingly positive response to the *Case for Change* is a credit to the countless members who have been involved, from its inception to publication. But the path to meaningful tax reform doesn't end there. The Tax Institute continues to lead the way as the voice of the tax profession. In addition to countless media features, the innovative ideas and expertise reflected in the paper formed the basis of a presentation delivered by the TPA team to the federal Treasury in October. To ensure that we maintain this momentum, we have established a Tax Reform Committee to drive this initiative and keep holistic change on the political agenda.

Technical committee transparency and engagement

Committee engagement has been a strong focus and, earlier this year, the Institute launched a review of its technical committees. We consulted widely to gauge members views on what has been working well and areas for improvement, with the overarching objective of improving member experience. In light of the feedback received, we revised our technical committee charter and have implemented changes to ensure, among other things, greater transparency and opportunities for you to get involved.

Key submissions and consultations of significance

One of the key areas of work to which our technical committees contribute is the submissions that The Tax Institute makes to various external stakeholders. While the year is not yet over, the TPA team prepared and lodged around 60 submissions in 2021 alone! Many of these submissions have involved our technical committees, and subcommittees of Institute members with expertise in the relevant subject matter, providing specialist input and sharing their insights. Others have been joint initiatives with other professional bodies. The vast majority of these submissions are available on the submissions page on our website.

Professional Bodies Tax Forum

Over the course of the year, we have worked closely and continued to forge strong relationships with other professional bodies. This year, the Institute initiated the Professional Bodies Tax Forum (PBTF). The professional bodies meet in this setting to discuss a broad spectrum of matters, including tax policy, law and administration, both in the long and short term.

The PBTF is an autonomous forum where member bodies raise concerns and exchange ideas, with the fundamental purpose of the betterment of the tax system. The professional bodies work together in this group on issues of strategic and technical importance, with a view to escalating matters to the relevant stakeholders to drive change.

A new beginning

Despite the challenges of the past year, we remain optimistic about 2022 and beyond. There is much momentum and 2021 has shown us that, together, we can achieve great things, even in the most difficult of times.

We hope you enjoy this festive season, stay safe and recharge. We look forward to seeing you next year as we eagerly return to face-to-face events and deliver a range of exciting new offerings and initiatives!

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 2021.

Government initiatives

1. G20 endorses global minimum tax rate

In a media release on 31 October 2021, the Treasurer said that the global economy is one step closer to a minimum corporate tax rate of 15% after the Prime Minister and other G20 leaders endorsed the OECD Inclusive Framework on BEPS (base erosion and profit shifting) proposed tax reforms.

This followed G20 finance ministers and Central Bank governors pledging support for the OECD BEPS proposal on 13 October 2021 and vowing to work together to achieve a possible 2023 start date, consistent with the OECD's implementation timeline.

On 9 October 2021, 136 members of the OECD/G20 Inclusive Framework on BEPS, representing more than 90% of global GDP, agreed to a new tax system to help ensure that multinationals pay their fair share of tax globally and in Australia. This will put a floor on the "race to the bottom" on corporate tax rates and will support the domestic and global economy.

The Treasurer said that Australia's ongoing engagement in the OECD-led multilateral process complements the strong action the government has taken to strengthen the integrity of Australia's corporate tax system and prevent multinational tax avoidance. More than a dozen measures have been implemented to address corporate and multinational tax avoidance, including the multinational anti-avoidance law, the diverted profits tax, increased tax penalties for large entities, and establishing a Tax Avoidance Taskforce within the ATO.

2. AGMs and electronic communications

An amending Bill (the Corporations Amendment (Meetings and Documents) Bill 2021), which was introduced into the House on 20 October 2021, contains amendments to modernise the *Corporations Act 2001* (Cth) by permanently allowing companies to use technology to meet regulatory requirements under the legislation.

The amendments will allow companies and registered schemes to hold virtual meetings, distribute meeting-related materials, and validly execute documents. These reforms build on recently renewed temporary relief, which is to remain in place until 31 March 2022. Specifically, the permanent reforms:

- ensure that meetings can be held physically, as a hybrid or, if expressly permitted by the entity's constitution, virtually, provided members, as a whole, are given reasonable opportunity to participate in the meeting;
- ensure that companies and registered schemes can meet their obligations to send documents in hard copy or soft copy and give members the flexibility to receive documents in their preferred format; and
- allow documents, including deeds, to be validly executed in technology neutral and flexible ways, including by company agents.

Proprietary companies with a sole director and no company secretary will be able to use the statutory document execution mechanisms.

The Commissioner's perspective

3. The games and sports exemption

The Commissioner has released a draft ruling in relation to societies, associations or clubs (referred to collectively as "clubs") seeking to determine whether they are exempt from income tax under item 9.1(c) of the table in s 50-45 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) as a society, association or club established for the encouragement of a game or sport (the games and sports exemption) (TR 2021/D6).

A club qualifies for the games and sports exemption where it:

- is established for the main purpose of the encouragement of a game or sport;
- is not carried on for the purposes of its individual members' profit or gain; and
- meets other special conditions.

The draft ruling does not cover the special conditions.

TR 2021/D6 states that, as part of good governance practices, it is recommended that clubs self-review their entitlement to income tax exemption each year or when there is a major change in the structure or activities of the club. When conducting self-review, clubs should consider how the law explained in TR 2021/D6 applies to their circumstances. From 1 July 2023, clubs with an active ABN will need to complete an annual online self-review form.

TR 2021/D6 is replacing TR 97/22 (which has been withdrawn with effect from 7 October 2021) but does not reflect a change in the Commissioner›s view on the application of the games and sports exemption; rather, it refreshes the view expressed in TR 97/22 to make it more contemporary. The draft ruling also takes into account relevant case law that has occurred since TR 97/22 was published and, in particular, the decision of the High Court in *FCT v Word Investments Ltd*.[1]

4. Employee share schemes

The Commissioner has released a draft determination that sets out the principles for working out when an employee share scheme's (ESS's) disposal restrictions are "genuine disposal restrictions" and, if they are, when the employee is no longer genuinely restricted by the scheme for the purposes of determining the ESS's deferred taxing point (TD 2021/D5).

Division 83A ITAA97 applies when certain benefits (ESS interests) are provided to employees at a discount to their market value under an ESS as defined in s 83A-10(2) ITAA97. Generally, an employee includes the discount in their assessable income in the income year that they acquired the shares or rights to shares. However, where certain conditions are met, the amount included in the employee's assessable income is deferred to a later point in time (the ESS deferred taxing point).

An employee's ESS deferred taxing point for ESS interests that are shares or rights to acquire shares occurs at the earliest of the times set out in s 83A-115(4) to (6) for shares, or s 83A-120(4) to (7) for rights. One ESS deferred taxing point occurs if, at the time the employee acquired their ESS interest, the scheme "genuinely restricted [the employee] immediately disposing of the interest". In those circumstances, the ESS deferred taxing point arises when the employee is no longer so restricted. The employee therefore needs to establish whether they were "genuinely restricted" by the scheme and the time when the scheme no longer restricted them. This is also referred to as the restrictions being "lifted".

5. Luxury car tax: avoidance arrangements

The Commissioner has released a taxpayer alert in relation to arrangements involving sales of both new and second-hand luxury cars between participating entities designed to improperly obtain refunds of luxury car tax (LCT) and evade LCT on the retail sale of the cars (TA 2021/4).

Luxury car tax is ordinarily imposed on the sale or importation of cars that exceed the LCT threshold. Luxury car tax can be effectively deferred until the retail sale of a car or a change in use of that car, utilising decreasing adjustments and quoting provisions. These provisions can be exploited, particularly when coupled with illegal phoenixing behaviours.

The arrangements of concern typically involve the following features:

- the supply of a luxury car to a predetermined recipient identified by the controlling mind of the arrangement;
- a number of wholesale sales of the car are purportedly made, along a chain of participating entities often acting in collusion, prior to the final retail sale to the predetermined recipient;
- one of the entities claims a refund of LCT while creating a consequential liability to another entity in the supply chain; and
- one or more of the participating entities (described as a "missing trader") does not correctly report and pay their purported LCT liabilities to the Commissioner.

The arrangements may also involve artificially embedding LCT in the price of the car that is not otherwise subject to LCT. One of the participating entities will then seek to recoup this LCT as a refund. The corresponding and artificially created LCT liability is never reported and paid.

The Commissioner is concerned that entities are using these types of arrangements to improperly obtain LCT refunds and to evade LCT. These arrangements can also result in luxury cars being sold without income tax and GST obligations being met. TA 2021/4 states that cars are sold to end-users at more competitive prices, with generally greater profit margins, due to those involved intentionally avoiding their tax obligations and falsely claiming refunds. These practices undermine the business of compliant car dealers. Entities in the supply chains liquidate to circumvent ATO compliance or recovery action.

TA 2021/4 states that the arrangements are contrived and the sales between participating entities appear to be designed to improperly procure a tax benefit for the financial betterment of those entities.

6. GST property decision tool

The ATO has released a GST property decision tool that is designed to assist when determining the GST implications for property-related transactions.

The tool can be used where real property is being bought, sold or leased across a broad range of property types.

The tool includes:

- a series of questions to help buyers, sellers and lessors determine the GST classification of real property transactions;
- links to additional information;
- assistance with eligibility for the margin scheme and calculating the margin;
- guidance on claiming GST credits and making GST-free supplies;
- information as to whether GST at settlement applies to sales of new residential premises or potential residential land; and
- guidance and explanations to work through the tool.

A GST decision will be generated that contains:

- a decision advising if GST is included in the purchase;
- a decision advising if GST is payable on the sale;
- an estimate of the amount of GST payable when applying the margin scheme; and
- a decision advising if input tax credits can be claimed.

There are a number of aspects of GST that the GST property tool does not address, including:

- the partitioning of land;
- amalgamated land;
- easements, restrictive covenants and options; and
- mixed supplies.

7. "Connected with"

The Commissioner has released three draft tax determinations to help entities determine whether they are "connected with" another entity for the purposes of working out their aggregated turnover under Subdiv 328-C ITAA97.

Aggregated turnover is relevant to a range of tax concessions, including temporary loss carry back by companies, temporary full expensing, and a number of small business concessions including the small business CGT concessions.

An entity's aggregated turnover for an income year is comprised of its "annual turnover", together with the annual turnover of any entity (including foreign resident) that is "connected with" it, or is an "affiliate" of it, at any time during the income year.

The three draft tax determinations are:

- TD 2021/D3: Income tax: aggregated turnover — application of the "connected with" concept to corporate limited partnerships;
- TD 2021/D2 Income tax: aggregated turnover — application of the "connected with" concept to partnerships, foreign hybrids and non-entity joint ventures; and
- TD 2021/D4 Income tax: aggregated turnover — application of the public entity exception to the indirect control test.

The draft determinations provide a number of practical examples on the application of the "connected with" concept to various entity types often found in large market and international structures, such as foreign hybrids, corporate limited partnerships and public entities.

The Commissioner has also released a final determination which gives his view on the calculation of the annual turnover of a connected entity or affiliate with a different accounting period to the entity whose aggregated turnover is being calculated (TD 2021/7).

Recent case decisions

8. Backpacker tax appeal: High Court

In a unanimous decision handed down on 3 November 2021, the High Court (Keifel CJ, Gageler, Gordon, Edelman and Gleeson JJ) upheld an appeal by the taxpayer from a decision of the Full Federal Court in the so-called "backpacker tax case" and, in doing so, held that the taxpayer was not taxable at the backpacker rates of tax because of the non-discrimination clause in the UK double tax agreement (*Addy v FCT*[2]).

The taxpayer was a United Kingdom citizen who lived in Australia from 20 August 2015 to 1 May 2017, apart from a two-month period in early 2016 when she toured South-East Asia. She arrived in Australia on a 12-month working holiday visa, but obtained a second 12-month visa before the first one expired.

Before the High Court, there was no dispute that the taxpayer was a "national" of the UK (as defined in art 3(1) of the UK tax convention), that the taxpayer was an Australian "resident" for tax purposes during the 2017 income year, and that the backpacker rates of tax in Pt III of Sch 7 to the *Income Tax Rates Act 1986* (Cth) (working holiday makers) imposed taxation that was "other or more burdensome" than that which applied to resident Australian nationals.

The question was whether that more burdensome taxation was imposed on the taxpayer owing to her nationality. In a joint judgment, the High Court answered this question in the affirmative. The court said that when the position of the taxpayer was compared with that of an Australian national, as it must be, that was the only conclusion which might be drawn. Part III of Sch 7 to the *Income Tax Rates Act 1986* was applied to the taxpayer, a national of the UK. The taxpayer's circumstances in the 2017 income year, including that of her residency in Australia for tax purposes, were relevantly the same as an Australian national. She did the same kind of work and earned the same amount of income from the same source; yet an Australian national was required by Pt I of Sch 7 to the *Income Tax Rates Act 1986* to pay less tax. In contravention of art 25(1) of the UK tax convention, the more burdensome taxation was imposed on the taxpayer owing to her nationality and, for that reason, the tax rates in Pt III of Sch 7 did not apply to the taxpayer in the 2017 income year.

9. Default assessments

In two recent cases, the AAT upheld the Commissioner's objection decisions against assessments made by the Commissioner on the basis of the particular taxpayer's bank account deposits, one case involving income tax assessments and the other GST assessments (*Carvell and FCT*;[3] *Southern Global Group Pty Ltd and FCT*[4]).

Income tax

In the income tax case (*Carvell*), the taxpayer failed to lodge tax returns for the 2015, 2016 and 2017 income years. The Commissioner undertook an audit of the taxpayer's affairs which identified deposits for the income years for which there was no satisfactory explanation. The Commissioner assessed the taxpayer to income tax on the basis that the amounts of the unexplained deposits for an income year were the taxpayer's taxable income for that year and also assessed the taxpayer to administrative penalties. The taxpayer lodged an objection against the assessments.

On 18 March 2019, the Commissioner made an objection decision by which he allowed in part the objection made by the taxpayer to the default assessments for the 2015 and 2017 income years, disallowed the objection against the default assessment for the 2016 income year, and disallowed the objection to the imposition of administrative penalties, although the assessment of penalties was adjusted to reflect the part of the objection against the primary tax that was allowed. On review, the AAT affirmed the Commissioner's objection decisions.

The taxpayer's approach in the review was to attempt to disprove elements of the Commissioner's default assessment by identifying particular deposits and attributing them to something that the taxpayer claimed was not taxable income. The AAT said that this approach misunderstood the way in which the default assessment process operates: for one thing, it wrongly treated the default assessment as an actual assessment, which it was not. For another thing, it assumed that taxpayers can derogate from their obligation to prove their taxable income by assuming that the Commissioner's default assessment was some sort of starting point, which again it was not. It also misunderstood the taxpayer's obligation to prove what in fact his taxable income was for the relevant years.

Although the matter could be disposed of on the basis that the taxpayer had not satisfied the onus of establishing what his taxable income was for each of the years, the AAT nonetheless dealt with his explanations for the deposits that were unexplained in each of the years because the taxpayer and the Commissioner argued some of the matters on that basis. The taxpayer's "explanations" did not offer any sound basis for a conclusion that the amounts were not assessable income.

The AAT also held that, in the circumstances, there was no basis for remitting the administrative penalties or any part of them.

GST

In the GST case (*Southern Global Group*), the Commissioner undertook a covert audit into the applicant's GST affairs using a bank account methodology. The Commissioner formed the view that unexplained deposits in the applicant's bank accounts were unreported consideration for taxable supplies for the relevant tax periods.

At the conclusion of the audit, on 3 April 2019, the Commissioner notified the applicant that a covert audit had been completed and issued an audit completion letter with reasons for decision and notices of amended assessments of net amounts for the tax periods, calculating total GST shortfall amounts of $60,520. As a result of information provided by the taxpayer, the Commissioner reduced the total GST shortfall amounts to $38,835. The applicant objected to these assessments and the objections were allowed in part.

The Commissioner also issued a notice of assessments of penalty on the basis that the applicant or its agent made false or misleading statements that resulted in the applicant having shortfall amounts, but the applicant did not object to the imposition of penalties.

The AAT said that the discharge of the applicant's evidentiary burden before the tribunal must be considered, keeping in mind that the evidence said to support the applicant's position was uniquely within the applicant's possession or control. Considering the evidence as a whole, the AAT agreed with the Commissioner that the evidence provided by the applicant was limited, on the basis that:

- there was a lack of independent, contemporaneous and primary source documents which should have been available to the applicant to support its contentions;
- the applicant had not called any witness to corroborate its contentions;
- the material provided on behalf of the applicant was brief and lacked supporting evidence; and
- that material did not accord with the evidence gathered by the Commissioner in relation to where amounts being deposited in the applicant's bank accounts came from or where transfers out of the applicant's bank accounts went to.

Based on the evidence before it, the AAT found that the applicant had not satisfied its onus to prove that the assessments for the relevant tax periods were excessive or otherwise incorrect, and what the correct assessments should be.

TaxCounsel Pty Ltd
ACN 117 651 420

References

1 [2008] HCA 55.

2 [2021] HCA 34.

3 [2021] AATA 3627.

4 [2021] AATA 3968.

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Tax Tips

by TaxCounsel Pty Ltd

Wills and potential CGT

Issues that arose under wills in relation to a potential CGT liability in respect of real property distributed in specie were recently considered by two decisions.

Background

Where it is desired to achieve equality between the beneficiaries of the estate of a deceased individual, latent CGT issues that are carried by particular assets (typically, real estate) will need to be addressed in the terms of the will.

Where a parcel of real estate owned by a deceased passes under the deceased's will in specie to a beneficiary, the value of the gift to the beneficiary will often be affected, to a greater or lesser extent, by the incidence of CGT. The problems will, of course, be compounded if the deceased owned more than one parcel of land and there is more than one beneficiary.

Thus, to take a simple example, assume that a testator, Edgar, owns two identical and adjoining parcels of vacant land, one acquired pre-CGT (parcel 1) and the other acquired post-CGT (parcel 2). Both parcels have increased in value. If parcel 1 is devised to one of the testator's children (David) and parcel 2 is devised to the testator's other child (Roslyn), and each child sells their parcel of land two years later, both will make a capital gain but:

- the capital gain made by David will be calculated by reference to a cost base equal to the market value of parcel 1 at the time of Edgar's death;[1] and
- the capital gain made by Roslyn will be calculated by reference to a cost base equal to the CGT cost base of parcel 2 at the time of Edgar's death.[2]

No real equality problem would arise if the executor had to realise the real property included in an estate in order to distribute the estate among the beneficiaries

Two recent decisions, one by the South Australian Supreme Court (*Todd v Todd*[3]) and the other by the Victorian Supreme Court (*Craven v Bradley*[4]), have examined some inequality issues that were raised by the terms of a will.

South Australian decision

In the South Australian Supreme Court case (*Todd v Todd*), the testator, Joan, who died on 2 April 2018, appointed by her will her four children (Alexander, Wendy, Bronwyn and Yvonne) as executors. At the time of her death, the testator owned four parcels of real estate known as the Clarence Gardens property, the Hawthorn property, the Goolwa property and the Millswood property. Under her will, the Clarence Gardens property was devised to Wendy (cl 5), the Hawthorn property was devised to Yvonne (cl 6) and the Goolwa property was devised to Bronwyn and Alexander as tenants in common (cl 7).

Clause 8 of the will devised the fourth parcel of real estate (the Millswood property) to the four children and provided for a means of "equalisation" or "adjustment" regarding the gifts of real property as follows:

> "**I GIVE DEVISE AND BEQUEATH** my property situate at and known as 7 Regent Street Millswood 5034 in the said State to my children the said **ALEXANDER GEORGE TODD**, the said **WENDY JOAN HOLLOWAY**, the said **BRONWYN BEATRICE ANDREWS** and the said **YVONNE HELEAN TODD** to be divided between them in such a manner so as to ensure that as at the finalisation of the administration of my estate all of my said children have received an equal value of bequests under this my Will **PROVIDED HOWEVER** that such beneficiaries shall have survived me for a period of twenty eight days from and after the date of my death."

Clause 10 provided that the testator's residuary estate was to be distributed equally among her grandchildren. Clause 11(1) relevantly provided:

> "… that all benefits given by this my Will and any Codicil shall be paid delivered or retained free from all duties whatsoever which (whether presently or presumptively or prospectively payable) shall be paid out of my estate in the same manner as my funeral and testamentary expenses and debts shall be payable so that there shall be no subsequent adjustment or apportionment thereof as between any of the beneficiaries of this my Will."

The Millswood property was sold by the executors for $1,425,000 in March 2020. The net proceeds of the sale were $1,395,802. As the Millswood property was the testator's main residence throughout her ownership of it, it was exempt from CGT.

One question that arose for decision was whether the latent CGT liability in respect of the Clarence Gardens property, the Hawthorn property and the Goolwa property (the three properties) should be taken into account when determining the value of the individual bequests under cl 8. On this question, Bampton J held that the latent CGT liability in respect of the three properties was not to be taken into account when determining the value of the individual bequests under cl 8 of the will.

Her Honour further held that valuation of the three properties was to take place just prior to the finalisation of the deceased's estate or as the parties may otherwise agree.

In relation to the meaning of "value" in cl 8, Bampton J said that the executors were not able to refer to any authority in the context of the interpretation of a will in support of their argument that the word "value" in cl 8 should notionally bring potential future CGT liabilities to account. Having considered the authorities in related contexts, it was apparent that such a submission may only be sustained in truly exceptional circumstances. There was no evidence that suggested that the present case involved such exceptional circumstances. "Value" in cl 8 was to be interpreted as market value as explained in *Spencer v The Commonwealth of Australia*,[5] being the price agreed between a willing but not anxious purchaser and vendor, both of whom are aware of the circumstances affecting the value of the land and current market conditions.

The deceased's children acquired the properties devised to them under her will on her death. The three properties, for the purposes of the ITAA97, were CGT assets which passed to the children under the will. Capital gains tax did not apply to the properties at the time the children acquired the properties, as the transfer in ownership on the deceased's death in the circumstances of her estate was not a CGT event on which CGT was payable.

