THE JOURNAL FOR MEMBERS OF THE TAX INSTITUTE

Taxation in Australia

VOL 55(9) APR 2021

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THE TAX INSTITUTE

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Tax News – at a glance

by TaxCounsel Pty Ltd

March – what happened in tax?

The following points highlight important federal tax developments that occurred during March 2021. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 446 (at the item number indicated).

FBT: cents per kilometre rates

The cents per kilometre rates for calculating the taxable value of a fringe benefit arising from the private use of a motor vehicle other than a car for the FBT year commencing on 1 April 2021 are set out in TD 2021/4. **See item 1.**

FBT: food and drink expenses

The Commissioner has released a determination that sets out the amounts that he considers reasonable (under s 31G of the *Fringe Benefits Tax Assessment Act 1986*) for food and drink expenses incurred by employees receiving a living-away-from-home allowance fringe benefit for the FBT year commencing on 1 April 2021 (TD 2021/3). **See item 2.**

Allocation of professional firm profits: ATO compliance approach

The Commissioner has released a draft practical compliance guideline that sets out the ATO's proposed compliance approach to the allocation of profits by professional firms (PCG 2021/D2). **See item 3.**

Employee transport expense deductions

The Commissioner has released a final ruling which sets out when an employee can deduct transport expenses (including the cost of travel by airline, train, taxi, car, bus, boat or other vehicle) as general deductions (under s 8-1 of the *Income Tax Assessment Act 1997* (ITAA97)) (TR 2021/1). **See item 4.**

Allowances or benefits provided to an employee: ATO compliance approach

The Commissioner has released a draft practical compliance guideline that outlines the ATO's compliance approach to determining whether employees in certain circumstances are travelling on work or living at a location away from their normal residence (PCG 2021/D1). **See item 5.**

Employee expenses and allowances

The Commissioner has released a draft ruling which considers income tax and FBT issues relating to employee accommodation and food and drink expenses, travel allowances, and living-away-from-home allowances (TR 2021/D1). **See item 6.**

Employee option and incentive scheme cancellation payments

The Federal Court (Colvin J) has held that an amount of just over $15m paid by the taxpayer company to employees in the 2014 income year in consideration for the cancellation of employee entitlements under an employee option plan and an employee incentive scheme was not deductible as a general deduction (under s 8-1 ITAA97) because the positive limbs of the section were not met (*Clough Ltd v FCT* [2021] FCA 108). **See item 7.**

Scheme promoter penalties

The Federal Court (Thawley J) has fixed the civil penalties that are payable by the respondents for contraventions of the tax exploitation scheme promoter provisions of the *Taxation Administration Act 1953* (*FCT v Bogiatto (No. 2)* [2021] FCA 98). **See item 8.**

Tax agent registration cancellation affirmed

The AAT has upheld the decision of the Tax Practitioners Board to cancel the registration of a corporate tax agent for breaches of the Code of Professional Conduct in Div 30 of the *Tax Agent Services Act 2009* and, in particular, the Code principle that a registered agent must ensure that a tax agent service that the agent provides, or that is provided on the agent's behalf, is provided competently (*S & T Income Tax Aid Specialists Pty Ltd Trading as Alpha Tax Aid and Tax Practitioners Board* [2021] AATA 161). **See item 9.**

Active asset

The Commissioner has recently issued a final determination which considers whether a company that carries on a business in a general sense (as described in TR 2019/1), but whose only activity is renting out an investment property to unrelated third parties, can claim the CGT small business reliefs provided for in Div 152 ITAA97 in relation to a capital gain that arises from a CGT event that happens in relation to the investment property (TD 2021/2). This determination is considered in the Tax Tips column in this issue of the journal at page 451.

President's Report

by Peter Godber, CTA

Our consulting and advocacy efforts on your behalf

Whether on a profession-wide or individual scale, The Tax Institute continues to consult on matters of importance for you.

Ahead of the upcoming 2021-22 federal Budget announcement, I would like to reflect on the way in which our work in the policy and regulation space is informed by the best interests of our members.

Last year, our federal Budget report was comprehensive, insightful and well-received. I consider it a testament to the wonderful tax minds working with the Institute, and the technical expertise that our organisation fosters.

This year, you can rest assured that we will once again be producing excellent technical tools, analysis and resources to assist you in understanding and interpreting any tax measures announced. We will be working to communicate vital insights in the best possible way, so you can quickly and efficiently digest the impact to you and your clients. Our aim is to make these materials accessible, practical and, as always, of the highest technical standard. This is, of course, no less than our members deserve.