Bampton J went on:

> "54. The value of the three properties bequeathed under [the deceased's] will should not depend on the tax affairs of the person to whom they are bequeathed, nor is there any taxing event that arises upon such bequests. It is incorrect to say that a property bequeathed to a person in the highest bracket of income tax payable for a given year would have a higher value had it been bequeathed to a person who had nil taxable income. Such a proposition ignores the fact that CGT liability in respect of a property shall only arise when (and if) that property is disposed of, and only then will the resultant tax payable (if any) be able to be determined. As such, to value property on the basis proposed by the executors, Wendy and Bronwyn would present a nearly impossible task, as it would involve hypothesising the implications of an event which involves too many variables (including, of course, the fact that the likelihood of such event occurring cannot be discerned on the evidence)."

In relation to cl 11(1), Bampton J said that that provision was not engaged in the process of equalising the value of the gift to each of Joan's children. To construe the process of equalising the value of the gifts provided for in cl 8 as requiring latent CGT liability to be accounted for, necessarily engaged cl 11 by interpreting "duties" in cl 11(1) as encompassing CGT liabilities on future disposal of land given under Joan's will. Such a construction could lead to the untenable situation where the gift of residuary estate under cl 10 and finalisation of the estate would necessarily be suspended for an unknown and unascertainable future time.

Having regard to the will as a whole, no intention could be gleaned, indicating that the process of ascertaining the equal value of bequests required the taking into account of a taxation liability. There was no evidence suggesting that any of the three properties was to be sold imminently. The executors just do not know if or when any of the three properties might be sold and what the CGT might be. The CGT consequences were unknown and could not reasonably be taken into account in the process of valuation pursuant to cl 8. A CGT liability can only be calculated if an immediate sale is contemplated, and if no sale is contemplated, CGT cannot be reasonably calculated.

Victorian decision

The Victorian Supreme Court case (*Craven v Bradley*) was an action brought by a beneficiary of an estate against the executor of the estate of his mother (Phyllis Margaret Craven).

Under her will, dated 12 November 2013, the deceased gave her residuary estate to her three sons in equal shares but subject to a parcel of real property (Point Lonsdale) being devised to the plaintiff (Ian) and another parcel of real property (Balwyn North) being devised to one of his brothers, Bruce. Provision was made for distribution of the remaining estate being equalised between the three sons, taking into account the different values of the properties (the equalisation clauses). The equalisation clause in the case of the Point Lonsdale property was as follows:

> "**Property located at 16 Golightly Street, Point Lonsdale**
>
> 7.2 If the remaining balance is more than three (3) times the value of my property located at 16 Golightly Street, Point Lonsdale ('the Point Lonsdale property'), then I give the Point Lonsdale property to my son **IAN KENNETH CRAVEN** ('Ian') free of all duties and encumbrances, and after all costs associated with its transfer have been met from my Estate, provided that he survives me by thirty (30) days and the value of the Point Lonsdale property is included in the gift to my son Ian in clause 7.10.
>
> 7.3 If the remaining balance of my estate is less than three (3) times of the value of the Point Lonsdale property, then I give the Point Lonsdale property to my son Ian free of all duties and encumbrances, provided that he survives me by thirty (30) days and he pays to my estate the difference between the value of the Point Lonsdale property and one-third of the balance of my estate as aforesaid.
>
> 7.4 Transfer of the Point Lonsdale property in accordance with the preceding subclause constitutes my son Ian receiving his one equal part in clause 7.10.
>
> 7.5 The value of the Point Lonsdale property should be determined by a registered valuer and on terms that would be granted to an arm's length purchaser from my Estate less an amount equal to the capital gains tax liability my Estate would pay if the property were sold at the date of my death."

There were similar provisions that applied in relation to the Balwyn North property, save that the valuation provision was as follows:

> "7.9 The value of the Balwyn North property should be determined by a registered valuer and on terms that would be granted to an arm's length purchaser from my Estate."

Clause 7.10 provided:

> "Gift to my Sons
>
> 7.10 Each of my sons, including Ian, Bruce and NEIL JARVIE CRAVEN, who survives me by thirty (30) days shall receive one such equal part."

Derham AsJ said that the parties did not agree as to whose income was to be used to calculate the hypothetical "amount equal to the capital gains tax liability my Estate would pay" on a sale of Point Lonsdale. Was it the income of the deceased as at the date of her death or the income of the estate? Given the hypothesis dictated by cl 7.5 being a sale by the estate ("on terms that would be granted to an arm's length purchaser from my Estate"), and the hypothetical CGT being that which would be paid by the estate ("less an amount equal to the capital gains tax liability my Estate would pay), it might be said that the easy answer was that it is the income of the estate for the relevant tax year.

However, his Honour said that cl 7.5 set up a hypothetical set of circumstances as at the date of the deceased's death. It contemplated a sale on that date, which, as the CGT law applies, means a disposal of the property on that date. That fixed the value of Point Lonsdale for the purposes of calculating CGT. But the wording of cl 7.5 also dictated that the estate's liability to pay CGT be calculated "as at that day" because that liability is the CGT the deceased's "Estate would pay if the property were sold at the date of my death".

Derham AsJ concluded:

> "92. … Reading clause 7.5 as a whole, the final phrase should be understood as saying 'if the property were sold by [my Estate as] at the date of my death'. That gives consistency of meaning to the clause read as a whole so that the hypothetical sale is by, and the hypothetical CGT liability is of, the Estate of the deceased."

His Honour went on to hold that, for the purposes of cl 7.8, cl 7.9 and cl 7.10 of the will of the deceased, the value of the Balwyn North property should be determined by a registered valuer and on terms that would be granted to an arm's length purchaser from the estate as at the date of death of the deceased.

Construction of wills: principles

In both of the decisions discussed above, observations were made as to the approach to be taken when construing a will.

In *Todd v Todd*, Bampton J said that, when construing the will before the court in that case, it was her task to discover the testator's intentions and the scheme that the testator conceived for her will. The deceased's intentions and the scheme were to be ascertained from an examination of the language of the will viewed as a whole. This involved identifying the natural and ordinary meaning of words and sentences used in the will in the context of all provisions in the will. Her Honour then went on:

> "14. … In this task, I can be aided only by 'such facts as existed and were known to the testator at the date of the will' which are admissible in interpreting the language of the will, but subjective evidence of Joan's intentions cannot be taken into account."

In *Craven v Bradley*, Derham AsJ said that the parties agreed that, when construing a will, the task of a court is to give effect to the testator's intention through examination of the words used in the will, having regard to the will as a whole, aided as necessary by any admissible extrinsic evidence. Prima facie, the words of a will must be given their ordinary meaning. Some further relevant principles noted by his Honour were:

- the interpretation of a will is analogous to the interpretation of a contract;
- the testator's intentions are not necessarily to be discovered by looking at the literal meaning of the words alone if this leads to the frustration of their intentions. If, in light of the surrounding circumstances, the literal interpretation gives rise to a capricious result which the testator can never have intended, the literal interpretation should be rejected in favour of a sensible interpretation which accords with their intention;
- if the law has consistently given a particular meaning to some word or phrase, that is the meaning which the word or phrase must, prima facie, be given;
- it is open to the court, when construing a will, to insert missing words which are clearly necessary to give effect to the testator's intention;
- if, in the context of the will read as a whole, and of the surrounding circumstances, the ordinary meaning of the words in the will do not make sense, extrinsic evidence is admissible under the "armchair principle". In effect, the court is able to consider evidence of the circumstances surrounding the testator at the time of executing the will; and
- a court is not entitled to rewrite a will merely because it suspects that the testator did not mean what is said in the will.

Observations

It will be seen from the decisions considered above that, where a CGT liability is effectively latent in a post-CGT asset (typically, real estate) which is to be distributed in specie to a beneficiary under a will, care will need to be taken when drafting the will to ensure that there is an appropriate outcome. It may also be necessary to cover the situation where the executor (or trustee) may exercise a power of appropriation.

TaxCounsel Pty Ltd

References

1 Item 4 of the table in s 128-15(4) of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).

2 Item 1 of the table in s 128-15(4) ITAA97.

3 [2021] SASC 36.

4 [2021] VSC 344.

5 (1907) 5 CLR 418.

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Mid Market Focus

by Josh Chye, ATI, HLB Mann Judd

Migrating funds to Australia: tax traps

An overview of some of the tax traps for private individuals and business owners when migrating funds to Australia.

Introduction

The access of funds by Australian resident taxpayers from overseas sources has been a significant area of focus by the ATO over the last few years.

In 2014, the ATO provided a "one-off" amnesty under "Project DO IT" to allow eligible taxpayers to disclose omitted offshore income, capital gains and over-claimed deductions to allow significantly reduced penalties for any adjustments required to taxable income in prior years, as well as protection against criminal offences.

Since that time, however, it would be fair to say that the ATO has had significantly more resourcing since Project DO IT (for example, in the 2019-20 Federal Budget, the ATO was allocated $1b in funding over four years to extend its Tax Avoidance Taskforce and it expects to get $3.6b back from that investment!). The ATO has also accumulated greater experience and access to information, such as through exchange of information agreements with other countries, as well as information leaks such as through the Panama, Pandora and Paradise Papers.

This greater experience and resourcing has allowed the ATO to be aware of the different arrangements for funds received from overseas that should be recognised as assessable income in Australia even if, on face value, there may be no tax exposure (eg purported loans or gifts from unrelated parties overseas).

This article explores some of the key risk areas that the ATO will consider (based on the author's experience) to assist practitioners to be aware of the risks and to facilitate greater understanding of their clients' tax affairs, and to plan accordingly in order to comply with the relevant tax laws.

TA 2021/2

On 17 September 2021, the ATO issued TA 2021/2, titled "Disguising undeclared foreign income as gifts or loans from related overseas entities".

The ATO is concerned about Australian taxpayers not disclosing as assessable income, funds received from overseas where they are purported to be gifts or loans. Examples of undisclosed foreign income in TA 2021/2 include Australian taxpayers disguising foreign capital gains, foreign income or the repatriation of profits from a foreign entity as a gift or loan from a related overseas entity.

This article will not replicate the examples used in TA 2021/2 as readers should make the time to read these. However, the following key observations/takeways are made:

- TA 2021/2 is intended to clearly warn taxpayers and advisers that any arrangements to artificially avoid recognising assessable income in Australia can result in significant penalties (up to 90% plus shortfall interest). The ATO also warns that taxpayers and their advisers face criminal prosecution and penalties under criminal law;
- TA 2021/2 should be taken seriously. The ATO is not only warning of its concerns, but highlighting its significant resources and data-matching capabilities to cross-reference any statements or positions provided by the taxpayer to the ATO. For example, the ATO can access financial records through Austrac and information on overseas entities through exchange of information agreements with overseas tax authorities;
- the ATO is concerned about unexplained wealth. Based on the author's experience, if there is a disconnect between the amount of income/profits recognised by the Australian taxpayer in their Australian tax returns and the lifestyle of the taxpayer, a broader ATO review is likely, including a review of any funds received from overseas;
- while documenting a loan or gift agreement is important, this is only the start. The ATO will review the facts and circumstances holistically, such as whether the gift or loan arrangement is genuine or commercial (ie reviewing all facts and circumstances for both personal and business reasons), whether the terms of the loan or gift have been properly recorded for accounting purposes, and whether the repayments and tax compliance have been followed through correctly; and
- the ATO may require commercially and personally sensitive information from overseas parties. Of significant concern is the fact that the ATO may require commercially and personally sensitive information of the donor or lender, such as bank statements, evidence that the funds are from the donor/lender, and a copy of their photo ID/passport. The author considers that, if someone is truly an independent party from overseas providing a genuine gift or commercial loan, a key consideration is whether it is reasonable, practical or even possible to obtain this level of information.

Division 7A may apply to funds received from overseas

An area of the tax law that may not be well understood is that Div 7A of Part III of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) may apply to funds received from an overseas "associated" company.

As most readers would be aware, Div 7A is an anti-avoidance measure designed to prevent private companies from making tax-free distributions of profits to shareholders or to their associates in the form of payments, loans or debts that are forgiven.

Most readers would also be aware that, as a general principle, Australian resident taxpayers are taxable on worldwide income.

It may therefore come as a surprise to some readers that Div 7A, through the operation of s 109BC ITAA36 (introduced in 2010 to purportedly clarify the existing operation of the law), can apply to loans made from overseas companies to an associated person who is an Australian resident taxpayer.

An example of this may be where a foreign company, owned by foreign taxpayers, makes a loan to an Australian taxpayer that is deemed to be an associate. For example, a foreign company that is owned by offshore private individuals makes a loan to an Australian tax resident entity that is an associate (eg because of a parent and child relationship).

Therefore, if the funds of the loan from the overseas company were sourced from non-Australian profits and controlled by non-Australian resident taxpayers, it would appear that s 109BC may technically apply and trigger such loans as assessable unfranked income to the Australian associated taxpayer.

Unfortunately, the operation of s 109BC is far from clear at the moment. For example:

- in October 2018, Treasury sought industry feedback on ss 109BC and 109T ITAA36 in its consultation paper *Targeted amendments to the Division 7A integrity rules* due to uncertainty on aspects of how these provisions are intended to operate; and
- while s 109BC was introduced to provide clarification on the application of Div 7A to non-resident private companies, a number of issues remain unclear and present practical difficulties to fully comply with the law. For example, the definition of "tax accounting period" used in s 109BC only refers to companies that are resident in listed countries.

Final comments

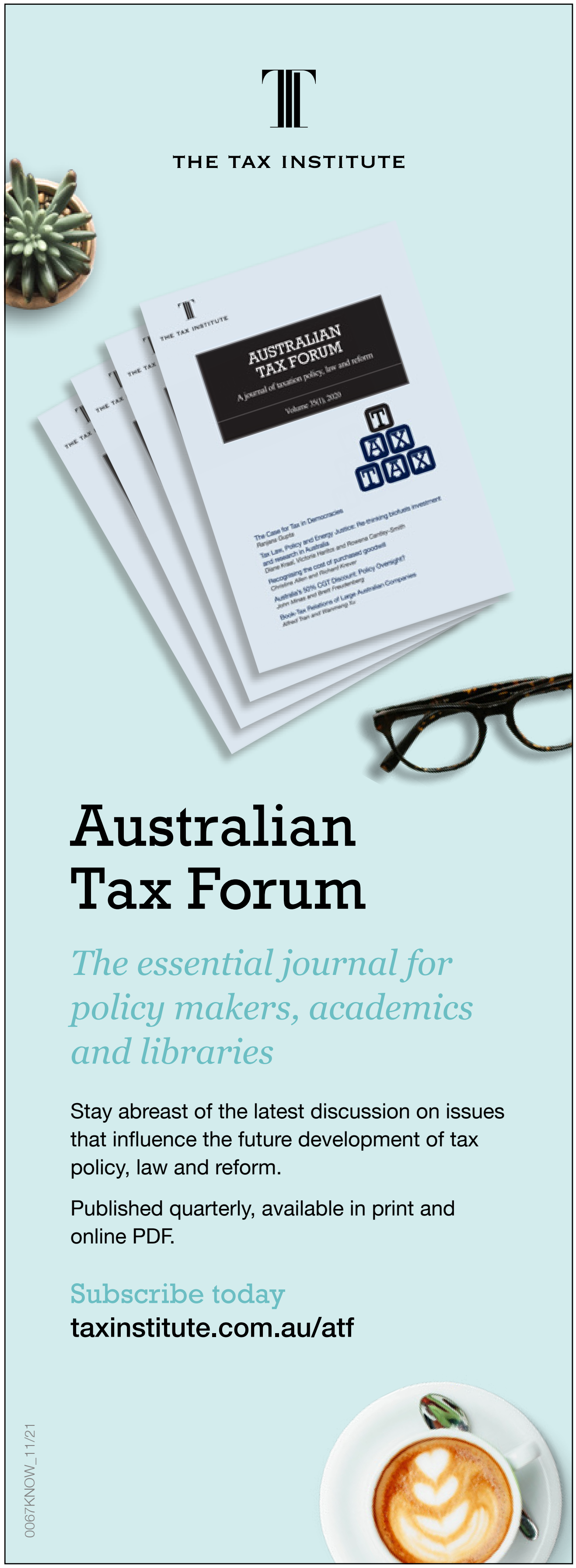
The ATO is significantly resourced and has had years of experience reviewing the tax implications of funds received from overseas and understanding the different structures that may be put in place by taxpayers.

The best time for tax planning is before accepting a gift or loan from overseas to ensure that appropriate tax advice, planning, documentation and post-implementation processes are understood.

To the extent that a taxpayer is unsure about how their existing affairs are compliant, a review is recommended to understand and explain any risk areas and to consider appropriate tax planning strategies, including sourcing further evidence and/or making a voluntary disclosure to the ATO. A voluntary disclosure can mitigate against the substantial penalties, time, costs and angst of a protracted ATO review or audit.

Josh Chye, ATI
Partner
HLB Mann Judd

Note: Further commentary on undeclared foreign income and TA 2021/2 is covered in another article in this issue of the journal.



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The national winner of the Justice Graham Hill Scholarship and the 2020 dux of CTA3 Advisory shares his advice on what it takes to succeed in tax.

Brayden Irving, Director, Private Business Tax & Advisory, Grant Thornton, Melbourne

Please provide a background of your career.

I started as a graduate in Private Business Tax & Advisory at Grant Thornton and currently have 7½ years of professional experience. I am a Chartered Accountant, Chartered Tax Adviser (CTA) and, throughout my career, have been lucky to work with a portfolio of successful and growing clients who have exposed me to a broad range of tax issues. I also went on a two-year secondment to our London office in January 2018 and worked in the Corporate & International Tax team.

What was the reason for undertaking CTA3 Advisory?

I enrolled in CTA3 Advisory when I returned from the United Kingdom. It was a great opportunity to refresh my Australian tax knowledge, develop my advisory skills, and obtain the CTA designation, which is a respected title globally.

How does it feel to be the national winner of the Justice Graham Hill Scholarship for 2020?

Justice Graham Hill achieved a lot academically and in taxation law, so I am incredibly proud to win an award named in his honour.

What is the most valuable aspect of studying CTA3 Advisory that you have taken away?

CTA3 Advisory developed my Australian tax knowledge, increased my confidence advising clients and emphasised the importance of understanding the specific facts, circumstances and goals of your clients in order to achieve positive outcomes.

What are your areas of new confidence?

CTA3 Advisory broadly covers the small business CGT concessions, corporate tax, international tax and GST, and I can apply all of these learnings to my diverse range of clients. My new area of confidence includes researching, applying and delivering complex tax advice.

How did you juggle study, work and other commitments and perform so well?

I set aside a fixed time each week to focus solely on study. While everyone will have a method to balance work, study and other commitments, my suggestion would be to start your work early and study consistently throughout the program. That will give you the best opportunity for success in the final assessment.

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

I will take a break from formal education but may eventually complete either a Master of Taxation or an MBA.

What advice do you have for other tax professionals considering the Chartered Tax Adviser Program?

I would encourage tax professionals to take on the challenge of the Chartered Tax Advisor Program. I found it greatly beneficial for my tax knowledge and when advising clients.

What advice do you have for others wanting a successful tax career?

My advice would be to have a positive attitude, embrace new opportunities, and to care about your clients and the people you work with. Those behaviours, partnered with having mentors who are invested in your career, will give you every opportunity to be successful.

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Small and family business concessions

by The Tax Institute

Several policy goals have influenced tax legislation in the small business sector. One goal has been to incentivise greater small business capital re-investment. Another has been to provide small business owners with access to funds for their retirement, especially when, as ASBFEO notes, 62% of Australian businesses are sole traders with no employees. Both of these policies have guided the creation of the small business concessions rules. However, as a result of continuous and piecemeal legislative amendments, the tax rules affecting small business taxpayers have grown both in length and complexity. Each new amendment has imposed additional compliance costs on small business taxpayers who often do not have access to the advisory resources of larger businesses. In light of this, The Tax Institute considers that the tax law relating to small business concessions is due for significant reform.

Board of Taxation review of the small business tax concessions

The Tax Institute's *Case for Change* is not the first time the need for such reform has been highlighted. The Board of Taxation specifically identified the small business tax concessions as needing major reform in its 2019 review.[1] The Board made several recommendations to overhaul the current system, including:

– applying a $10m threshold across all concessions while maintaining the current small business entity (SBE) definition;

– repealing the $6m maximum net asset value (MNAV) test;

– replacing or reforming the small business income tax offset (SBITO) with an alternative measure for non-corporate businesses;

– repealing the SBE rules relating to trading stock; and

– simplifying the SBE rules relating to the pooling rules by having a single depreciation rate of 30%.[2]

The Tax Institute endorses the intent behind the Board's recommendations, but also seeks to build on them so that the small business tax concessions rules are easily understood and applied, equitable, efficient, and meet the overarching policy purpose for which they were introduced.

Meaning of 'small business' based on aggregated turnover test and other thresholds

Following the enactment of the *New Business Tax System (Simplified Tax System) Act 2000* in response to the recommendations of the Ralph review,[3] the aggregated turnover test formed a fundamental part of the former simplified tax system (redesigned in 2007 as the SBE regime).

An individual, partnership, company or trust is an SBE if it carries on a business in an income year and has an aggregated turnover of less than $2m in the previous income year or is likely to have an aggregated turnover of less than $2m in the current income year.[4]

Eligibility for the small business CGT concessions in Div 152 ITAA97 was broadened in 2007 to include the $2m aggregated turnover test.[5] The $2m threshold was then increased with effect from 1 July 2016 to $10m as an economic policy measure. However, as the Board of Taxation's 2019 review notes,[6] the increased threshold was not 'applied across the board, effectively fracturing the small business definition'.[7] This theme runs through this chapter of the *Case for Change* paper.

The $10m threshold was further increased to $50m for 10 small business concessions (see Table 1) following an announcement in the Federal Budget 2020–21.[8]

Summary of aggregated turnover tests applied throughout the tax law

Table 1 sets out the measures throughout the tax law which rely on the aggregated turnover test, most of which apply differing thresholds. There are at least 25 different small business concessions, most of which rely on the entity satisfying the aggregated turnover test.

Summary of other small business eligibility thresholds

Table 2 sets out the small business measures throughout the tax law which are based on other eligibility conditions.

There are also parameters which define a small business within the *Corporations Act 2001* (Cth) and the financial services sector.

The *Corporations Act 2001* defines[9] a small proprietary company to be one which satisfies at least two of the following tests:

a. the consolidated revenue for the financial year of the company and the entities it controls (if any) is *less than $25m*;

b. the value of the consolidated gross assets at the end of the financial year of the company and the entities it controls (if any) is *less than $12.5m*;

c. the company and the entities it controls (if any) have fewer than 50 employees at the end of the financial year.

The *Financial Sector (Collection of Data) Act 2001* (Cth) imposes reporting obligations on registered financial corporations where the assets are $50m or more.

Table 1. Summary of aggregated turnover tests applied through the tax law

Threshold	Application	Legislative reference
$2m	Used to determine if a taxpayer is a CGT SBE being an alternative pathway to the $6m MNAV test to access the small business CGT concessions	s 152-10(1)(c)(i) and s 152-10(1AA) ITAA97
$5m	Used to determine if a taxpayer is eligible for the SBITO	s 328-357 ITAA97
$10m	Used to determine if a taxpayer is eligible for a range of small business concessions:	
	– simplified depreciation rules	s 328-175 ITAA97
	– small business restructure roll-over	s 328-430 ITAA97
	– accounting on a cash basis (GST attribution)	s 29-40(1)(a) of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GST Act)
	– apportioning input tax credits on an annual basis	s 131-5(1)(a)(i) GST Act
	– pay GST by quarterly instalments	s 162-5(1)(a)(i) GST Act
	– not subject to indirect value shifting rules	s 727-15(8) ITAA97
$20m	Used to determine if a taxpayer is eligible for a refundable R&D tax offset	s 355-100 ITAA97
$50m	Used to determine if a taxpayer is eligible for a range of small-to-medium business concessions:	
	– $150,000 instant asset write-off (IAWO) (medium-sized business)	s 40-82(4) ITAA97
	– simplified trading stock rules[10]	s 328-285(2) ITAA97
	– base rate entity rules (corporate tax rate)	s 23AA of the *Income Tax Rates Act 1986* (Cth)
	– immediate deduction for certain start-up expenses[11]	s 40-880(2A) ITAA97
	– immediate deduction for certain prepaid expenditure[12]	s 82KZMA(2)(a) and s 82KZMD of the *Income Tax Assessment Act 1936* (Cth) (ITAA36)
	– FBT exemption for car parking benefits[13]	s 58GA(1A) of the *Fringe Benefits Tax Assessment Act 1986* (Cth) (FBTAA)
	– FBT exemption for multiple work-related portable electronic devices[10]	s 58X(5) FBTAA
	– remit PAYG instalments based on GDP adjusted notional tax[14]	s 45-130(1A) of Sch 1 to the *Taxation Administration Act 1953* (Cth)
	– settle excise duty monthly on eligible goods[15]	s 61C(1AA) of the *Excise Act 1901* (Cth)
	– settle excise-equivalent customs duty monthly on eligible goods[16]	s 69(1AA) of the *Customs Act 1901* (Cth)
	– two-year amendment period[17]	items 1, 2 and 3 of the table in s 170(1), and s 170(14) ITAA36
	– simplified accounting method determination for GST purposes[18]	s 123-7(1A) GST Act
$100m	Used to determine if an entity is required to apply the taxation of financial arrangements provisions	s 230-455(4)(a) ITAA97
$500m	Used to determine if a taxpayer is eligible for:	
	– the $150,000 IAWO (large business)	s 40-82(4A) ITAA97
	– accelerated decline in value under the backing business investment measure	s 40-120(2)(b) (in Subdiv 40-BA) of the *Income Tax (Transitional Provisions) Act 1997* (Cth) (IT(TP)A)
$5b[19]	Used to determine if:	
	– an entity is eligible for full expensing of depreciating assets (FEDA)	s 40-155 (in Subdiv 40-BB) IT(TP)A
	– a corporate tax entity is eligible for temporary loss carry back	s 160-20 ITAA97

Small business CGT concessions

Historical note — small business CGT relief

It has been government policy for more than 35 years to provide some form of relief from CGT for small business taxpayers. The concessions were introduced to further encourage investment in small business and assist small business taxpayers to provide for their retirement. More particularly, the concessions were designed to provide a retirement funding equivalent for small to medium-sized enterprise (SME) owners who reinvest in their business rather than contribute to superannuation.

Overview of the small business CGT concessions

The small business CGT concessions are some of the most, if not the most, important bundles of tax concessions

Table 2. Summary of other small business eligibility thresholds applied through the tax law

Threshold	Application	Legislative reference
$6m MNAV	Used to determine if a taxpayer satisfies the MNAV test being an alternative pathway to access the small business CGT concessions Used to determine if a taxpayer satisfies the MNAV test being an alternative exemption from the indirect value shifting rules	s 152-10(1)(c)(ii) and s 152-15 ITAA97 s 727-15(8) ITAA97
$2m debt deductions	Used to determine if a taxpayer is required to apply the thin capitalisation rules	s 820-35 ITAA97
'Family group'	Used to determine whether a trust that has made a family trust election or an entity that has made an interposed entity election has made a distribution outside the 'family group' of the test individual	s 272-90 in Sch 2F ITAA36
4 or fewer employees	Used by the ATO to determine if an employer is eligible to apply for the Single Touch Payroll micro employer quarterly reporting concession	

available to small businesses. The concessions, in Div 152 ITAA97, enable small business taxpayers to significantly reduce or disregard captain gains that have occurred after 11:45pm on 21 September 1999.

Division 152 enables small businesses to access four significant concessions:

– a 15-year exemption on the disposal of business assets (Subdiv 152-B);
– a 50% reduction on the disposal of business assets (Subdiv 152-C);
– a retirement exemption on the disposal of business assets (Subdiv 152-D); and
– a roll-over into replacement business assets (Subdiv 152-E).

The policy rationale for the concessions is to enable small business owners to adequately fund their retirement from the disposal of their business or business assets as it was acknowledged that, due to constraints on cash flow, they may not be able to avail themselves throughout their working lives of the concessionary superannuation normally available to employees.[20]

To be eligible to access these concessions in relation to a capital gain happening from a CGT event, a taxpayer must satisfy the 'basic conditions' set out in s 152-10 ITAA97, including that the taxpayer has to satisfy at least one of the following conditions:

– the taxpayer is a CGT SBE (satisfies the $2m aggregated turnover test) for the income year;
– the MNAV test — that is, the net value of the taxpayer's CGT assets, and those of the affiliates of the taxpayer and any entities connected with the taxpayer, does not exceed $6m just before the CGT event;[21] or
– the taxpayer is a partner in a partnership that is a CGT SBE and the CGT asset is an interest in the asset of the partnership.[22]

The CGT asset must also satisfy the active asset test. An active asset is a CGT asset used in the carrying on of a business by the taxpayer, an affiliate of the taxpayer or an entity connected with the taxpayer.[23]

Overview of the aggregation rules

The aggregation rules are a major source of the complexity when determining whether a taxpayer is eligible for a small business tax concession. The aggregation rules are applied to determine whether an entity is an 'affiliate'[24] of another entity or is 'connected with'[25] that entity (i.e. whether one entity controls or is controlled by another entity, or is commonly controlled by the same third entity, based on a 40% control test[26]).

The 40% control test in s 328-125(2) ITAA97 applies for the purpose of determining whether a partnership, a company or a non-discretionary trust is connected with an entity. An alternative 40% voting test also applies in the case of companies,[27] and a modified 40% test for trustees and beneficiaries of discretionary trusts is set out in s 328-125(4).

These grouping rules are similar to those which apply for the purposes of the controlled foreign company rules in Pt X ITAA36. While the specific wording varies, the broad design of the SBE aggregation rules is akin to the tests that apply when determining whether a taxpayer controls a foreign company, tests which tend to be within the province of larger, more complex taxpayers.

The aggregation rules are relevant to the following tests in Table 3 (the first two tests are threshold tests which include the annual turnovers or net asset values of affiliates of the taxpayer and entities connected with the taxpayer).

Overview of the active asset test

A CGT asset is an active asset used, or held ready for use, in the course of carrying on of a business by an entity, its affiliate or an entity connected with it.[28]

The active asset test stipulates that, for a CGT asset to qualify as an active asset, the asset must:[29]

– if owned for 15 years or less — be active for a total of at least half of that period; or
– if owned for more than 15 years — be active for a total of at least 7½ years during the period.

The period starts from the time the asset is acquired and ends at the CGT event. However, if the business ceased to be carried on in the 12 months before the CGT event (or any longer period that the Commissioner allows), the period

Table 3. Relevant tests applying aggregation rule

Test	Application	Legislative reference
SBE aggregated turnover test	Used to determine if the taxpayer satisfies the $2m aggregated turnover test to access the small business CGT concessions	s 152-10(1AA) ITAA97
	It is also used to determine eligibility for a range of other small business tax concessions	s 328-110 ITAA97
MNAV test	Used to determine whether the taxpayer satisfies the $6m MNAV test	s 152-15 ITAA97
Active asset test	Used to determine whether an asset owned by the taxpayer satisfies the active asset test[30]	s 152-40 ITAA97

starts from the time the asset is acquired and ends at the cessation of the business.

Employee share scheme ‘concessions’

The provision of remuneration and incentives to employees in the form of shares or options has been around for many years. The tax laws have endeavoured to assess such benefits as remuneration, and therefore ordinary income, through the evolution of the provisions from s 26AAC to Div 13A of Pt III ITAA36 through to what is now Div 83A ITAA97.

Each evolution of the tax provisions sought the same policy outcome — to include in the assessable income of an individual the discount received on shares or rights/options. However, incentivised by the differential taxation of income and capital, taxpayers and their advisers continue to seek opportunities to have the gains arising from the respective instruments assessed on capital account.

Due to the significant variation in the different classes and terms of shares and options which can be issued, the provisions have been excessively complex. These complexities are most pronounced in relation to the valuation rules for unlisted shares and options. The complexities also arise due to the continued amendments to address the underlying behaviours of having the shares or options assessed on capital account rather than revenue account, and to address international tax issues associated with an ever-increasing globally mobile workforce.

The replacement of Div 13A with Div 83A, however, introduced additional complexity and administration for little gain in addressing the inherent issues in the system. These current provisions were introduced in an environment clouded by concerns over the effectiveness of the former elections to be taxed upfront under Div 13A, where the government held an opinion that such elections were ‘held in the top draw’ to hedge market movement. As such, Div 83A was developed as a self-operative provision.

Today’s employee share and option schemes developed predominantly for private entities have somewhat rendered these provisions ineffective yet again. For start-up entities and large businesses, they remain overly cumbersome and burdensome.

Issues

Meaning of ‘small business’

One of the primary tax issues facing the small business sector is the uncertainty surrounding the meaning of what a ‘small business’ is.

As can be seen from Table 3, although the primary meaning of SBE is set out in s 328-110 ITAA97 based on the aggregated turnover test in s 328-115, the turnover threshold is modified eight times for the purposes of a range of small business tax concessions. Further, there are alternative meanings of ‘small business’ beyond the aggregated turnover test (see Table 1) for the purposes of other small business concessions.

Entities must remain below the specified thresholds for the aggregated turnover test applicable to the particular measure, or satisfy other eligibility tests, to access one or more of the small business tax concessions. Knowing which threshold or test to apply and when has unnecessarily increased the complexity and compliance costs for SMEs.

Entities must consider the following when determining whether they are eligible for one or more small business concessions:

– the applicable threshold for the aggregated turnover test, or other eligibility test;

– the period in which the measure applies (particularly important where the measure is temporary or the relevant turnover threshold has increased with effect from a certain date); and

– other eligibility conditions, including changes to those conditions.[31]

Determining whether the eligibility conditions for some of these concessions have been satisfied has become incredibly complex. This has resulted in some advisers outsourcing this work to experts due to concerns about advising beyond their experience and abilities. Constant legislative change in pursuit of distinct policy intents has caused an interplay of provisions which many SMEs and their advisers find highly confusing and complex. Of greater concern is the increased likelihood that errors are being made in applying the law, which can result in messy reviews later, should the ATO determine that a taxpayer is not entitled to a concession the taxpayer had understood was available to them.

Much of the complexity in determining an entity’s aggregated turnover arises from applying the grouping rules (i.e. the ‘connected with’ and ‘affiliate’ provisions) discussed below.

This outcome seems to be counterintuitive to the policy intent of supporting small businesses and ensuring that they do not incur substantial compliance costs in complying with the law.

Complex eligibility criteria significantly increases compliance costs for small business taxpayers

A taxpayer can access the small business CGT concessions only if they, and the CGT asset, satisfy a range of eligibility conditions. The costs incurred by small business taxpayers in determining eligibility to access the concessions are often disproportionate to the benefit received and contrary to the overarching policy of the concessions, which is to maximise the cash in small business taxpayers' pockets upon retirement.

Several commentators over the years have noted that the eligibility rules around Div 152 have failed to meet the 'simplicity' principle needed in an efficient and equitable tax regime.[32] In a 2015 survey (the 2015 survey), 20 tax practitioners from 10 chartered accountancy firms were asked about the practical complexity of the SBE CGT regime.[33] The survey made several important findings:

- 85% of the tax practitioners believed that their small business taxpayer clients had a 'very poor' or 'poor' knowledge of the CGT provisions;[34]
- small business taxpayers were 'almost entirely reliant' on their tax advisers to explain the small business CGT concessions to them;[35] and
- 75% of the tax practitioners believed that the interpretation and the application of the basic conditions in Div 152 were the most complex aspects of the process.[36]

The corollary of this complexity is that small business taxpayers are paying high fees to their advisers to determine whether they are eligible for small business CGT relief. As the Board of Taxation's 2019 review notes:[37]

> "The generosity of the concessions is matched by equally complex legislation that leads to increased compliance costs and distortions in business decision-making."

Good tax law should not require advisers to hold the hand of their business clients at every step. The complexity of the small business tax concessions, magnified by the added layers of legislation every few years, has caused small business taxpayers to rely too heavily on their tax advisers at significant cost.

For this reason, reform that simplifies the legislation is much needed.

Practical problems with the 'affiliate' and 'connected with' tests

The aggregation rules were introduced in 2001 to prevent a larger group from breaking itself into smaller entities to exploit access to the then simplified tax system. Today, the aggregation rules continue to operate as integrity rules and apply to a wide range of measures across the tax law.

Rules originally designed for micro businesses not fit-for-purpose for large businesses

The operation of the aggregation rules is problematic, as they satisfy policy outcomes in some contexts but fail in others. The scaling of the same aggregation rules originally designed for micro businesses (i.e. those with an aggregated turnover of less than $2m) for much larger businesses has caused practical difficulties for businesses and their advisers.

The aggregation rules are not fit-for-purpose for larger businesses, as evidenced by the recent amendments to the expansion of the temporary FEDA measure beyond businesses with an aggregated turnover of less than $500m to those with an aggregated turnover of less than $5b. Following the original enactment of the measures in Subdiv 40BB IT(TP)A,[38] the measures were modified on 17 December 2020[39] to provide an alternative mechanism to the existing test for working out if the $5b threshold applies to qualify for the temporary full expensing concession. This was to overcome large companies operating in Australia with substantial foreign ownership (i.e. at least 40%) by multinationals failing the $5b aggregated turnover test due to the domestic turnovers of the Australian-based businesses being grouped with their shareholders' global turnovers.

Complexity in identifying affiliates and entities 'connected with' the taxpayer

The Board of Taxation's 2019 review noted several issues with the affiliate test. While the affiliate test is not often applied in practice, stakeholders reported to the Board that, when the test is used, it is unclear. The uncertainty exists because the test involves concepts such as 'reasonably be expected to act' and 'in concert with', which, according to the review, 'are difficult to apply in practice and lead to "grey" positions being taken'.[40]

There have been few cases in which the courts have had cause to consider the operation of the affiliate rule. This has contributed to the lack of understanding as to how it should be applied.

As the 2015 survey highlighted earlier notes:[41]

> "[One] of the main complexities in analysing the basic conditions arises from having to trace through a clients' structure to identify connected entities and associates."

Although the control test in s 328-125 ITAA97 is more easily calculable than the affiliate test in s 328-130 ITAA97, the control test is no less complex in its application. The following aspects of the control test present continual challenges for practitioners and their clients:

- the confusion which arises from the inconsistency between the significant individual test in s 152-70 ITAA97,[42] which, broadly, is based on holding or receiving at least 20% of income *or* capital entitlements in an entity, and the control test, which is based on holding or receiving at least 40% of income *and* capital entitlements;
- the complex operation of the four-year rule for beneficiaries of discretionary trusts in s 328-125(4), including:
  - the determination of the four-year period as it applies for different purposes (MNAV test and the aggregated turnover test versus the active asset test);
  - the dependency on the terms of trust deeds to characterise trust income and capital;
  - the inability, in many cases, to correctly identity beneficiaries who are connected with the trust due to inaccessible information (for example, a beneficiary who received at least 40% of the trust income or capital three years ago who is no longer in contact with the family but who remains connected with the trust for

four years after the year in which that distribution was received); and

  - the difficulty in applying the four-year rule to groups comprising many layers of trusts and corporate beneficiaries;

- the inordinate time needing to be spent to determine whether an entity or individual is connected with an entity can be disproportionate to the benefit available under the concession; and
- there is a high risk of erring when applying the control test, which can lead to taxpayers unwittingly thinking they are entitled to a concession when they are not.

Integrity measures are constricting the practical operation of, and access to, the concessions

The 40% control test and the affiliate rule are integrity measures which serve to ensure that larger groups do not inappropriately access the concessions.

The 2018 amendments[43] affecting CGT events that happen to shares in companies and interests in trusts were similarly designed to close a loophole that allowed high wealth individuals to inappropriately access the concessions. However, they were overengineered and greatly increased the complexity of the eligibility rules, making this a specialist area for advisers. The fact that the commencement of the amendments was delayed by nearly eight months reflected the chasm that existed between what was foreshadowed in the Federal Budget 2017–18 announcement and the eventual form of the rules when the exposure draft legislation was released on 8 February 2018. They were poles apart and the Senate's insistence on a delay to the start date was appropriate.

Acknowledging that there is a role for integrity provisions in the law to ensure that small business concessions are appropriately targeted and accessed, there are concerns across the profession that the complexity of the integrity rules are constricting the practical operation of, and access to, the concessions. The additional law created by the 2018 amendments is highly technical, and many SME practitioners have indicated that they will outsource work associated with applying the new integrity rules due to their complexity and the increased risk and exposure for their practices of inadvertent negligence. There is also a concern of potential consequential litigation from getting it wrong.

A balance must be struck between ensuring the law contains adequate integrity provisions and ensuring the law is workable, able to be understood and achieves the policy intent in the most efficient way. There is enormous scope for the small business CGT concessions to be simplified, streamlined and better targeted.

Difficulties associated with the active asset test

The difficulties taxpayers face in applying the concessions is exemplified in the recent Full Federal Court decision in *Eichmann.*[44] This case dealt with interpretational differences in what should have been a relatively straightforward set of circumstances.

Applying the active asset test to shares in companies and interests in trusts

The active asset test is particularly difficult to apply to shares in companies and interests in trusts. Section 152-40(3) ITAA97 sets out a modified test for these types of CGT assets. However, this test requires the taxpayer to determine whether, broadly, at least 80% of the assets in the company or trust are active for at least half the time the shares in the company or interests in the trust have been held. The test is complex to apply, prone to error and needs simplifying.

Design of law changes is causing anomalous outcomes

Much of the complexity of tax law affecting small businesses is derived from the way the law has been drafted. As new policies are legislated, layers upon layers of rules compound, which increases the complexity for taxpayers. Provisions that interrelate on a particular issue are commonly found in entirely different areas of legislation.

New full expensing of depreciating assets measures an example of clunky complex legal design

The temporary FEDA measure is a prime example of clunky legislative design. The original IAWO for SBEs was designed to help small businesses to write off assets and to encourage them to invest in capital assets. It was originally set at $1,000 for businesses with an aggregated turnover of less than $2m. The ability to fully expense a depreciating asset (albeit temporarily) now applies for businesses with an aggregated turnover of less than $5b with no cap on the cost of the asset, a far cry from the original legislative design.

The increases in the thresholds over the years are set out in Table 4.

Table 4. Instant asset write-off and full expensing of depreciating assets thresholds

Aggregated turnover threshold	Cap on cost of asset	Period of concession[45]
Less than $2m	Less than $1,000	1 July 2001 to before 7:30pm on 12 May 2015
Less than $2m/less than $10m[46]	Less than $20,000	From 7:30pm on 12 May 2015 to before 29 January 2019
Less than $10m	Less than $25,000	From 29 January 2019 to before 7:30pm on 2 April 2019
Less than $50m	Less than $30,000	From 7:30pm on 2 April 2019 to before 12 March 2020
Less than $500m	Less than $150,000	From 12 March 2020 to 31 December 2020[47]
Less than $5b	No cap	From 7:30pm on 6 October 2020 to 30 June 2022

The above measures are contained in, or interact with, the following legislative provisions:

- generally, Div 40 ITAA97;
- generally, Subdiv 328-D ITAA97;
- s 328-180 ITAA97 — IAWO for SBEs;
- s 328-180 IT(TP)A — temporary IAWO rules for SBEs;
- s 328-181 IT(TP)A — temporary full expensing of general small business pool rules for SBEs;
- s 328-210 ITAA97 — full expensing of general small business pool;
- s 40-82 ITAA97 — IAWO for medium-sized and large businesses, i.e. aggregated turnover of at least $10m to less than $500m;
- Subdiv 40-BA IT(TP)A — backing business investment measure (50% accelerated depreciation in the first year); and
- Subdiv 40-BB IT(TP)A — FEDA for businesses with an aggregated turnover of less than $5b.

With even a cursory glance at Table 4 and the extensive list of interrelated legislative provisions — noting the spread of rules across multiple pieces of legislation and divisions of the law, together with different thresholds for different taxpayers at different times — it becomes evident that law design is a major contributing force to complexity.

The way in which the new temporary FEDA measure has been implemented, while a worthwhile and effective measure, has increased complexity for taxpayers. New Subdiv 40-BB IT(TP)A contains integrity rules, various exclusions and a clause that gives this new Subdivision priority over all other legislative provisions with some exceptions.

Rather than implementing the FEDA measure in a different Subdivision, drafters could have instead amended existing provisions, namely ss 328-180 and 40-82 ITAA97, to give effect to the new policy. Now, small business taxpayers and their tax advisers must consider how the existing rules interrelate with the new rules. All of this just to write off an asset, which is a timing difference only and has no permanent impact on the revenue.

To avoid these sorts of anomalous outcomes, legal drafters should consult with expert stakeholders (including the professional bodies) so that the law is drafted in a way that is easily understood and readily explainable to small business taxpayers and practitioners.

Concessions need to be tailored to the small business life cycle

The small business life cycle

In maximising the benefits obtainable by small businesses from tax concessions, the government should recognise that small businesses, rather than being monoliths, are incredibly varied and diverse, and primarily operate in 'life cycles'. This is a key recommendation in the Board of Taxation's 2019 review.[48]

Small businesses typically go through five stages of evolution: inception, survival, growth, expansion and maturity. The support a small business needs in the form of concessions will depend on its stage of evolution. As the Board of Taxation's 2019 review notes, small businesses in the inception stage seek cash and capital markets, while small businesses in the maturity stage are looking for succession.[49] Without a proper understanding of how small businesses evolve, concession measures cannot effectively meet their policy goals.

Concessions should provide the benefit at the time it is needed

The Board of Taxation's 2019 review found that almost all of the concessions available to small businesses targeted those at the maturity stage of their evolution.[50] This makes sense in light of a goal of enabling small business taxpayers to retire with more money in their pocket.

However, in the age of start-ups and innovation, the government must focus not only on the retirement of small business taxpayers, but also on supporting newly formed businesses so that they can survive and flourish. This requires rethinking the approach to small business concessions to create a landscape that better accommodates inception-stage small businesses and supports them through the operational phase to retirement or exit.

Tax concessions should provide small businesses with the targeted benefit at the time that they need it the most. Accordingly:

- concessional measures should encourage entrepreneurial activity and support start-ups;
- cash flow assistance should be targeted during the phase of business operations — for example, retaining permanently temporary measures such as the IAWO/FEDA and loss carry-back (or adopting cash flow taxation as suggested above); and
- measures should support retirement and exit strategies — including the role of the existing superannuation lifetime CGT cap.

Some small business measures not widely adopted

Some small business tax concessions have not been widely adopted as they are perceived, or have proven, to be impractical or the eligibility requirements were too hard to satisfy.

These include the following measures.

- **simplified trading stock rule:** most businesses undertake stocktakes for commercial reasons regardless of the rule in s 328-285 ITAA97 which allows SBEs to choose not to account for changes in their trading stock if the difference between their opening and closing stock is no more than $5,000. Of course, in order to qualify for this concession, the taxpayer is required to determine whether the movement in their trading stock is no more than $5,000, which is difficult to determine in the absence of conducting a physical stocktake or maintaining sophisticated stock records. This concession does not have the effect of reducing the compliance burden, which was the very thing the rules were designed to alleviate;
- **FBT record-keeping exemption:**[51] employers are allowed to not maintain FBT records if their aggregate fringe benefits amount does not exceed the exemption threshold. This has broadly been regarded as a useless

concession as how does a business know whether they have exceeded the exemption threshold if they are not required to keep records? And small businesses must keep records to show that they fall below the threshold; in each case defeating the exemption completely; and

- **small business restructure roll-over:**[52] this beneficial measure allows an SBE to transfer active assets from one entity to another entity without triggering adverse tax outcomes in relation to CGT assets, depreciating assets and trading stock. However, the fundamental drawback with the small business restructure roll-over (SBRR), as highlighted by the Board of Taxation's 2019 review, is that the requirements for eligibility are 'too complex' for small businesses to use to with 'confidence'.[53] The issue primarily relates to the requirement that there be a genuine restructure (notwithstanding the existence of the safe harbour rule[54]) and no material change in the ultimate economic ownership.

Small business roll-over

The small business roll-over in Subdiv 152-E ITAA97 is problematic for a number of reasons:

- its design adds considerable complexity, requiring the taxpayer to monitor the passage of time from the CGT event (i.e. two years) to determine whether CGT event J5 or J6 happens. Many taxpayers and their advisers regard this concession as simply a two-year deferral of the taxing point of the capital gain, as there is no requirement to establish intent to acquire a replacement active asset at the time of the original CGT event or when choosing to apply the roll-over;
- if a replacement active asset is acquired, there is no tracing or notification to the ATO of this fact, making it incredibly difficult to determine years later when the asset is sold or otherwise ceases to be an active asset to which CGT event J2 has happened. Unlike carried-forward tax losses and capital losses which are reported each year in the income tax return, there is no process other than relying on workpapers to flag that a replacement asset carries with it a deferred CGT event J2 capital gain;
- where an individual who chooses to apply the small business roll-over, thereby deferring the taxable capital gain until at least two years after the CGT event, dies before the end of the replacement asset period, the deferred capital gain is disregarded. CGT event J5 or J6 cannot happen before the end of the replacement asset period so the deferred capital gain cannot be assessed to the deceased taxpayer, and there is no mechanism in the law to 'transfer' the deferred capital gain to the legal personal representative or a beneficiary of the taxpayer's deceased estate. The same outcome arises where the taxpayer dies after a replacement asset is acquired but before CGT event J2 happens;
- the rules relating to the acquisition of a replacement active asset:
  - that is a share in a company or an interest in a trust; or
  - by a company or the trustee of a trust,

  are complex, and not well understood by small business taxpayers and their advisers; and
- the small business roll-over does not interact well with other CGT roll-overs, and is reportedly less relevant now that the SBRR may be available.

Employee share schemes[55]

Division 83A ITAA97 only addresses those shares or options issued to employees at a discount.[56] Accordingly, if, at the time of acquisition, the share or right was acquired at or even slightly above market value, the provisions do not apply. This is the case even in circumstances where employment conditions apply to the relevant instrument and they are later sold for a gain. By example, a $1 share issued to an employee for $0.99, with employment and sale restrictions, that is sold five years later for $3 is likely to be taxed on revenue account. Whereas that same share issued for $1 or $1.01, with those same employment and sale restrictions, that is sold at the same time is likely to be assessed on capital account and eligible for the CGT discount.

Division 83A's default position is that any discount on shares or options is assessable upfront as ordinary income, unless fact patterns otherwise result in the assessment being made at the deferred taxing point. The provisions achieve this through defining such terminologies as follows.

- **shares or rights:** to be taxed on a deferred basis, the shares must be ordinary shares or rights to acquire ordinary shares. It is noted in the private client market that there is a greater flexibility over the type of share or right able to be issued and, therefore, a greater choice as to whether the employee will be assessed upfront or on a deferred basis. This can result in future gains being taxed on capital account and eligible for the CGT discount rather than on revenue account, even though the underlying share is at risk of forfeiture;
- **discount provided:** the provisions apply only to shares or rights issued at a discount to market value. Accordingly, where the market value can be ascertained, there is no real risk of forfeiture, and where a loan is granted for the acquisition of the shares or rights, the provisions have no practical implications. This remains the case where underlying put/call options set pre-determined sale prices should the employee leave within a prescribed period; and
- **real risk of forfeiture:** not only must there be a risk of forfeiture, but such a risk must be 'real'. The use of the term 'real' in these provisions creates unnecessary ambiguity, particularly where the concerns this seeks to address are somewhat limited.

Other issues also exist with regard to start-up entities. Employee share and option schemes are a valuable tool for cash-strapped and start-up entities to facilitate the attraction and retention of high-quality staff with the skills and knowledge to help grow those businesses. The current concession for start-up entities — whereby the discount included in the employee's hands is reduced to nil, but any gains arising on ultimate disposal will be assessed on capital account — provides eligibility criteria which are very limited and too prescriptive.

To be eligible for the start-up concession, the following conditions must be met (among others):

– the company is a start-up company[57] (i.e. it cannot be listed or a subsidiary of a listed entity, it must be incorporated for less than 10 years, and its aggregated turnover must not exceed $50m);
– if the interest is a share, any discount must be no more than 15% of the market value of the instrument when provided; and
– if the interest is a right, any amount that must be paid to exercise the right must be greater than or equal to the market value of an ordinary share in the company at the time of provision of the right.

These provisions are unnecessarily restrictive and overly burdensome from an evidentiary perspective to facilitate start-up entities attracting and retaining appropriate talent and skills.

> *"... the small business CGT concessions are among the most complicated and least understood provisions affecting small businesses."*

Options

Streamline eligibility thresholds across measures

Affirming the Board of Taxation's recommendations made in the 2019 review, The Tax Institute is of the view that the eligibility thresholds should be streamlined across various concessions to address the complexity and simplify the small business tax system.

This is one of the most significant tax challenges facing the small business sector, and large-scale reform involving consultations with a broad group of stakeholders could potentially transform the system. Streamlining the eligibility thresholds across most, if not all, of the concessions would have a positive impact by:

– reducing compliance costs for small business taxpayers;
– increasing cash in the pockets of small business taxpayers for capital reinvestment and retirement;
– lessening the burden on tax advisers navigating very complex and tangled rules;
– quickening the pace at which small business tax concessions could be accessed, thereby increasing economic activity; and
– creating a business-friendly environment which encourages entrepreneurial and start-up activity.

Alignment of turnover thresholds

Subject to the discussion on repealing the SBITO below, the current aggregated turnover threshold of $5m is unnecessary given the $1,000 cap on the amount of the offset. The aggregated turnover threshold for the SBITO should be aligned with the other concessions, that is, increased to $10m.

Alternatively, the aggregated turnover threshold which applies solely for the purpose of the small business CGT concessions in Div 152 ITAA97 should be increased to $5m to align with the SBITO turnover threshold. These are just two examples of the unnecessary inconsistency across the small business thresholds.

There may be some efficiency in moving to a universal $10m aggregated turnover threshold for small business, but it could also be more effective to align the threshold more broadly with the $50m turnover threshold under the *Corporations Act 2001*. This reform is supported by the $50m aggregated turnover threshold which applies for the purpose of the corporate tax rate (base rate entity rules) and the recent amendments which increased the threshold from $10m to $50m for 10 small business concessions.[58]

Alternative small business tests

Instead of relying solely on a turnover test for tax purposes (with the exception of the $6m MNAV test), the meaning of 'small business' could be universally determined by reference to satisfying one of three tests:

– aggregated turnover for the income year;
– net assets at a testing point; or
– the number of employees at a testing point.

Alternatively, eligibility could be based primarily on aggregated turnover, with a secondary test using net assets for those that do not satisfy the turnover test.

Applying a turnover test is problematic for high-turnover low-margin businesses that struggle to meet the turnover test. Section 328-120(3) ITAA97 acknowledges this, but only for businesses that derive their ordinary income from sales of retail fuel. There are many other types of high-turnover and low-margin businesses that are otherwise owned and operated as a small business but which fail the relevant turnover test. This approach needs a rethink. For example, an adjusted turnover based on set commercial margins for industry sectors could be more appropriate.

Consideration should also be given to the imposition of a lifetime cap on certain small business concessions (see "Rationalise small business CGT concessions" below), in which case, an asset threshold may be an unnecessary integrity measure for asset-rich low-turnover activities such as farming.

Reduce complexity of grouping rules

Most of the complexity in determining an entity's aggregated turnover arises from the grouping rules in s 328-125 ITAA97 (about other entities connected with the entity) and s 328-130 ITAA97 (about affiliates of the entity). Unless the grouping issues identified above are addressed, there will be no substantial improvement in this area of the law for SBEs.

A sensible reform could involve identifying a family or business group on a basis more akin to the 'family group' as defined in the trust loss provisions in Sch 2F ITAA36, or a consolidatable group with some special rules for non-fixed trusts. A grouping equivalent to a family group or a consolidatable group instead of using the 'connected with' and 'affiliate' rules would provide greater consistency across the tax law and facilitate the transfer:

– and/or utilisation of intragroup losses;
– of intragroup profits by way of income distributions; and
– of CGT assets, depreciating assets and trading stock as part of a business restructure.

Consistent indexation of all thresholds

The small business tax system could be further streamlined if consistent indexation of thresholds were applied for all purposes. Thresholds such as the car limit, various superannuation caps, the main residence exemption improvement threshold and the rates for the car expenses cents per kilometre method are indexed annually. However, the indexation method applied to these limits is not consistent across the measures, and most of the small business thresholds are not indexed at all. The CGT retirement exemption limit of $500,000 has not increased since its introduction on 21 September 1999, even though it forms part of the lifetime CGT cap amount which is indexed annually.

'Soften' the hard thresholds

As the law currently stands, all of the aggregated turnover threshold tests to access any of the small business concessions are 'hard' thresholds. This means that, if the taxpayer is even $1 over the threshold, they are not eligible for the small business concession.

In The Tax Institute's view, this is an unfair consequence of setting hard lines. While it may be simpler for the ATO to enforce 'hard' thresholds, the system would be more equitable if the thresholds were 'softened' into a tiered system (no more than two or three tiers) whereby a taxpayer that is slightly above the threshold could still access a small concession but at a decreased rate.

Softening the thresholds through tiering would also dissuade taxpayers and their advisers from creating complicated business structures to maximise potential access to the concessions, or engaging in behaviour that is primarily designed to gain access to the concessions. This would result in reduced compliance costs and increased satisfaction with a more equitable tax system.

Remove the small business income tax offset

Following the discussion on the taxation of SMEs in chapter 3 of the *Case for Change*,[59] if the tax treatment of business income were impartial to the entity type, then the SBITO could be repealed as there would be no need to separately target through a tax offset the two-thirds of small businesses that operate outside a corporate structure.

Allow a tax-free period for start-ups

The Board of Taxation's 2019 review highlighted that, in their inception stage, small businesses do not have access to sufficient concessions that adequately support them through this crucial phase of development. A significant reform would be the introduction of a tax-free period for start-up businesses.

Allowing a tax-free period for start-ups for the first two to three years would get these taxpayers into the tax system. It would apply for income tax purposes only, not GST nor PAYG withholding, and would overcome the perennial problem of PAYG instalments compounding[60] in the second year of operation. A threshold could be set, above which the tax-free concession is not available (for example, based on turnover, profit or assets).

Not only would a tax-free period for start-ups provide small businesses in their earliest stages with much needed financial relief, but it would also signal to the global community that Australia is a place that takes start-up innovations and businesses seriously. By aligning the tax law and reducing red tape with the growing culture of risk-taking entrepreneurship, Australia has the potential to create a highly dynamic and thriving start-up environment.

Allow permanent full expensing of depreciating assets and prepayments

It has been a feature since the introduction of the former simplified tax system in 2001 for small businesses to be able to fully expense depreciating assets they acquire. Table 4 sets out the thresholds that have increased since 2015. The FEDA measure applies until 30 June 2022 for businesses with an aggregated turnover of less than $5b.

The changing rules create complexity and require small businesses to incur unnecessary compliance costs to determine whether a depreciating asset can be fully written off in the year in which it is acquired. It is unnecessary because the impact on government revenue is a timing difference due to the ability to depreciate the asset over its effective life or via a general small business pool.

Similarly, there are complexities associated with the treatment of prepayments. While SBEs can fully expense a prepayment[61] in certain cases, businesses with an aggregated turnover of $10m or more are required to allocate the deduction for the prepayment over its eligible service period.

Permanently allowing FEDA and prepayments for businesses with an aggregated turnover of less than $50m would align the tax treatment with the outlay of funds, reduce complexity and remove the need for SBEs to maintain a general small business pool under Subdiv 328-D ITAA97. A suitable cap should apply to depreciating assets that are fully expensed.

Rationalise CGT roll-overs for small business

The law relating to CGT roll-overs for small business should be streamlined to reduce the complexity in meeting the conditions and make them easier to apply.

Currently, small businesses have a range of CGT roll-overs when restructuring or acquiring a replacement asset:

– roll-over for the disposal of assets to a wholly owned company;[62]
– small business roll-over;[63]
– small business restructure roll-over;[64] and
– roll-overs for business restructures.[65]

The objective of a business roll-over is to remove restructuring impediments and reduce complexity. The existing roll-overs listed above, to the extent that they relate to small businesses, should be rationalised into a new single small business CGT roll-over which would allow an entity with an aggregated turnover of less than $50m to roll a taxable capital gain, balancing adjustment amount or other assessable amount from the disposal of active CGT assets, depreciating assets and trading stock into a replacement business/active asset.

The new single CGT roll-over for small businesses would operate as an alternative to the 'lifetime business retirement cap' discussed below.

Repeal impractical small business measures

The following small business tax concessions which have not been widely adopted as they are perceived, or have proven, to be impractical should be repealed:

- **the simplified trading stock rule:** most businesses undertake stocktakes for commercial reasons regardless of the rule in s 328-285 ITAA97, and anecdotally, there is little evidence of its widespread use; and
- **the FBT record-keeping exemption:**[66] similarly, there is little evidence that employers value this concession or find it useful.

The SBRR[67] should be incorporated into a single small business roll-over (discussed below) that simplifies the eligibility requirements.

Rationalise small business CGT concessions

As discussed above, the small business CGT concessions[68] are among the most complicated and least understood provisions affecting small businesses. The constant changes over the years and the intricacy of the integrity measures are an impediment to effortlessly exiting a business by way of sale or retirement. This complexity is inconsistent with the policy intent that concessions be available to small businesses in recognition of their investment in their businesses over the years rather than in the superannuation system.

The design of the concessions needs a rethink when it comes to retirement and stakeholders exiting the business, bearing in mind that the purpose of operating a business for most is to build up wealth for retirement.

Goodwill is often the most valuable CGT asset held by a small business. Even prior to the 1999 CGT reforms, goodwill was recognised in the tax law as a valuable asset by exempting all or part of the capital gain from the disposal of goodwill.[69] When the CGT regime was reformed in 1997 and again in 1999, goodwill was subsumed into the definition of a 'CGT asset' to which the concessions apply more broadly.[70]

The four existing small business CGT concessions[71] could be consolidated into a single concession, allowing eligible businesses to disregard the capital gain, balancing adjustment or profit on the disposal of business/active assets up to a prescribed cap. The new concession would be agnostic across business assets, that is, it could apply to goodwill, business real property, plant and equipment, intellectual property and trading stock.

The amount disregarded would be subject to a lifetime cap, reported and tracked through income tax returns in a manner similar to carry-forward losses and identified on the ATO's online services so that taxpayers would be able to determine how much of their lifetime cap has been utilised.

A new 'lifetime business retirement cap' of, say, $1.7m[72] per stakeholder could apply, unless the government determines that a higher lifetime cap should apply. The current small business CGT concessions theoretically permit up to $6m to be realised tax-free (originally $5m until 1 July 2007), in the circumstance that this wholly comprises internally generated goodwill that has no cost base. The introduction of the $2m aggregated turnover test as an alternative test from 1 July 2007 has permitted greater amounts to be realised tax-free for asset-rich low-turnover businesses. Effectively, the amendments in 2007 uncapped the $6m tax-free limit. Hence, consideration should be given to the setting of an appropriate tax-free limit.

This cap should be indexed annually and would not be subject to the non-concessional contributions cap. The process for contributing the amount to superannuation should be simplified.[73] The funds should be transferred into a regulated superannuation environment except where the stakeholder is older than the age pension age (rather than the current age of 55 which applies for the purpose of the retirement exemption[74] and is inconsistent with other age limits).

Consideration should be given to how the funds are treated in or upon withdrawal from the superannuation environment, but this is a separate matter relating to a sustainable design of the superannuation system.

Introducing a single lifetime business retirement cap to replace the current $500,000 CGT retirement exemption limit and the CGT cap amount would eliminate many of the special rules.

Simplify the process for making choices and elections

Taxpayers must evidence the choices they make when applying the tax law. In most cases, a choice made by a taxpayer must be made by the day on which they lodge their income tax return for the year in which the transaction or event occurred, or within a further time allowed by the Commissioner.[75] The way in which the tax return is prepared is usually sufficient evidence of the making of the choice.

However, in some cases, the taxpayer is required to make a written choice, which may or may not be required to be provided to the ATO (depending on the measure). Examples include choosing to apply the retirement exemption and the small business restructure roll-over, and making a family trust election or interposed entity election.

The process for small businesses making choices and elections should prioritise equity, efficiency and common sense over strict legal form. This issue was highlighted in *Davies and FCT*[76] where the AAT decided that:

> "… signed elections to apply the small business retirement exemption provisions of [S]ubdivision 152-D of the *Income Tax Assessment Act 1997* (the Act) to the capital gains from the sale of the land … was done in their personal capacities as there is no indication that the elections were signed in any other capacity."

The requirements in the tax law can be very complex and confound even the most seasoned of tax practitioners. The government should strive to simplify the manner in which choices and elections are made, but the law should also allow the intent of the taxpayers to be taken into account when determining eligibility for concessions in cases where the manner in which the choice or election is made may not otherwise fully accord with the strict legal form of the provisions.

Assisting SMEs to build their digital/technological capability

In a modern, digital economy, technological and digital capabilities are essential for the survival and growth of small businesses. Research has demonstrated that digital tools have saved small businesses an average of 10 hours a week of work and boosted revenue by 27%, equating to an additional $385b per year in revenue.[77]

The federal government announced a Small Business Digital Taskforce in 2017 and has accepted the Taskforce's recommendations entirely or in principle.[78] The Empowering Business to Go Digital program has emerged from the Taskforce to specifically deal with the digital needs of small businesses. The objective of the program is to establish a non-government organisation, or leverage an existing non-government organisation, to increase small business awareness and adoption of digital technology, in line with the recommendations of the Small Business Digital Taskforce report.

The next step is to increase funding or to create new programs to assist small businesses in increasing or establishing digital capability so that they are adequately equipped to deal with the ever-increasing digitalisation of the Australian economy. Enabling small businesses to digitalise will allow them to recover and reinvent themselves following the COVID-19 pandemic. Ultimately, a strong small business digital infrastructure will create a business environment that is dynamic, competitive and growth-oriented, all of which are good for small businesses and for the Australian economy as a whole.

Redesign the employee share scheme provisions

In reviewing and considering the options available to reform the employee share scheme provisions, simplicity is paramount.

Firstly, the underlying policy intent is that the receipt of shares or options in relation to employment is ordinary income, and any well-designed tax system should align as best as possible the receipt of cash to the assessment of the income, most particularly for individuals not in business. Accordingly, consideration should be given to ensuring that all shares or rights be taxed as ordinary income at the deferred taxing point.

If this is accepted as the most appropriate policy, there will be a natural management of share plans in listed companies as shareholders will be less inclined to support boards granting excessive share remuneration. Further, private groups would not be incentivised to excessively utilise employee share schemes as the ability to utilise the capital treatment under such schemes will be significantly reduced.

In considering such a change, there should be a more considered design of the employment nexus. The risk of forfeiture may be one factor relevant to determining this; however, an employment nexus is a broader concept than this and should be appropriately addressed.

Where this is appropriately defined, the concept of deferred taxation could then apply for all shares and rights, whether they are ordinary shares or rights to acquire such shares, and whether or not they have been acquired at a discount. This would significantly simplify the provisions, reduce the ease by which they can be manipulated, and likely reduce the incidence of burdensome valuation requirements.

Entry into 'upfront' taxation could be designed to cover those instances where there are policy reasons for allowing concessions for future gains to be treated on capital account, for example, start-up entities.

A review of the concessions for start-up entities should also be undertaken to ensure that this is more readily accessible by these entities needing to attract and retain talent without being overly restrictive in what can otherwise be provided to attract such talent.

Options for reform

- Streamline the aggregated turnover thresholds by initially (i.e. in the short term) increasing the SBITO turnover threshold from $5m to $10m, and aligning the aggregated turnover thresholds.
- Consider alternative small business tests.
- Reduce the complexity of the grouping rules by identifying a family or business group on the basis of the 'family group' (per Sch 2F ITAA36), or a consolidatable group with some special rules for non-fixed trusts.
- Apply consistent indexation of all small business eligibility thresholds.
- Introduce tapering of eligibility thresholds (for example, above the $6m MNAV test threshold) instead of a hard threshold — this could step down in two to three tiers.
- Remove the SBITO (subject to reforms of the taxation of SMEs).
- Allow a two- to three-year tax-free period for start-ups.
- Allow permanent full expensing of depreciating assets and prepayments.
- Repeal the simplified trading stock rules and the FBT record-keeping exemption as, practically, they are of little use to small businesses.
- Rationalise CGT roll-overs into a single small business roll-over.
- Consolidate the four existing small business CGT concessions into a single concession, with an indexed lifetime business retirement cap.
- Simplify the process for making choices and elections.
- Redesign the employee share scheme provisions.

The Tax Institute

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1 Board of Taxation, *Review of small business tax concessions – a report to the Treasurer* (Board of Taxation's 2019 review), Australian Government, Canberra, March 2019. Available at https://taxboard.gov.au/sites/taxboard.gov.au/files/migrated/2019/12/RSBTC-report.pdf.

2 Ibid.

3 Review of Business Taxation (John Ralph, Chair), *A tax system redesigned: more certain, equitable and durable*, final report of the Review of Business Taxation, July 1999. Available at https://webarchive.nla.gov.au/awa/20180316084138/http://rbt.treasury.gov.au.

4 S 328-110 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).

5 In addition to the $6m MNAV test.

6 Board of Taxation's 2019 review, p. 17 at para 3.17.

7 Ibid at para 3.18.

8 This measure is contained in Sch 3 to the *Treasury Laws Amendment (A Tax Plan for the COVID-19 Economic Recovery) Act 2020* which was enacted on 14 October 2020 as Act No. 92 of 2020.

9 S 45A(2) of the *Corporations Act 2001*.

10 Turnover threshold increased from $10m to $50m with effect from 1 July 2021.

11 Turnover threshold increased from $10m to $50m with effect from 1 July 2020.

12 Ibid.

13 Turnover threshold increased from $10m to $50m with effect from 1 April 2021.

14 Turnover threshold increased from $10m to $50m with effect from 1 July 2021.

15 Ibid.

16 Ibid.

17 Ibid.

18 Ibid.

19 These two measures are not strictly SBE measures, but they rely on the same meaning of aggregated turnover that applies to SBEs.

20 Peter Costello, "The new business tax system", media release no. 058, 21 September 1999. Available at www.petercostello.com.au/press/1999/2176-the-new-business-tax-system.

21 S 152-15 ITAA97.

22 An additional alternative condition is available in s 152-10(1A) and (1B) ITAA97 which deal with passively held assets.

23 S 152-40 ITAA97.

24 S 328-130 ITAA97.

25 S 328-125 ITAA97.

26 S 328-125(1) ITAA97.

27 S 328-125(2)(b) ITAA97.

28 S 152-40 ITAA97.

29 S 152-35 ITAA97.

30 The active asset test does not include the annual turnovers or net asset values of affiliates of the taxpayer and entities connected with the taxpayer. Instead this test permits an asset owned by a taxpayer to be active where it is used in a business carried on by an affiliate of the taxpayer or an entity connected with the taxpayer.

31 For example, the changes made to the eligibility conditions in s 152-10 ITAA97 where a CGT event happens to a share in a company or an interest in a trust on or after 8 February 2018.

32 See P Kenny, "The 1999 review of business taxation: should we fast track small business tax reform?", (2008) 18(1) *Revenue Law Journal* (available at http://classic.austlii.edu.au/au/journals/RevenueLawJl/2008/6.pdf); C Coleman and C Evans, "Tax compliance issues for small business in Australia", in N Warren (ed), *Taxing small business: developing good tax policies for SMEs*, Australian Tax Research Foundation, 2003, pp. 147-181; C Evans, "Studying the studies: an overview of recent research into taxation operating costs" (2003) 1(1) *eJournal of Tax Research* 64-92 (available at http://www5.austlii.edu.au/au/journals/eJlTaxR/2003/4.html).

33 K Sadiq and S Marsden, "The small business CGT concessions: evidence from the perspective of the tax practitioner", (2015) 24(1) *Revenue Law Journal* 11 (available at http://classic.austlii.edu.au/au/journals/RevenueLawJl/2014/1.pdf).

34 Ibid, p. 13.

35 Ibid.

36 Ibid, p. 14.

37 Board of Taxation's 2019 review, p. vii.

38 Contained in Sch 7 to the *Treasury Laws Amendment (A Tax Plan for the COVID-19 Economic Recovery) Act 2020* which was enacted on 14 October 2020 as Act No. 92 of 2020.

39 Amended by Sch 1 to the *Treasury Laws Amendment (2020 Measures No. 6) Act 2020* which was enacted on 17 December 2020 as Act No. 141 of 2020.

40 Board of Taxation's 2019 review, p. 65 at para 5.86.

41 K Sadiq and S Marsden, "The small business CGT concessions: evidence from the perspective of the tax practitioner", (2015) 24(1) *Revenue Law Journal* 15. Note that the reference to 'connected entities and associates' here means entities connected with the taxpayer and affiliates of the taxpayer.

42 This provision explains how to calculate the direct *small business participation percentage* which primarily determines whether the significant individual test is satisfied.

43 *Treasury Laws Amendment (Tax Integrity and Other Measures) Act 2018.*

44 *Eichmann v FCT* [2020] FCAFC 155.

45 Detailed eligibility rules in respect of the date the asset was first acquired or held ready for use, and the date the asset was first used or installed ready for use, apply. These detailed rules are not reproduced here. The dates indicated in Table 4 are broadly the dates of application of the measure.

46 The SBE aggregated turnover threshold increased from $2m to $10m on 1 July 2016.

47 The SBE aggregated turnover threshold increased from $2m to $10m on 1 July 2016.

48 Board of Taxation's 2019 review, p. 36 at para 4.45.

49 Ibid.

50 Ibid, p. 37 at para 4.47.

51 S 135C FBTAA.

52 Subdiv 328-G ITAA97.

53 Board of Taxation's 2019 review, p. viii.

54 S 328-435 ITAA97.

55 In the 2021–22 Federal Budget, the government announced that it is proposing to remove the cessation of employment taxing point for tax deferred employee share schemes which will result in tax being deferred until the earliest of the remaining taxing points: in the case of shares, when there is no risk of forfeiture and no restrictions on disposal; in the case of options, when the employee exercises the option and there is no risk of forfeiting the resulting share and no restrictions on disposal; the maximum period of deferral of 15 years. The change to the cessation of employment taxing point will apply to employee share scheme interests issued on or after 1 July following royal assent. These proposed changes do not address most of the issues raised in this section.

56 S 83A-20 ITAA97.

57 S 83A-33 ITAA97.

58 The amendments were made by the *Treasury Laws Amendment (A Tax Plan for the COVID-19 Economic Recovery) Act 2020*, which received royal assent on 14 October 2020 as Act No. 92 of 2020.

59 Chapter 3 of the *Case for Change* paper was published in the November issue of *Taxation in Australia*. Available at https://dashboard.taxinstitute.com.au/portal/membership/taxation-in-australia.

60 This arises because the payment of PAYG instalments is not triggered until an income tax return is lodged. The income tax payable on the income from the first year of operation is payable on lodgment of the income tax return in addition to PAYG instalments which also become payable for the first time. Essentially, two years' worth of taxes are payable within a 12-month period.

61 Ss 82KZMA(2) and 82KZMD ITAA36.

62 Div 122 ITAA97, and noting that this roll-over is not limited to small business.

63 Div 122 ITAA97, and noting that this roll-over is not limited to small business.

64 Subdiv 328-G ITAA97.

65 Div 615 ITAA97.

66 S 135C FBTAA.

67 Subdiv 328-G ITAA97.

68 Div 152 ITAA97.

69 Former s 160ZZR ITAA36 (no longer in force).

70 S 108-5(2)(b) ITAA97.

71 Div 152 ITAA97.

72 Consistent with the recently indexed transfer balance cap.

73 The current interaction between the small business CGT concessions and s 292-100 ITAA97 is awkward and needs a rethink.

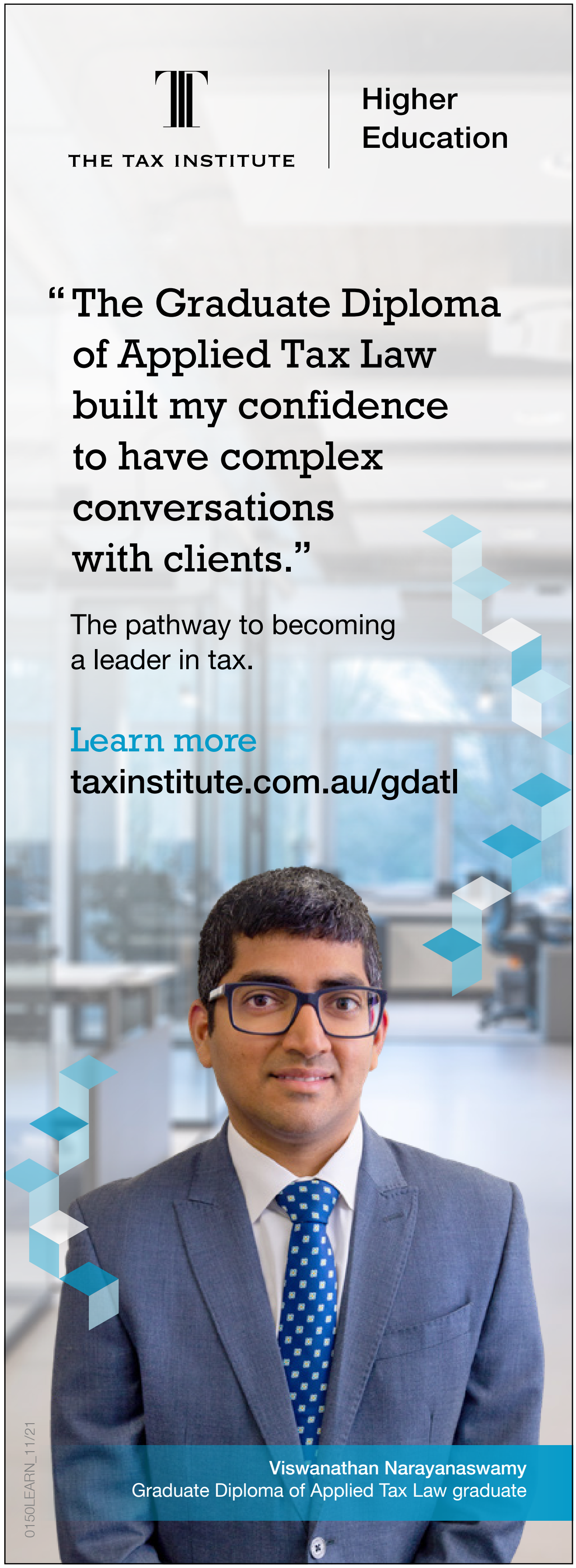
74 Subdiv 152-D ITAA97.

75 S 103-25 ITAA97.

76 [2009] AATA 297.

77 Department of Industry, Innovation and Science, Australian Government, *Small Business Digital Taskforce – report to government*, Canberra, March 2018. Available at https://treasury.gov.au/sites/default/files/2021-07/p2018-191027-sbdt-report.pdf.

78 Australian Government, *Government response to the Small Business Digital Taskforce*, Canberra, December 2018. Available at https://www.industry.gov.au/sites/default/files/2018-12/government-response-to-the-small-business-digital-taskforce.pdf.



Undeclared foreign income: the "stick" approach

by Amanda Kazacos, Senior Associate, and Jerome Tse, CTA, Partner, King & Wood Mallesons

Over the course of almost a decade, the ATO has been consistently focused on ensuring that foreign income of Australian residents is taxed correctly in Australia. TA 2021/2 is the latest initiative by the ATO in its focus on ensuring that Australian residents are assessed for tax on all of their worldwide income. TA 2021/2 highlights the ATO's concerns with certain arrangements where Australian resident taxpayers derive income or capital gains (foreign assessable income) offshore, but fail to declare the foreign assessable income in their Australian income tax returns due to the characterisation of the funds as a "gift" or "loan" from a related overseas entity. It is essential that taxpayers obtain sufficient evidence to prove that their loan or gift is genuine or they should seek professional advice.

Over the course of almost a decade, the ATO has been consistently focused on ensuring that foreign income of Australian residents is taxed correctly in Australia. This can be seen from as early as the launch of "Project DO IT" in 2014, to the introduction of the common reporting standard for the automatic exchange of financial account information, through to the ATO's "Tax Avoidance Taskforce" launched in 2019 (and in operation until the 2022-23 income year).

On 17 September 2021, the ATO released TA 2021/2 identifying the ATO's concerns with certain arrangements where Australian resident taxpayers derive income or capital gains (foreign assessable income) offshore, but fail to declare the foreign assessable income in their Australian income tax returns due to the characterisation of the funds as a "gift" or "loan" from a related overseas entity. TA 2021/2 is the latest initiative by the ATO in its focus on ensuring that Australian residents are assessed for tax on all of their worldwide income.

The importance of TA 2021/2 is that, while the ATO's focus on taxing foreign assessable income has remained unchanged, the motivational approach the ATO employs to ensure that foreign assessable income is taxed in Australia has changed. Namely, the ATO has moved from a "carrot" approach, being an incentives-based voluntary disclosure regime in Project DO IT, to a "stick" approach — a warning in the form of TA 2021/2 that arrangements of this nature could result in both taxpayers and their advisers facing "substantial penalties and [the] risk of potential sanctions under criminal law". The transition to the "stick" approach also aligns with the ATO's increased ability to source data to identify arrangements of this nature.

This combination of factors should cause taxpayers to pause and either ensure that they have enough documentation to substantiate the receipt of funds as a genuine gift or loan, or voluntarily disclose the arrangement to the ATO to minimise substantial penalties, interest and sanctions. The ATO's increased data collection and matching capabilities means that it is only a matter of time until the transaction is reviewed.

Key takeaways from TA 2021/2

The ATO has indicated that it will target arrangements that have some or all of the following common features:

- an Australian resident taxpayer deriving foreign assessable income that is not declared in their Australian income tax return (whether by deriving the foreign assessable income, attribution of the foreign assessable income, or otherwise);
- the foreign assessable income is repatriated by a related overseas entity to the taxpayer (or an associate of the taxpayer) in Australia (whether in a single instalment or multiple instalments);
- the true character of the foreign assessable income is concealed under the guise of a gift or loan;
- in the case of a purported loan used by the Australian resident taxpayer in gaining or producing assessable income, the taxpayer claims a deduction for interest on the purported loan, and while withholding tax is remitted, often no amount of interest or principal is ever repaid (interest is capitalised); and
- where the transaction is identified or audited, the Australian resident taxpayer concedes that they were disguised transfers to avoid laws in other countries (without evidence of this).

The ATO is not focused on arrangements where an Australian resident taxpayer has not derived any foreign assessable income but has received a genuine gift or genuine loan from a related overseas entity. A genuine gift or loan would be one where appropriate documentation supports the characterisation of the receipt as a gift or loan (as appropriate), the parties' behaviour is consistent with that characterisation, and the moneys provided are sourced from funds genuinely independent of the taxpayer.

The taxpayer's burden and the need for evidence

Where a taxpayer has received a gift or loan from a foreign related entity, the onus will be on the taxpayer to substantiate the position that this gift or loan (as appropriate) is a genuine gift or genuine loan and not an arrangement that will fall within TA 2021/2. The ATO has provided guidance[1] on examples of the types of appropriate documentation to evidence a genuine gift or genuine loan (see Table 1).

The authors acknowledge that the ATO's guidance requires taxpayers to obtain and retain extensive documentation. In their experience, it can be difficult to obtain the documents

Table 1. Appropriate documentation to evidence a genuine gift or loan

Evidence to support a genuine gift	Evidence to support a genuine loan
Contemporaneous declarations that the donor has made in their country of residence about the nature of the amounts transferred.	A properly documented loan agreement that details the terms of the loan (including the parties, term of the loan, interest rate payable, principal amount, and other conditions).
An executed contemporaneous deed of gift prepared by the donor (or other similar documentation).	Correspondence/documentation relating to the loan arrangement, including pre-contractual negotiations as to the terms and any variations made post-agreement.
Formal identification of the donor (such as a copy of their photo identification from their passport or identity card).	Documents to support the security provided or guarantees given in support of the loan.
A copy of the donor's bank statements showing the gift and the donor's capacity to make the gift from their own resources.	Facility arrangements governing the draw down and transmission of funds, as well as authorisation to access or draw down loan amounts.
A certified copy of the donor's will or distribution statement for the estate (to the extent that it relates to the distribution of the gift).	Financial records such as bank statements evidencing the terms of the loan (eg showing the advance of funds and subsequent repayments, including interest payments).
Financial records reflecting the donor's transfer to the taxpayer.	Financial and accounting records that show how the taxpayer used the amounts (eg journal entries, bank statements, receipts).
	Any declarations that the lender has made in their country of residence about the provision of the loan.
	Foreign bank account statements reflecting the transactions relating to the loan and the lender's ability to make the loan.
	Financial plans, cashflow forecasts, net assets position or budgets showing an intention or capacity to repay the loan.

mentioned above from entities in foreign jurisdictions for a number of reasons.

First, it is common for gifts or loans (even of substantial sums) between family members and/or related entities to lack documentation simply due to the relationships between the parties. While the greater the sum involved, the more likely the ATO will objectively consider documentation to be necessary, this is not always the case in practice. In these situations, the authors have suggested to taxpayers to consider other evidentiary sources by which a loan or gift can be substantiated. This might include taking witness statements overseas or providing sufficient comfort to the ATO of the source of those funds through financial records or by a review of less formal contemporaneous communications (emails, faxes and social media apps such as WhatsApp and WeChat). It may become the case that the various sources of information, individually or when viewed holistically, can provide sufficient evidentiary comfort to the ATO.

Second, such difficulties could be owing to the foreign entity, or sometimes even the Australian taxpayer, being unfamiliar with the necessity for the requested documentation to be provided to the ATO. Here, a patient explanation of the Australian tax system, including the reverse onus of proof, is required. Just as we in Australia sometimes misunderstand foreign laws when travelling, the same can apply when foreigners or those newer to Australia are being asked to apply our laws. Ultimately, an unwilling or resistant taxpayer (or foreign party) will only harm themselves, and our job as advisers is to address the root of such unwillingness or resistance so that we can achieve the best outcome possible.

Third, there may be a reluctance to hand over information because it will be provided to a government authority (ie the ATO). Among other reasons, this reluctance can stem from a mistrust of government generally, having regard to the lived experiences of the foreigner, or because, as the ATO states, the transaction is intended to "avoid laws in other countries". These are the most difficult discussions, as even genuine loans or gifts that lack corroborating evidence will result in the taxpayer failing to satisfy the evidentiary burden. In these situations, it is critically important to find an alternative means to identify the true source of the donor's or lender's funds.

Overall, while it is trite to say, it is in a taxpayer's best interests to ensure that, where they have a loan or gift arrangement of a substantial sum from an overseas party, appropriate contemporaneous documentation is prepared, obtained and retained.

ATO intelligence and data gathering

The ATO's movement from a "carrot" to a "stick" approach aligns with the ATO's increased capabilities to obtain data from domestic government agencies and overseas regulators, and then to process significant terabytes of data at astonishing speeds. In doing so, the ATO's data capabilities to identify potential arrangements of the nature described in TA 2021/2 should not be underestimated.

By way of example, the ATO and the Australian Transaction Reports and Analysis Centre have an agreement to share and compare financial information. Specific data-matching programs are also commonplace and the list of the ATO's current specific data-matching protocols can be found on its website.[2] In addition, specifically with respect to foreign information, Australia has entered into 36 tax information exchange agreements (including with Lichtenstein, Bermuda, The Cayman Islands, and The Bahamas) and, under the common reporting standard, the ATO has shared data on financial account information of foreign tax residents with over 65 foreign tax jurisdictions. It should be assumed that the ATO will exercise at least some of these powers in the course of auditing arrangements that are the subject of TA 2021/2. The increased information at the ATO's fingertips, combined with its focus on taxing foreign assessable income of Australian residents, means that the ATO is likely to identify and investigate arrangements that are the subject of TA 2021/2.

What should affected taxpayers consider?

Taxpayers that are potentially able to obtain sufficient evidence to prove that their loan or gift is genuine should seek professional advice and begin to do so immediately.

Taxpayers that cannot obtain evidence to discharge their burden of proof or have, to date, failed to declare foreign assessable income in their tax returns should very seriously consider obtaining professional advice and voluntarily disclosing arrangements of this nature to the ATO. As the ATO has outlined in TA 2021/2, such arrangements will result in both taxpayers and their advisers facing substantial penalties. Voluntary disclosures can significantly reduce the imposition of penalties of up to 90% of the tax liability. Additionally, where the ATO alleges fraud or evasion in its review of the arrangement, the time limit for the ATO to review the potential arrangement is unlimited. Again, a voluntary disclosure, on the basis that it is more and more likely that the ATO will become aware of the transaction, should be considered.

Finally, the tax issues around undeclared foreign assessable income received by an Australian resident can be incredibly complicated. They include not just a consideration of whether income is assessable under ordinary principles in Australia, but also (and not limited to), in the authors' experience, whether there should have been an application of Div 7A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36), the transfer pricing regime, the controlled foreign company regime, the transferor trust regime, or Pt IVA ITAA36. The ambit of potential tax issues that could arise, along with penalties and interest that often exceed the primary tax in dispute, mean that it is in a taxpayer's best interests to obtain advice quickly, and to get greater peace of mind in order to move forward with their business and personal lives.

Amanda Kazacos
Senior Associate
King & Wood Mallesons

Jerome Tse, CTA
Partner
King & Wood Mallesons

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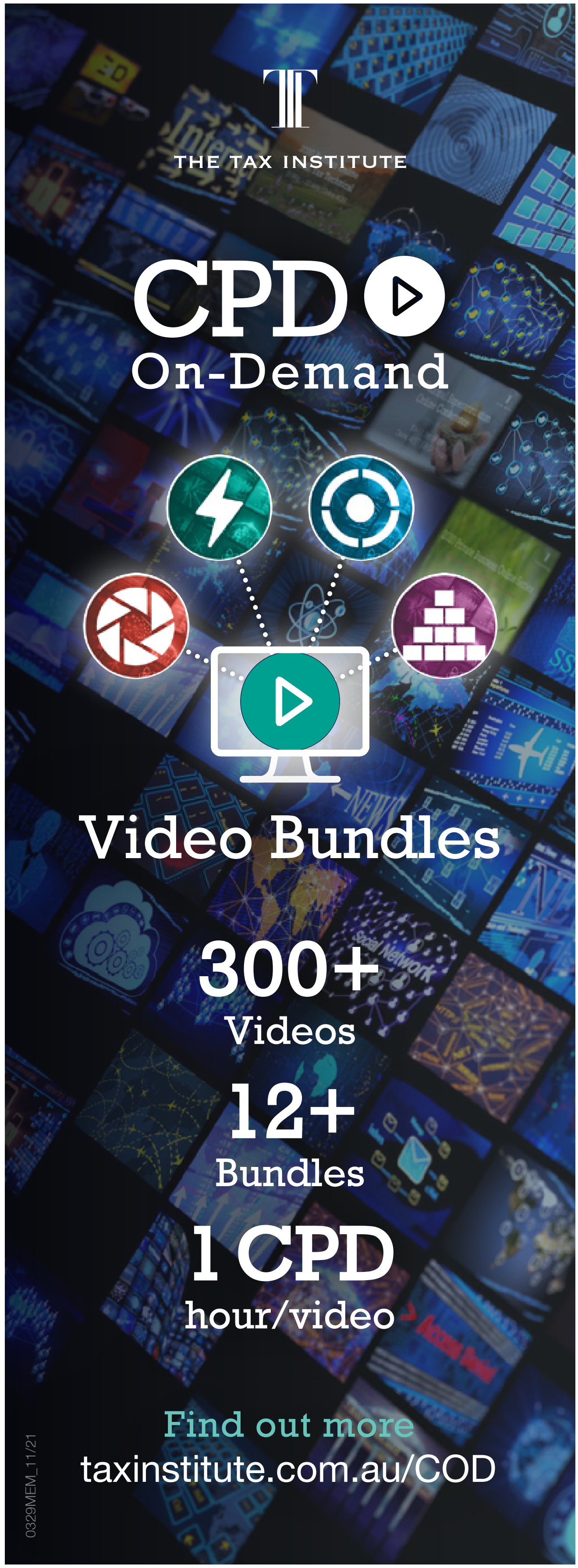

CCIVs: a more workable approach

by Serena Chow, Senior Associate, Baker & McKenzie

In the latest Federal Budget, the government announced that the corporate collective investment vehicle (CCIV) regime would be finalised with a revised commencement date of 1 July 2022. This proposed regulatory and tax framework, which was originally announced during the 2016-17 Federal Budget, is an initiative to increase the marketability of Australian managed funds by providing an investment vehicle that is internationally recognised and more familiar to foreign investors. This article discusses the latest exposure draft legislation released by Treasury which extends the current tax regime that governs attribution managed investment trusts to CCIVs, providing investors with the benefits of flow-through taxation.

Introduction

As foreshadowed in the 2021-22 Federal Budget, the Australian Government has released for public consultation revised draft legislation that implements the tax and regulatory components of the corporate collective investment vehicle (CCIV) regime and related explanatory materials. A CCIV is an investment vehicle with a corporate structure similar to comparable vehicles overseas. This regulatory and tax framework for a new type of collective investment vehicle is aimed at increasing the competitiveness of Australia's managed fund industry.

The proposed new law includes tax legislation which better aligns the tax treatment of CCIV sub-funds with the existing treatment of attribution managed investment trusts (AMITs), providing investors with the benefits of flow-through taxation.

Background

As part of the 2021-22 Federal Budget, the government announced that the CCIV regime would be finalised with a revised commencement date of 1 July 2022. This updated start date and revised tax framework will be welcomed by Australian fund managers. These measures were originally announced in the 2016-17 Federal Budget, where the Australian Government announced that it would introduce a tax and regulatory framework for two new types of collective investment vehicles (CIVs):

- a corporate CIV (CCIV); and
- a limited partnership CIV.

This announcement was in response to concerns raised by the Board of Taxation in a December 2011 report to the Assistant Treasurer[1] regarding lack of global competitiveness of the Australian managed funds industry due to tax complexity and lack of familiarity with the prevailing unit trust structure which is commonly used by Australian funds in the form of Australian managed investment schemes (MISs).

The key policy objective is to increase the competitiveness of Australia's managed fund industry through the introduction of internationally recognisable investment structures which are a viable alternative to an Australian managed investment trust.

The CCIV tax regime has been designed to align with the existing AMIT regime, such that the tax outcomes for an investor in a CCIV sub-fund are intended to be the same as an investor in an AMIT. To achieve this outcome, the CCIV tax regime uses the same attribution flow-through tax regime that applies to AMITs. To gain access to the AMIT regime, sub-funds of a CCIV are subject to the AMIT eligibility criteria, with certain modifications.

The last exposure draft legislation was released in early 2019. The latest exposure draft addresses two features of the 2019 exposure draft which drew considerable criticism. First, there has been a change in tax policy where a CCIV sub-fund fails to meet the AMIT eligibility requirements. In the 2019 exposure draft, a non-complying sub-fund was to be taxed as a company that was not a franking entity, and therefore would not be able to distribute franking credits to members. This resulted in a risk of ongoing double taxation, given the investment income may be taxed at both the sub-fund and investor level. In contrast, a trust which no longer qualifies as an AMIT may continue to be treated as a pass through (or, if it is taxed as a company, may frank distributions to members). This meant that, under the 2019 exposure draft, non-complying CCIVs would not be on an equal playing field compared to non-complying AMITs for tax purposes. It undermined the potential attractiveness of a CCIV as the sub-fund may not comply with the AMIT requirements due to factors that are out of its control (eg the widely held requirement). In the latest exposure draft, a non-complying sub-fund will now be taken to be treated as a trust, thus aligning with the tax treatment of trust investment vehicles.

Second, the current draft does not contain the 2019 proposal to introduce an administrative penalty in respect of understatements and overstatements of tax amounts attributed to investors (these errors are commonly referred to as "unders and overs") that arise as a result of a trustee's failure to take reasonable care. This proposal drew heavy criticism from stakeholders in the last draft.

Submissions relating to the exposure draft legislation closed on 24 September 2021.

What is a CCIV?

Under the CCIV regulatory framework to be contained in Ch 8B of the *Corporations Act 2001* (Cth):

- a CCIV is a new type of company that is limited by shares and has as its director a public company with an Australian financial services licence authorising it to operate the business and conduct the affairs of the CCIV;

- a CCIV is structured as an umbrella vehicle or fund incorporating one or more sub-funds. The CCIV, and each sub-fund of the CCIV, must have at least one member; and
- the business of a CCIV must be conducted through one or more sub-funds (that is, a CCIV must have at least one sub-fund). A person is a member of a sub-fund if the person is a member of a CCIV and holds one or more shares that are referable to that sub-fund.

Under the *Corporations Act 2001*:

- a sub-fund is established on registration by ASIC and is identifiable by its unique name and Australian registered fund number;
- each security that is issued by a CCIV must be referable to one (and only one) sub-fund;
- there is a requirement for strict segregation of the business of each sub-fund of a CCIV. All of the assets and liabilities making up the business of the CCIV must be allocated to a sub-fund. The assets and liabilities referable to a sub-fund are strictly segregated from the assets and liabilities referable to other sub-funds of the CCIV; and
- as a company with legal personality, the CCIV is the legal entity which owns all of the assets, owes all of the liabilities, and carries on the business of each sub-fund. A sub-fund does not have legal personality.

> *"... the tax outcomes for an investor in a CCIV sub-fund are intended to be the same as those for an investor in an AMIT."*

Tax framework: new Subdiv 195-C

A new Subdiv 195-C will be introduced into the *Income Tax Assessment Act 1997* (Cth) that effectively:

- deems each sub-fund of a CCIV to be a unit trust (CCIV sub-fund trust);
- deems a beneficiary to have a fixed entitlement to income and capital of the CCIV sub-fund trust; and
- deems a beneficiary to have a present entitlement to a share of income of the CCIV sub-fund trust.

Deemed unit trust

Although a CCIV is a company registered under the *Corporations Act 2001*, for tax purposes, a trust relationship is deemed to exist between a CCIV, the business, assets and liabilities referable to a sub-fund, and the relevant class of members, for the purposes of all taxation laws (unless specifically excluded).

As a result of this deeming provision:

- the assets, liabilities and business referable to a sub-fund are treated as separate trusts and therefore each of the sub-funds will be treated as separate entities;
- the CCIV is treated as the trustee of the CCIV sub-fund trust; and
- the members of the CCIV are treated as beneficiaries of the CCIV sub-fund trust.

As a result of the deeming principle, the tax laws and tax attributes apply to a CCIV sub-fund trust, rather than the CCIV as a company. This sub-fund segregation approach will also extend to the dealings by a sub-fund of a CCIV with a third party and the Commissioner. For example:

- the requirements to have a separate Australian business number and a tax file number apply in relation to each CCIV sub-fund trust;
- a CCIV should be treated as a trust for the purposes of applying the associate test in s 318 of the *Income Tax Assessment Act 1936* (Cth) (ITAA36);
- the trust loss provisions apply to the sub-funds rather than the company loss utilisation provisions;
- other entities (that is, third parties) dealing with a CCIV may need to recognise the trust tax treatment of the CCIV sub-fund trust for the purposes of the taxation laws;
- dealings between sub-funds of a CCIV should be recognised for the purposes of the taxation laws (this is to be contrasted with an AMIT where asset transfers between classes are not recognised for tax purposes unless the trustee makes a multiclass election); and
- a CCIV sub-fund trust is an entity as prescribed in the *A New Tax System (Goods and Services Tax) Act 1999* (Cth). Therefore, to determine whether a CCIV is required to be registered for GST in relation to a particular CCIV sub-fund trust, the CCIV would need to separately ascertain if that CCIV sub-fund trust is carrying on an enterprise and its GST turnover.

Under the latest exposure draft legislation, this deeming principle will have effect for the purposes of the *International Tax Agreements Act 1953* (Cth), and therefore any double tax agreements that Australia has entered into. As such, Australia's double tax agreements will apply to, or in respect of, the CCIV sub-fund trust, the CCIV as trustee, and the members of the CCIV as beneficiaries of each CCIV sub-fund trust, despite the legal form of a CCIV, its shareholders or any of the distributions made.

As each sub-fund is treated as a unit trust, the public trading trust rules may apply where the relevant requirements are satisfied. The shares referable to the sub-fund are taken to be the units in the sub-fund trust. The rights, obligations and characteristics referable to a unit in the sub-fund trust is taken to be the same as the rights, obligations and characteristics attaching to the share that is taken to be that unit. Therefore, if the shares are listed, this will be relevant to whether the widely held requirement in the AMIT provisions or public trading trust provisions are satisfied.

Application of AMIT rules to CCIV sub-fund trust

The CCIV tax regime has been designed to broadly align with the existing tax regime for AMITs, such that the tax outcomes for an investor in a CCIV sub-fund are intended to be the same as those for an investor in an AMIT. To achieve this outcome, the CCIV tax regime uses the same attribution flow-through tax regime that applies to AMITs. To gain access to the AMIT regime, sub-funds of a CCIV are subject to the AMIT eligibility criteria, with modifications to reflect the sub-fund and corporate structure of a CCIV.

Broadly, in order for the CCIV sub-fund trust to qualify as an MIT and an AMIT, it must satisfy the following requirements:

- the trustee (ie the CCIV) is an Australian resident during the income year or the central management and control of the sub-fund trust was in Australia;
- the sub-fund trust does not carry on or control a trading business in relation to an income year (ie it is limited to carrying on passive income activities);
- the sub-fund trust is being used for collective investment by pooling the contributions of the members of the sub-fund; and
- the sub-fund trust satisfies the widely held requirements and closely held restrictions in relation to the income year.

Modifications to the AMIT rules include:

- a CCIV sub-fund trust does not need to be an MIS as defined in the *Corporations Act 2001*;
- the law makes modifications in relation to the widely held requirements to essentially replicate the existing test but remove the MIS requirement;
- a CCIV does not have to satisfy the clearly defined rights requirement. This is because a CCIV, by virtue of satisfying the regulatory requirements under the *Corporations Act 2001*, will have clearly defined rights; and
- the AMIT provisions will automatically apply to a CCIV sub-fund trust that meets the AMIT requirements. This is to be contrasted with a trustee of a managed investment trust which has the choice of whether to elect to apply the AMIT provisions to the trust.

A comparison of the AMIT and CCIV sub-trust requirements is summarised in Table 1.

However, if a CCIV sub-fund fails the AMIT requirements due to temporary circumstances that are outside the control of the CCIV, the CCIV sub-fund can continue to be treated as an AMIT in relation to the income year if it is fair and reasonable to do so. This is consistent with the current approach for AMITs.

The consequences of qualifying as an AMIT include:

- **flow-through tax treatment:** the sub-fund trust will receive "flow-through" tax treatment (ie investors will generally be taxed as if they had invested directly in the underlying assets);
- **attribution taxation:** investors will be taxed based on the amounts of assessable income, exempt income, non-assessable non-exempt income, and tax offsets of the CCIV sub-fund trust attributed to investors as disclosed in a distribution statement provided by the CCIV sub-fund trust. These amounts will retain their tax character when attributed to the investor (ie a character flow-through treatment). This ensures that distributions from a CCIV sub-fund trust will not be treated as a dividend for treaty purposes (unless the underlying character of the income is a dividend);
- **unders and overs regime:** any errors at the CCIV sub-fund trust level between the amounts actually attributed to investors for an earlier income year and the amounts that should have been attributed (referred to as "unders" and "overs") may be dealt with in the income year in which the errors are discovered (rather than requiring investors to amend prior year assessments);
- **cost base adjustments:** the tax cost of shares in the CCIV sub-fund trust should be adjusted (upwards or

Table 1. Comparison of the AMIT and CCIV sub-trust requirements

Requirement	AMIT	CCIV sub-fund trust
Type of entity?	A trust which is an MIS (as defined in the *Corporations Act 2001*)	A sub-fund which is being used for collective investment by pooling the contributions of the members of the sub-fund as consideration to acquire rights to benefits produced from those contributions
Australian trustee or central management and control requirement?	✓	✓
Clearly defined rights of investors to income and capital of the entity?	✓	N/A
Widely held and closely held requirements?	✓ To be satisfied by trust	✓ To be satisfied by the CCIV sub-fund trust
Active trading business restriction requirement?	✓ To be satisfied by trust	✓ To be satisfied by the CCIV sub-fund trust
Registration requirement?	✓	✗
Licensing requirement?	✓	✗
Elect into attribution regime?	✓	✗ It is automatic
Multi-class election available?	✓	✗

downwards, as applicable) to reflect any differences between the amounts received by the investor and the amounts attributed to the investor by the CCIV sub-fund trust during an income year;

- **capital election:** the CCIV sub-fund trust may elect to treat certain assets of the entity (ie shares, non-share equity interests, units in a unit trust, land or rights or options to acquire such assets to the extent that such assets are not dealt with under the taxation of financial arrangement provisions) on capital account under the CGT provisions (rather than on revenue account); and
- **MIT withholding tax:** foreign investors located in a jurisdiction with which Australia has effective exchange of information arrangements on tax matters, will be subject to a concessional withholding tax of 15% or 30% for non-concessional MIT income on income attributed to them (other than dividends, interest and royalties) provided a substantial proportion of the investment management activities carried out in relation to all Australian assets of each CCIV sub-fund trust is carried out in Australia. Non-concessional MIT income includes MIT cross staple arrangement income, MIT trading trust income, MIT agricultural income, and MIT residential housing income.

In addition, CCIVs and CCIV sub-fund trusts cannot be members of a tax consolidated group. This reflects the fact that CCIVs are intended to be a collective investment vehicle that is not intended to engage in active trading business

Consequences of not qualifying as an AMIT

Where a CCIV sub-fund trust fails to meet the AMIT eligibility criteria, it will either be:

- taxed in accordance with general trust provisions in Div 6 ITAA36; or
- taxed as a company under the public trading trust provisions in Div 6C ITAA36 (if it carries on or controls a trading business in a relevant income year).

In contrast to the position in the 2019 exposure draft legislation, a CCIV sub-fund that is taxable as a company under the public trading trust provisions should be eligible to frank distributions to members of the CCIV.

Final thoughts

The latest exposure draft legislation is a significant improvement on the 2019 version. However, a notable absence from the latest exposure draft (which was previously contained in the 2019 draft) is a restructure roll-over provision for existing MITs that are transitioned into a CCIV sub-fund trust structure. The 2019 draft legislation roll-over provisions were improved from the 2017 version and were extended to include not only the CGT consequences, but also revenue assets and tax losses. It will be important that these roll-over provisions also address the potential stamp duty implications of transitioning into a CCIV sub-fund trust. While the latest explanatory memorandum made no mention of this restructure roll-over provision, it would seem to be an important provision to include to ensure that an existing AMIT may convert to a CCIV sub-fund trust in order to attract more capital. It is assumed that this will make its way into the exposure draft legislation before the commencement date.

It will be important that any roll-over mechanism does not result in a material tax or stamp duty consequence for the trust and investors.

It is unclear from the latest exposure draft whether the Australian Government intends to introduce a limited partnership CIV in the future as was originally proposed in the 2016-17 Federal Budget.

Overall, the revised exposure draft tax legislation represents a move in the right direction to establishing a CIV which is a viable alternative to a trust-based MIS. The amendments to the revised draft contain a number of positive changes, in particular, the treatment of non-complying CCIV sub-funds as tax flow-through trusts which overcomes a major tax hurdle to the successful implementation of the CCIV. The policy intent of increasing international competitiveness of the Australian funds industry appears to be much more achievable in light of the revised exposure draft legislation.

Serena Chow
Senior Associate
Baker & McKenzie

Note: On 25 November 2021 (shortly after this article was finalised for publication), a Bill containing the tax and regulatory frameworks for CCIVs, the Corporate Collective Investment Vehicle Framework and Other Measures Bill 2021, was introduced into the House of Representatives. This article does not contain an analysis of this new Bill.

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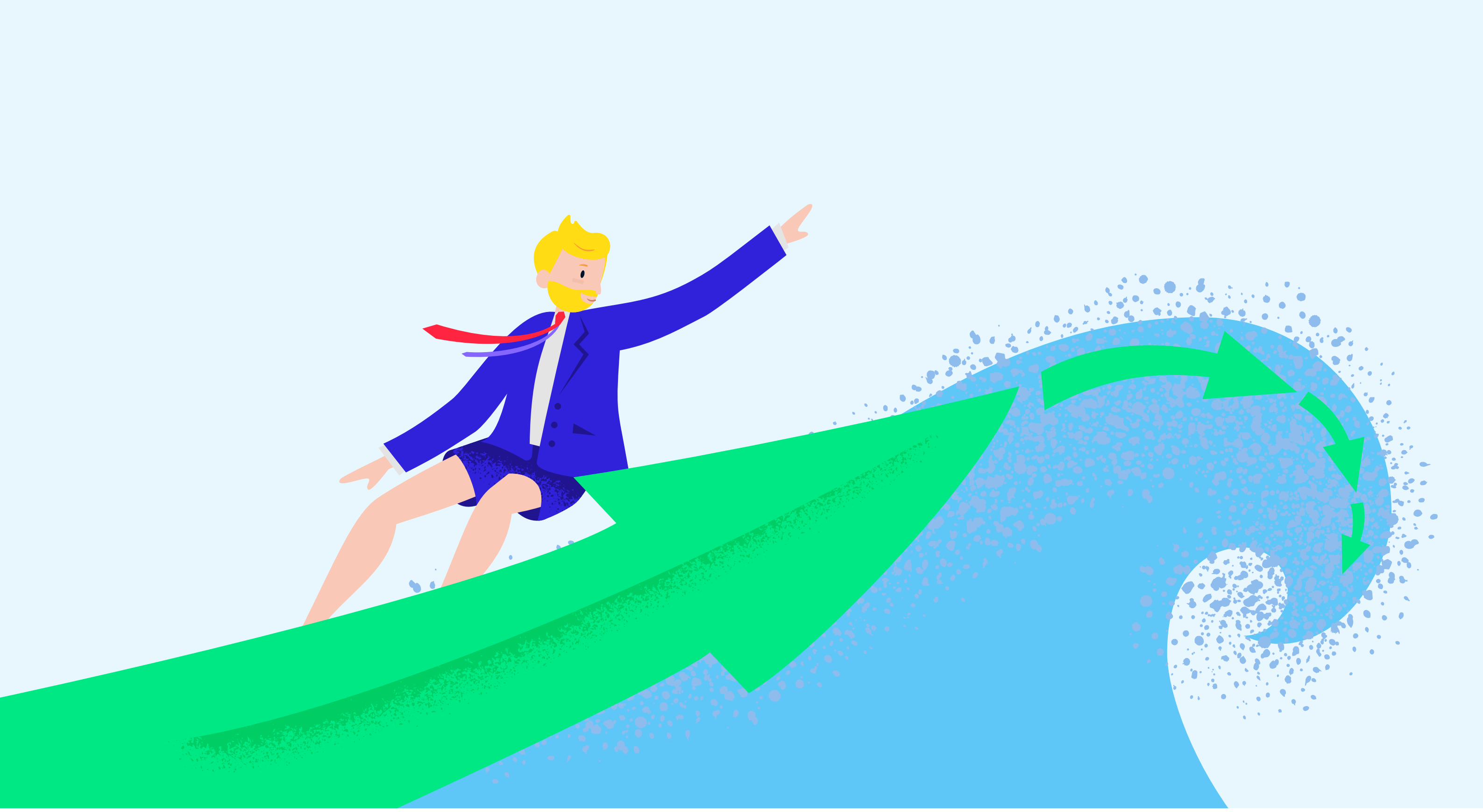

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Public benevolent institution "relief" via advocacy

by Ian Murray, Associate Professor, University of Western Australia

The recent decision of *Global Citizen Ltd and Commissioner of the ACNC* demonstrates that an entity can be a public benevolent institution (PBI) that relieves poverty, even if the means of achieving this is through education, advocacy and lobbying. It therefore builds on the earlier *FCT v Hunger Project Australia* case in explaining the ways in which PBIs can indirectly relieve need. Despite being an AAT decision, the case is likely to be highly influential as it is the first decision centred on PBI advocacy, the tribunal members are very experienced in the area, and the Australian Charities and Not-for-profits Commission has not appealed.

Introduction

In the civil society sector, one of the most generous packages of tax concessions is available to public benevolent institutions (PBIs), that is, institutions that are "organized or conducted for, or promot[e] the relief of poverty or distress" and that "conduc[t themselves] in a public way towards those in need of benevolence, however that exercise of benevolence may be manifested".[1] This helps explain why PBIs are the most common type (there over 10,500) of deductible gift recipient (DGR),[2] with PBIs also able to provide exempt fringe benefits to employees, up to a fairly generous cap.[3] As PBIs are typically viewed as a subset of charities, they would commonly also be able to access the range of concessions available to charities, such as income tax exemption[4] and a range of state/territory tax concessions for land tax, payroll tax, rates and duties, some of which are also directed specifically to PBIs.[5] The fiscal cost of this basket of concessions is likely to be large, with the FBT exemption for PBIs estimated as $1.9b for 2020-21 and the DGR concession being $1.3b for the same period, with PBIs comprising one-third of all DGRs.[2]

While there is no universal agreement over the basis for charity tax concessions, such as those for PBIs,[6] the commonly accepted rationale is that they are intended to subsidise the "positive externalities" of charities. These positive externalities encompass the public benefits from inducing charities to produce goods and services such as health care, education and welfare, and also the process benefits from the manner in which charities operate, such as the promotion of civic participation, pluralism or altruism.[7] It is this expectation of public benefit — often focused on the production of goods and services, rather than the process benefits — which causes disquiet when PBIs adopt indirect means to achieve their social welfare purposes. *Global Citizen Ltd and Commissioner of the ACNC*[8] exemplifies this disquiet and, although an AAT decision, raises material ramifications for the sector.

Case overview

Global Citizen Ltd (GCL) is an Australian company limited by guarantee, whose sole member is a United States corporation, Global Poverty Project Inc — itself a public charity. GCL is registered as a charity by the Australian Charities and Not-for-profits Commission (ACNC) and pursues the relief of global poverty by indirect means of education, advocacy, lobbying, and coordination with a global network of affiliated entities with similar purposes, to "convince governments and major philanthropists to provide [this] relief".[9] GCL described this approach as involving the following model:[10]

"– Element 1: informing and encouraging people to learn about the Global Goals [being the UN sustainable development goals] and equipping them with the knowledge and inspiration to achieve them.
– Element 2: encouraging people to take action to achieve the Global Goals, in particular but without limitation, by applying pressure to world leaders to make commitments to achieve the Global Goals to end world poverty'.
– Element 3: communicating, including by way of in person meetings, with parliamentarians and world leaders to advocate for commitments towards the achievement of the Global Goals.
– Element 4: combining the efforts of engaged individuals and Global Citizen's partners to secure commitments from world leaders in pursuit of the Global Goals.
– Element 5: tracking the commitments of world leaders to hold them accountable and also to ensure that Global Citizen, though its Model, is continuing to pursue its purpose of poverty relief."

GCL also provided evidence of its activities, particularly in relation to three campaigns, being campaigns for the eradication of polio, childhood vaccination against debilitating diseases, and the fight against AIDS, tuberculosis and malaria. Each of these campaigns was linked to large aid commitments by the Australian Government, and GCL received letters from government sources and partner organisations acknowledging GCL's role in achieving these commitments.

In 2018, GCL applied to the Commissioner of the ACNC, being the relevant regulator at the federal level, for a change in GCL's charity registration from a purpose of advancing education to the charity subtype of PBI, with a view to subsequent endorsement by the ATO as a DGR. It is worth noting here that, despite the global nature of its activities, GCL would likely satisfy the "in Australia" requirement that applies to most DGRs. That is because the ATO now accepts that an institution is in Australia if it is "established or legally recognised in Australia" (eg registered under the *Corporations Act 2001* (Cth)) and "makes its operational or strategic decisions mainly in Australia".[11] It does not matter that the people who will benefit from the elimination of global poverty are largely overseas.

The ACNC rejected GCL's PBI registration application on the bases that:

- GCL had a separate purpose (from the relief of poverty) of education and/or advocacy; and
- GCL did not provide relief to those in need.

In contrast, the two-member AAT panel determined that GCL's purpose was the relief of poverty and that it did relieve poverty through its activities; thus it was a PBI. Key to this outcome was a wholehearted application of the 2014 Full Federal Court decision of *FCT v Hunger Project Australia*.[12] Since *Hunger Project*, it has been clear that the meaning of PBI is in a state of flux, yet some other more recent decisions have, with respect, appeared a little lukewarm in their acceptance of the significance of *Hunger Project*.[13] The sector should therefore welcome the approach in *Global Citizen*. Of course, the factual similarities probably also helped in *Global Citizen*, which involved a global network conducting education, advocacy and lobbying to relieve poverty, whereas in *Hunger Project* a global network raised money in wealthy countries and sent it to affiliated organisations in developing countries to fund poverty relief projects.

We now turn to examine the AAT's reasoning on the two issues raised by the ACNC because, if adopted more broadly, that reasoning has material ramifications for the charity sector.

GCL's purpose

In line with the approach in *FCT v Word Investments Ltd*,[14] to determine "purpose" the AAT looked to GCL's constitution and its activities. Although it did not expressly state that it was doing so, the AAT did also look — as suggested in *Word Investments* — at GCL's circumstances of formation.[15] While activities play a role in determining purposes, the tribunal was highly attuned to the need to avoid characterising groups of activities as purposes, without more:[16]

> "The difference between purposes and activities is not always clear. A purpose or object is something that one strives toward or the reason that something exists. The Macquarie Dictionary defines purpose as 'the object for which anything exists or is done, made, used, etc; an intended or desired result; end or aim'. An activity is defined as the state of action; or doing. In terms of a charity, an activity is what the entity actually does day-to-day and over time.
>
> We are satisfied the evidence of Ms Meredith, Mr Moss and Mr Sheldrick establishes the educational and advocacy activities of GCL are what GCL does to achieve its purpose of relieving poverty. In that sense, we are satisfied GCL has only one purpose — the relief of global poverty — and that it engages in educational and advocacy activities to achieve that purpose. This conclusion is consistent with the reasoning in *Word Investments.* As we have already explained, that case was concerned with charitable rather than benevolent purposes but it appears to warn against treating activities as purposes."

The tribunal's decision flowed from its ready ability to "match" GCL's education, advocacy and lobbying activities with the stated end of benevolent relief (especially of poverty) found in GCL's constitution. This was not a case where it could be said that the education, advocacy and lobbying activities were not a means to that end.

A secondary issue, which the AAT did not need to decide given its view on GCL's purpose, was whether a PBI is permitted to have a non-ancillary but subsidiary purpose, unlike a charity which must have exclusively charitable purposes, all other purposes being merely incidental or ancillary means to the achievement of that exclusive purpose. Despite not having to decide the issue, the tribunal clearly expressed a preference that a PBI can have a dominant purpose of benevolent relief, permitting non-dominant, non-ancillary independent purposes.[17] This is consistent with the ATO's historic view when it administered the meaning of PBI for federal tax purposes,[18] but is directly inconsistent with the ACNC's view in para 5.5.2 of CIS 2016/03 Commissioner's Interpretation Statement: Public Benevolent Institutions.

> *"Global Citizen is further demonstration that PBIs can carry out a range of indirect activities in pursuing a purpose of benevolent relief."*

Provision of relief

The AAT decision clearly endorses a broad interpretation of *Hunger Project* that an entity can effect relief indirectly and still be a PBI. It also acknowledges and gives a proper operation to the reasoning in *Australian Council for Overseas Aid v FCT*,[19] an earlier decision that recognised indirect relief by way of administrative support and coordination activities for other PBIs, along with education and lobbying. This whole-hearted endorsement was in part due to the tribunal's acceptance of the need for the meaning of PBI to remain contemporary.[20]

When endorsing the reasoning in these decisions, the AAT was at pains to stress the open-textured nature of the connection between indirect activities and ultimate relief, stating:[21]

> "… the cases do not suggest it is necessary to require proof of the link between the activities of the entity and the provision of relief. Nor are the cases prescriptive about the relationship between the relevant entities."

CIS 2016/03 and CIS 2013/01 Commissioner's Interpretation Statement: The Hunger Project Case may therefore need to be reviewed in order to consider whether the ACNC requirements of "clear mechanisms for delivering the benevolent relief" and "a relationship of collaboration or a common public purpose" are really requirements at all.

However, the tribunal was mindful that there is a spectrum of activities from those that directly effect relief to those that do so only indirectly. At some point, the connection will be so indirect that "it is not possible to say the entity is 'organised' for, or 'concerned in' or 'promoting' the relief of poverty etc".[22] Thus, while in *Global Citizen* the indirect activities took the form of advocacy, education and lobbying, the tribunal emphasised at several points that these activities were part of a holistic process to seek specific changes that would relieve poverty.[23]

The decision therefore clears up a number of points of controversy about "relief". Nevertheless, it does raise some further questions. First, the PBI cases arguably require a main *purpose* of relieving distress, such as poverty.[24] The AAT in *Global Citizen*[25] discusses the wording used in the seminal decision, *Perpetual Trustee Co Ltd v FCT*,[26] and the language used by Starke and Dixon JJ is strongly supportive of a purpose characterisation. The most recent enunciation of a PBI definition by the Full Federal Court in *Hunger Project* — set out at the start of this article — is also expressed in such terms. *Activities* are then relevant when considering the targeting requirement — that is, whether the PBI conducts itself toward those in need. However, the AAT in *Global Citizen* seems to consider "relief" in the context of GCL's activities.[27] And it is true, as identified by the AAT,[28] that a number of the PBI cases contain language that seems to fudge a purposes/activities distinction when it comes to relief. Thus, in *Maughan v FCT*, while McTiernan J talks about a PBI being "a body organized for the relief of poverty or distress",[29] Williams J notes that "[t]o sum up, the sources of the Association's finances are public benevolence, it is controlled by an executive elected upon a *quasi*-public basis, and its activities, which accord with and fulfil the main objects in the memorandum of association, are of a public benevolent nature".[30]

However, the problem with incorporating a requirement that *activities* relieve distress is that, once you accept that a PBI can indirectly relieve distress, you are compelled to look to the purpose of the indirect activity to determine whether it is aimed at relieving distress. Of course, the likely effect of an activity will be relevant to that characterisation,[31] but, in the author's opinion, it seems that it is essentially a question of the purpose behind the activity. If that is correct, it might be better to acknowledge this explicitly and to focus on whether there is a purpose of relieving distress.

Second, *Global Citizen* implies that "relief" activities (or, in the author's view, as identified above, a purpose of relief) can include prevention. Paragraphs 46 to 51 describe polio eradication and vaccination programs intended to prevent diseases (that can result in poverty), and paras 119 and 122 reference actions aimed at addressing the structural causes of poverty. Although "prevention" might not first come to mind within the common meaning of "relief", this is a welcome development and there are doctrinal bases for interpreting "relief" so as to include prevention.[32]

Ramifications

While AAT decisions are not strictly binding precedent, they do influence future decision-makers, and *Global Citizen* is a particularly persuasive decision for a number of reasons. Both AAT members are experienced tax academics, one of whom just wrote the Australian book on the taxation of charities. Further, GCL and the ACNC had experienced legal teams (each including a QC). In any event, in the absence of a test-case litigation funding program on the part of the ACNC, a recent federal court ruling denying a maximum costs order effectively pushes charities to the AAT rather than the Federal Court when challenging an objection decision,[33] so AAT determinations are likely to be key sources of illumination for some time. One would hope that the ACNC will view the decision in this way as relevant to its approach to administration more broadly.

Global Citizen is further demonstration that PBIs can carry out a range of indirect activities in pursuing a purpose of benevolent relief. It also suggests that those indirect activities can essentially focus (through education, advocacy and lobbying) on persuading wealthy individuals and governments to change their policies and/or provide funding to achieve that benevolent relief. This is likely to mean that the ACNC will need to water down the requirements in CIS 2016/03 about the need for indirect activities to be accompanied by "clear mechanisms for delivering the benevolent relief" and "a relationship of collaboration or a common public purpose". It would also require the ACNC to be clearer about the distinction between activities and purposes in that Commissioner's interpretation statement. Happily, the ACNC is currently reviewing CIS 2016/03, so there is a clear pathway for updates to be incorporated.

As the AAT panel members expressly recognised, the reasoning in *Global Citizen* also has potentially material ramifications for the politics/PBI boundary. As a matter of policy, we may question whether we want a subset of the charity sector to adopt the coercive and administrative methods of the state rather than relying on voluntary collective action. However, *Global Citizen* does not take us to the point where a political party is being recognised as a PBI and so this may well be undue angst. After all, GCL still engaged in voluntary collective action and relied on persuading others to employ coercive taxation and distribution of aid. The same anxiety would arise whenever any charity or civil society organisation seeks to persuade government to change law or policy, yet, as reflected in *Aid/Watch Incorporated v FCT*[34] and in the *Charities Act 2013* (Cth),[35] there is no rule against charities having a purpose of changing the law or policy (let alone the mere activities of so doing).

The AAT suggested that the key issue here was whether an entity was engaging in political activities for their own sake (ie a political purpose) or for the achievement of a benevolent purpose, and it left open the question of whether "mere advocacy for policy change" could amount to "relief".[36] One wonders how many charities would merely advocate and not also adopt a more holistic set of activities, including suggesting specific changes to government as was the case for GCL. The bigger question is how might a boundary line be drawn here? The decision contains suggestions, in reference to a spectrum of direct to indirect relief, that at some point it would "not [be] possible to say the entity is 'organised' for, or 'concerned in' or 'promoting' the relief of poverty". The AAT is essentially posing a purpose test here, but, in the author's opinion, this is not so helpful for drawing this boundary. That is because all of the activities are aimed at the same purpose — the relief of poverty — but with some more closely and some more distantly linked to that purpose. However, the PBI concept already contains its own limits that help police the politics/PBI boundary. That is because, to be a PBI, the organisation's activities must be sufficiently targeted to a purpose of providing benevolent relief. That is, the question is not about "relief" or about "purposes", but about the PBI targeting requirement.[37]

Additionally, *Global Citizen* indicates that the prevention of poverty, distress etc (eg the polio vaccination campaign) can evidence a purpose of relieving that poverty or distress. Again, this will require broadening of CIS 2016/03. And, while reviewing CIS 2016/03, the ACNC will also need to consider the tribunal's preference that a PBI can have a dominant purpose of benevolent relief, permitting non-dominant, non-ancillary independent purposes. In short, *Global Citizen* represents a material loosening of restrictions on PBIs.

Ian Murray
Associate Professor
University of Western Australia

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12 [2014] FCAFC 69.

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14 [2008] HCA 55.

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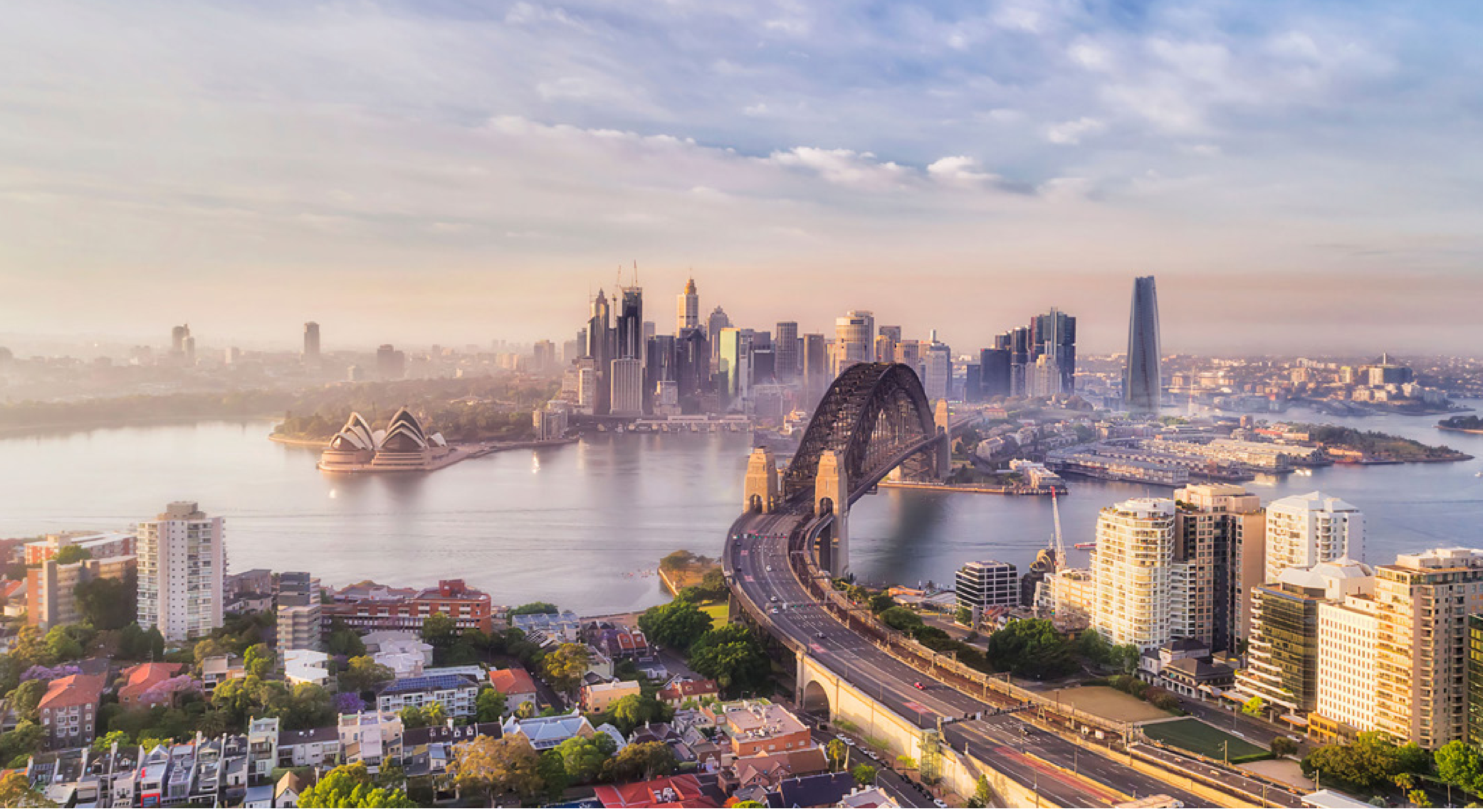

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Superannuation

by Shaun Backhaus and Daniel Butler, CTA, DBA Lawyers

NALI: history and overview

Non-arm's length income has recently become one of the hottest and most contentious topics in the superannuation industry, impacting both large superannuation funds and SMSFs.

Non-arm's length income (NALI) has recently become one of the hottest and most contentious topics in the superannuation industry, impacting both large Australian Prudential Regulation Authority (APRA) superannuation funds and SMSFs.

This is largely due to the finalisation of LCR 2021/2, which outlines the ATO's view of the application of the new non-arm's length expenditure (NALE) provisions. The ATO's interpretation regarding NALE, especially its view that a general fund expense has a sufficient nexus to all of a fund's ordinary and statutory income (including capital gains and concessional contributions), has given rise to a refocus on NALI and how NALE is linked to NALI.

While NALE is currently in the spotlight, advisers also need to be on top of the different heads of possible exposure under the NALI provisions. This article goes back to the basics of the NALI provisions and provides an overview of these provisions. Given the wide breadth of the ATO's views reflected in LCR 2021/2, every SMSF adviser should have a good understanding of NALI and NALE as these provisions can readily apply in many SMSF contexts. Failure to properly consider these aspects may result in an SMSF being taxed at 45% and leave advisers exposed to liability.

Current law and types of NALI

Broadly, there are four different types of NALI covered in s 295-550 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97). We will refer to these as:

- general NALI (includes NALE) (s 295-550(1));
- dividend NALI (s 295-550(2) and (3));
- non-fixed trust entitlement NALI (s 295-550(4)); and
- fixed trust entitlement NALI (s 295-550(5)).

Section 295-545 ITAA97 provides that the taxable income of an SMSF is split into a non-arm's length component and a low tax component. While the low tax component of a superannuation fund is subject to a 15% rate of tax (or zero on assets in pension or retirement phase), the non-arm's length component is subject to a 45% tax rate (s 26 of the *Income Tax Rates Act 1986* (Cth)).

Background to NALI

Former s 273 of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) was initially introduced to counter higher than arm's length dividends in private companies being paid to superannuation funds and to counter certain other non-arm's length transactions.

On 25 November 1997, the ITAA36 was expressly amended so that NALI caught certain trust distributions to superannuation funds. Insight into what strategies were developing in practice at the time were noted in *Allen (Trustee), in the matter of Allen's Asphalt Staff Superannuation Fund v FCT* (*Allen's*),[1] where the following extracts from the explanatory memorandum to the Superannuation Legislation Amendment Bill (No. 2) 1999 appear:

> "2.14 The ATO has become aware of arrangements which circumvent section 273. Under the arrangements, pre-tax income of a trust (usually a discretionary trust) is distributed to a complying superannuation fund set up for the benefit of the beneficiaries of that trust rather than to the beneficiaries themselves. The effect of the arrangements is that the income is taxed at only 15% as income of the superannuation fund rather than at the marginal rate of tax applicable to other beneficiaries.
>
> 2.15 It is doubtful whether subsection 273(4) of the ITAA 1936, which seeks to tax income derived by a superannuation entity from a non-arm's length transaction at the non-concessional rate of 47%, would catch these discretionary trust distributions."

Note that the rate applicable to NALI in late 1999 was 47%.

Former s 273 ITAA36 from 25 November 1997 largely remained unchanged until mid-2007 when it was replaced by s 295-550 ITAA97, which took effect on 1 July 2007. The mid-2007 superannuation reforms broadly resulted in Pt IX ITAA36 being replaced by Pt 3-30 ITAA97, and s 295-550 ITAA97 was largely a restatement of former s 273 ITAA36 in more modern language. As set out in TR 2006/7, to the extent that s 295-550 expresses the same ideas as s 273, the ruling is also taken apply to s 295-550.

Section 295-550 taxes trust distributions as NALI by reliance on much the same wording as in s 273(6) and (7) which are now reflected in s 295-550(4) and (5). However, s 295-550(1) from 1 July 2007 expressly covers statutory income (eg assessable capital gains and franking offsets), as well as ordinary income. It is interesting to note that s 295-550(4) and (5) still refer to "income" rather than "ordinary income" and "statutory income". (It is not clear if this was an oversight by the draftsperson or an intended outcome given that *Allen's* decision broadly held that "income" in s 273, being an anti-avoidance provision, included an assessable capital gain (ie statutory income).) Note that the decision in *Allen's* case was decided after the High Court's decision in *FCT v Bamford; Bamford v FCT*[2] which confirmed, broadly, that the term "the income of the trust estate" has "a content found in general law of trusts" (broadly, that "income" means "ordinary income" and not "statutory income").

In 2018, Treasury carried out a consultation process regarding changes to the NALI rules as part of the

Superannuation taxation integrity measures consultation paper. Treasury considered that the rules in place did not take into account fund expenditure incurred that would normally apply in a commercial transaction. The 2018 consultation paper and exposure draft legislation were aimed at assessing non-arm's length related-party limited recourse borrowing arrangements (LRBAs).

After an initial Bill lapsed in 2018, the Treasury Laws Amendment (2018 Superannuation Measures No. 1) Bill 2019 (2019 Bill) received royal assent on 2 October 2019. The 2019 Bill re-cast s 295-550(1) and (5) to expressly provide for arrangements where a superannuation fund trustee incurred no expenses or lower expenses than might have been expected had they been dealing at arm's length.

General NALI

Section 295-550(1) provides:

> "(1) An amount of ordinary income or statutory income is ***non-arm's length income*** of a complying superannuation entity if, as a result of a scheme the parties to which were not dealing with each other at arm's length in relation to the scheme, one or more of the following applies:
>
> (a) the amount of the income is more than the amount that the entity might have been expected to derive if those parties had been dealing with each other at arm's length in relation to the scheme;
>
> (b) in gaining or producing the income, the entity incurs a loss, outgoing or expenditure of an amount that is less than the amount of a loss, outgoing or expenditure that the entity might have been expected to incur if those parties had been dealing with each other at arm's length in relation to the scheme;
>
> (c) in gaining or producing the income, the entity does not incur a loss, outgoing or expenditure that the entity might have been expected to incur if those parties had been dealing with each other at arm's length in relation to the scheme.
>
> This subsection does not apply to an amount to which subsection (2) applies or an amount derived by the entity in the capacity of beneficiary of a trust."

The general NALI provisions are very broad and, importantly, are not concerned with the actual amount of the benefit obtained by an SMSF above what would have occurred had the parties been dealing at arm's length, but rather that the amount of income is higher (or expense lower). That is, the provisions do not take a proportional approach to the amount, but rather deem all income from the arrangement to be NALI.

The first step for the general NALI provisions to be applied is to determine whether a "scheme" exists.

The definition of "scheme" in s 995-1 ITAA97 is so broad as to provide little assistance. It provides:

> "'scheme' means:
>
> (a) any arrangement; or
>
> (b) any scheme, plan, proposal, action, course of action or course of conduct, whether unilateral or otherwise."

Based on this definition, in practice, it can usually be assumed that the SMSF trustee is a party to a scheme. At times, identifying what steps or actions form the relevant scheme and the parties to the scheme can be contentious.

The second step is to determine whether the parties to the scheme were dealing at arm's length. Section 995-1 ITAA97 provides the following as a definition of "arm's length":

> "'arm's length': in determining whether parties deal at arm's length consider any connection between them and any other relevant circumstance."

It has been said that this definition contains a direction about how to determine whether parties are dealing at arm's length rather than a definition or explanation of the expression (*The Trustee for MH Ghali Superannuation Fund and FCT* (*Ghali*)).[3]

A useful explanation of "arm's length" can be found in *Australian Prudential Regulation Authority v Derstepanian*:[4]

> "… a dealing that is carried out on commercial terms … a useful test to apply is whether a prudent person, acting with due regard to his or her own commercial interests, would have made such an investment."

Another explanation was provided in *Granby Pty Ltd v FCT*[5] as follows:

> "… the term 'at arm's length' means, at least, that the parties to a transaction have acted severally and independently in forming their bargain."

As noted above, in LCR 2021/2, the ATO view is that NALE that is a lower general fund expense taints all of a fund's ordinary and statutory income as NALI (see para 19). In contrast, the ATO's view is that, where NALE is incurred to acquire an asset (including associated financing costs), it will have a sufficient nexus to all ordinary or statutory income derived by the fund in respect of that asset (see para 18).

Paragraph 10 of PCG 2020/5 states that:

> "The ATO will not allocate compliance resources to determine whether the NALI provisions apply to a complying superannuation fund for the 2018-19, 2019-20, 2020-21 and 2021-22 income years where the fund incurred non-arm's length expenditure (as described in paragraphs 9 to 12 of LCR 2019/D3) of a general nature that has a sufficient nexus to all ordinary and/or statutory income derived by the fund in those respective income years (for example, non-arm's length expenditure on accounting services)."

The ATO proposes further administrative relief from 1 July 2022 in the Appendix to LCR 2021/2. Paragraph 92 states that, in the context of general expenses, the ATO's compliance resources will only be directed:

> "for an SMSF – toward ascertaining whether the parties have made a reasonable attempt to determine an arm's length expenditure amount for services provided to the fund, other than services provided by an individual either acting in the capacity as trustee of the SMSF or as a director of a body corporate that is a trustee of the fund,"

Clearly, the general NALI provisions are exceedingly broad and provide the ATO a wide opportunity to apply these provisions in a general anti-avoidance way.

Dividend NALI

Section 295-550(2) and (3) ITAA97 provides:

> "(2) An amount of ordinary income or statutory income is also ***non-arm's length income*** of the entity if it is:
>
> (a) a dividend paid to the entity by a private company; or
>
> (b) ordinary income or statutory income that is reasonably attributable to such a dividend;

unless the amount is consistent with an arm's length dealing.

(3) In deciding whether an amount is consistent with an arm's length dealing under subsection (2), have regard to:

(a) the value of shares in the company that are assets of the entity; and

(b) the cost to the entity of the shares on which the dividend was paid; and

(c) the rate of that dividend; and

(d) whether the company has paid a dividend on other shares in the company and, if so, the rate of that dividend; and

(e) whether the company has issued any shares to the entity in satisfaction of a dividend paid by the company (or part of it) and, if so, the circumstances of the issue; and

(f) any other relevant matters."

The ATO's position in relation to private company dividends and NALI is outlined in some detail in TR 2006/7. In TR 2006/7, the ATO explains what amounts are to be considered as "special income" under the former s 273 ITAA36. (As set out in TR 2006/7, to the extent that s 295-550 expresses the same ideas as s 273 ITAA36, the ruling is also taken to apply to s 295-550.)

Two notable cases where NALI was applied to dividends derived by an SMSF from private companies are *Darrelen Pty Ltd v FCT* (*Darrelen*)[6] and *GYBW and FCT* (*GYBW*).[7]

In *Darrelen*, an SMSF acquired shares in a private company at less than 10% of the market value of those shares. The dividends in each of the relevant years of income were far in excess of the purchase price which the trustee of the fund had paid for the shares. In this regard, against an acquisition cost of $51,218 (paid in October 1995), the trustee of the fund received dividends as follows: in the year ended 30 June 1996 — $26,400; in 1997 — $208,136; in 1998 — $140,000; in 1999 — $125,200; in 2000 — $143,720; in 2001 — $143,720; in 2002 — $86,320; and in 2003 — $76,640; being a total of $806,416 in dividends over eight financial years). The Full Federal Court confirmed the AAT's decision that the dividends were to be taxed as NALI.

The *GYBW* case involved an employee whose SMSF was provided with favourable terms to acquire shares in the employer's company. The employee's SMSF acquired shares at a nominal value of $200 which produced substantial dividends (eg a dividend of $672,900 with a $288,283.71 franking credit for FY2013, a dividend of $1,050,000 with a $450,000 franking credit for FY2014, and a dividend of $70,000 with a $30,000 franking credit for FY2015; being a total of $1,792,900 in dividends and $768,283.71 in franking credits over three financial years). The AAT held that s 295-550 did apply and relied on the analysis of the Full Federal Court in *Darrelen*. In particular, the tribunal confirmed that:

– s 295-550(2) is not limited to an enquiry about the circumstances surrounding the payment of the dividend, but can extend to the circumstances surrounding the acquisition of shares;
– it is not sufficient to merely show that dividends are paid on all shares in the company, including those owned by the SMSF, on an equal basis without preference;
– regard must be had to all of the factors in s 295-550(3)(a) to (f), not just some of them; and
– the reference to "value" in s 295-550(3)(a) is a reference to "market value".

Broadly, in both *Darrelen* and *GYBW*, a careful analysis of each of the factors in s 295-550(3)(a) to (f) was undertaken to determine whether NALI applied to dividends received from the SMSF's acquisition of shares in a private company. In each case, the analysis concluded that the shares had been acquired for less than market value. Thus, the application of the dividend NALI provisions provides a relatively structured analysis compared to the general NALI provisions.

Fixed and non-fixed trust entitlement NALI

Section 295-550(4) provides:

"(4) Income derived by the entity as a beneficiary of a trust, other than because of holding a fixed entitlement to the income, is ***non-arm's length income*** of the entity."

Section 295-550(5) provides:

"(5) Other income derived by the entity as a beneficiary of a trust through holding a fixed entitlement to the income of the trust is ***non-arm's length income*** of the entity if, as a result of a scheme the parties to which were not dealing with each other at arm's length in relation to the scheme, one or more of the following applies:

(a) the amount of the income is more than the amount that the entity might have been expected to derive if those parties had been dealing with each other at arm's length in relation to the scheme;

(b) in acquiring the entitlement or in gaining or producing the income, the entity incurs a loss, outgoing or expenditure of an amount that is less than the amount of a loss, outgoing or expenditure that the entity might have been expected to incur if those parties had been dealing with each other at arm's length in relation to the scheme;

(c) in acquiring the entitlement or in gaining or producing the income, the entity does not incur a loss, outgoing or expenditure that the entity might have been expected to incur if those parties had been dealing with each other at arm's length in relation to the scheme."

As can be seen, where the relevant trust provides a "fixed entitlement", there must be greater income derived or a lower (or no) expense incurred before the NALI provisions will be enlivened.

However, where the relevant trust does not provide a fixed entitlement, eg a distribution from a family discretionary trust, the income received will be NALI. It is generally accepted that distributions from "discretionary trusts" will result in that income being NALI. However, in other types of trusts, such as unit trusts, this aspect is not always clear and a careful review of the trust deed is required as there may be units that have some discretion attached.

In *CPT Custodian Pty Ltd v Commissioner of State Revenue*, the High Court confirmed that:[8]

"However, 'unit trust', like 'discretionary trust', in the absence of an applicable statutory definition, does not have a constant, fixed normative meaning …"

In *Colonial First State Investments Ltd v FCT*,[9] the Federal Court confirmed that a managed investment trust that allowed a 75% vote to amend the constitution of the trust did not qualify as a fixed trust as there was the possibility, although it was unlikely to be exercised, for the majority to dilute the 25% minority's interests in the trust.

An important practical aspect of TR 2006/7 is the ATO's view on what is required for a "fixed entitlement". TR 2006/7 provides:

> "208. Having regard to the statutory context, it is considered that the composite expression 'income derived … by virtue of a fixed entitlement to the income' is designed to test whether an amount of trust income … was included because the entity had an interest in the income of the trust that was, at the very least, vested in interest, if not in possession, immediately before the amount was derived by the trustee.
>
> 209. To have an interest in the income of a trust estate, a person must have a right with respect to the income of the trust that is susceptible to measurement … An interest in the income of a trust estate will be vested in interest if it is bound to take effect in possession at some time and is not contingent upon any event occurring that may or may not take place …"

However, "fixed entitlement" is defined in s 995-1 ITAA97 as:

> "an entity has a ***fixed entitlement*** to a share of the income or capital of a company, partnership or trust if the entity has a fixed entitlement to that share within the meaning of Division 272 in Schedule 2F to the *Income Tax Assessment Act 1936*."

It is generally accepted that the definition of "fixed entitlement" in s 272-5, Sch 2F ITAA36 would provide a stricter measure of fixed entitlement compared to the ATO's view in TR 2006/7. The application of the definition of "fixed entitlement" provided in Sch 2F ITAA36 to the NALI provisions was endorsed by the AAT Senior Member in *Ghali*. In the ATO's decision impact statement after *Ghali*, the Commissioner proposed to adhere to his view that the Sch 2F definition is inapplicable for the purposes of the NALI provisions.

Notably, at para 4 of PCG 2016/16, the Commissioner states that his view of fixed entitlement in respect of former s 273 ITAA36 and s 295-550 ITAA97 is explained in TR 2006/7.

In view of this analysis, we recommend that a fixed unit trust should be used where an SMSF invests in a unit trust, as many unit trusts include some form of hybrid or discretion that may not qualify as a fixed entitlement, especially if the Commissioner's current administrative view changes.

Conclusion

The NALI provisions have broad application which has been extended considerably further with the ATO's interpretation of the NALE amendments. In recent years, there has been an increased focus on NALI, and where these provisions apply, it can prove costly, time-consuming and challenging to respond to an ATO assessment raising NALI.

Advisers should view every SMSF transaction involving a related party carefully and through the lens of a potential application of the NALI provisions. In this way, advisers will provide an important first barrier to obvious non-arm's length transactions going ahead that may save their clients plenty of distress and money.

Shaun Backhaus
Senior Associate
DBA Lawyers

Daniel Butler, CTA
Director
DBA Lawyers

References

1 [2011] FCAFC 118 at [60].
2 [2010] HCA 10.
3 [2012] AATA 527 at [48].
4 [2005] FCA 1121 at [18].
5 [1995] FCA 259.
6 [2010] FCAFC 35.
7 [2019] AATA 4262.
8 [2005] HCA 53 at [15].
9 [2011] FCA 16.

Obituary

Roger Lyne Hamilton SC

1948–2021

The news that Roger Hamilton passed away on 28 October 2021 was met with profound sadness by his many friends and colleagues.

Roger had a rich and varied career, marked by considerable achievements that tended to be masked by his trademark humility.

Roger graduated from the Australian National University with a Bachelor of Arts in 1969 and a Bachelor of Laws (Honours) in 1972. He was awarded a scholarship to attend the prestigious Osgoode Hall Law School at the York University in Toronto, where he graduated with a Master of Laws in 1974.

Roger returned to Canberra and began his professional career in the Attorney General's Department. He rose to the rank of Principal Legal Officer in only four years. He left that role in 1978 in order to take up a position at the ANU, where he lectured in tax law and company law in the Faculties of Law and Economics. In 1980, he accepted a place as a visiting fellow at Harvard University, studying international taxation, and returning to his position at the ANU in 1981.

In 1982, Roger commenced his career in private practice, joining Freehill Hollingdale and Page where, along with Clive Cullinane, he was one of the founding partners of the firm's specialist taxation law practice.

In 1985, Roger left legal practice and took up a position as a director of the investment bank Morgan Grenfell in Hong Kong, where he worked until 1988 when he was offered and accepted a position as a partner of Minter Ellison in Sydney.

In 1993, Roger was admitted to the New South Wales Bar and commenced practice on the Ground Floor of Wentworth Chambers. He quickly developed a successful practice, specialising in taxation and representing taxpayers and revenue authorities in connection with state and federal tax disputes. He was made Senior Counsel in 2006 and appointed Head of Chambers shortly thereafter.

Roger made a real and lasting contribution in academic and professional circles throughout his entire career. He authored numerous books and articles. Perhaps the most widely read was his *Guidebook to Australian international taxation*, co-authored by Robert Deutsch. He was also a consulting editor of Butterworths' *Foreign investment regulation in Australia*. Roger lectured in the Master of Laws program at Sydney University in taxation law and taxation litigation, and contributed regularly as a speaker at seminars and conferences, including, notably, at the Vienna University Institute for Austrian and International Tax Law and, of course, The Tax Institute. He was also an active member and, for many years, the secretary of the Australian branch of the International Fiscal Association.

Roger was also a generous donor of his time and expertise to charitable causes. Along with the late Justice Kim Santow, Roger assisted in the creation of the Malcolm Sargent Cancer Fund for Children (now known as Redkite) in 1983, and contributed to and promoted its activities for many years thereafter. In addition, he volunteered his services to the Toongabbie Legal Centre, not only as a speaker at its equity and tax seminars, but also in representing its clients in matters before the Federal Court of Australia. His services to the Toongabbie Legal Centre were acknowledged with an award in 2013.

The final phase of Roger's career was tragically cut short. He was appointed as a Senior Member of the NSW Civil and Administrative Tribunal in 2016, and later as the Principal Member of the Revenue Division of the tribunal. In his short time in those roles, he quickly came to be admired by his colleagues for his industry and collegiality, and by practitioners for his patience, courtesy and helpfulness. In 2019, Roger was appointed as a Senior Member of the Administrative Appeals Tribunal but, sadly, his diagnosis, subsequent treatment and illness prevented him from making the significant contribution in that role that would otherwise most certainly have followed.

Notwithstanding his considerable professional achievements, Roger's predominant priority throughout his career was his family. He leaves behind a loving wife, Susan, four children (Claire, James, Claudia and Marcus) and four grandsons (Xavier, Orlando, Hugo and Jasper). His dedication to his family was rewarded during the final, very difficult months of his life. Roger's cheerfulness and positivity never waned throughout his arduous struggle, but he was surrounded for the whole of that time by his devoted family who were a source of tremendous support and comfort.

Roger also leaves behind a wide circle of true friends, deeply saddened by his passing. Roger's unerring good humour, optimism and kindness were unparalleled. His glass was never half empty and his company is and will be sorely missed by many.

Stuart Donaldson SC
Ground Floor Wentworth Chambers

Events Calendar

December 2021/February 2022

STATE/EVENT	DATE	CPD
Online		
2021 National GST Conference	2/12/21	13
National Infrastructure Conference	3–4/2/22	12
2022 Women in Tax National Congress	18/2/22	6.5
Private Business Tax Retreat	24–25/2/22	13
New South Wales		
2021 National GST Conference	2/12/21	13
National Infrastructure Conference	3–4/2/2022	12
2022 Women in Tax National Congress	18/2/22	6.5
Queensland		
Private Business Tax Retreat	24–25/2/22	13

For more information on upcoming events, visit **taxinstitute.com.au/professional-development**.

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Level 37, 100 Miller Street
North Sydney, NSW 2060

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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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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: Glen Hutchings, FTI

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 32, Central Park
152 St Georges Terrace
Perth, WA 6000

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

South Australia and Northern Territory

Chair: Nick Wilkins, CTA

The Tax Institute, WOTSO Adelaide
217/219 Flinders Street
Adelaide, SA 5000

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

Tasmania

Chair: Ian Heywood, CTA

The Tax Institute, WOTSO Adelaide
217/219 Flinders Street
Adelaide, SA 5000

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

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