We at The Tax Institute continue to advocate for meaningful reform of our tax system as part of the measures announced — though we aren't holding our breath just yet. In terms of the federal Budget, we have submitted for, and would hope to see, more short-term relief for individuals and business, in advance of a clearer re-think on structural change to the tax mix. Having said that, we know, as you do, that, when embarking on the kind of meaningful structural and design change we are aiming for, speed is not always our ally. Change should be carefully considered, with extensive thought towards future implications. The Institute is committed to continuing our work advocating for this vision.

We have also been advocating for you on an individual level, escalating your queries and client cases to help ensure that you secure the correct outcome in the most straightforward way possible. This has been especially valuable with issues such as those businesses which were affected by the COVID-19 stimulus eligibility oversight identified in the Inspector-General of Taxation and Taxation Ombudsman report, *A Report on aspects of the Australian Taxation Office's administration of JobKeeper and boosting cash flow payments for new businesses,* late last year.

Although this affected only a small number of stimulus applications, and therefore a small number of our members, it is heartening to see the overwhelmingly positive feedback on the process of escalation and review through the Institute and then working with the ATO.

The Tax Institute is represented in several consultative forums with the ATO and other regulatory bodies. This involves many of our volunteer members.

In March, we participated in a National Tax Liaison Group meeting with the ATO, Treasury and other professional bodies. This was the first of four meetings which take place over the course of the year, in addition to out-of-session meetings which can take place in light of new developments. This collaborative forum continues to address high-level matters of concern for members, including matters of law, policy and administration. The Tax Institute is also represented on the ATO's Tax Practitioner Stewardship Group which addresses many practical concerns for practitioners, and the Consultation Steering Group which considers matters relating to the ATO's consultative processes.

On topic is the outlook for 2021 for tax practitioners and their clients. 2021 still holds many uncertainties for Australian businesses. It is positive that, while we are coming out of the COVID-19 induced recession, most businesses seem to have been able to maintain high levels of tax compliance. The ATO's 2021 corporate plan contains helpful insights into the ongoing initiatives that are underway to improve its administration of the tax and superannuation systems. It will be of no surprise to many that the better, more efficient use of data is one project that is front of mind and will continue to transform tax administration and the role of tax intermediaries.

Advocating on matters that impact our members is essential to what The Tax Institute does, whether on a large scale, as in the case of tax reform, or on an individual level. I am exceptionally pleased by the work we have been able to do in supporting you, and I would urge you to keep in close contact with us on future matters.

As we move into a new stage of economic recovery and growth, remember that we are here first and foremost to support you, as you support your clients. We are continuing to build communities through our online platforms, and being part of a membership community like ours is increasingly valuable.

CEO's Report

by Giles Hurst

Creating connection from change

Meaningful, people-centric change is our goal as we bring our tax community closer.

It's mind-boggling to think how much can change in a relatively short span of time.

This time last year, we had wrapped up what was perhaps the biggest face-to-face event in the Institute's history, The Tax Summit 2020, and then, very swiftly, the world changed as we responded to COVID-19. We were thrust into a new world, a new way of work and life.

All of the work since The Tax Summit in March, throughout 2020 and now into 2021 — the quick shift to virtual events, the timely guidance around various stimulus measures, the individual advocacy support for our members, and The Tax Summit: Project Reform, just to name a few examples — is something we all, members, volunteers and staff alike, should be proud of.

Our aim is to cement the Institute's place as the home of tax. This is work that happens on a grand scale, with endeavours like the push for system-wide reform, and on a very personal scale, with our team assisting on matters that affect members' everyday practice and their clients' lives.

As our President, Peter Godber, has outlined in his report this month, we have been working tirelessly to assist you in escalating cases to the ATO where COVID-19 stimulus applications require review in light of new facts. We are also gearing up to support you with analysis and guidance on tax measures announced in the upcoming 2021-22 federal Budget. This work is part of our mission to make membership more meaningful for you, every single day.

As you know, during 2020, we took our world-class professional development events online. It was a wonderful way to stay connected to you in challenging times, and we are carrying forward a renewed sense of unity from the experience. Because of the strong local engagement that we enjoy at The Tax Institute, we may occasionally run the risk of forgetting that we are a national organisation and profession. Connecting with colleagues around the country through technology and these events is an important reminder for us all.

As we forge ahead in 2021, some of our events will continue to run in a hybrid style, incorporating face-to-face and online elements so that as many of you as possible can reap the considerable benefits of attending. Examples of these hybrid events in action include the recent Private Business Tax Retreat, and our Local Tax Clubs. As well as offering you an opportunity to develop your understanding of topical ideas and events in our profession, these events are also aimed at helping you re-connect and grow your own professional networks.

I know we have become used to being at home in our own space and comfy clothes, but I encourage you to keep an eye on upcoming events and come along to as many as possible. The face-to-face element is a much-needed return to connection and community, and the online portion of our hybrid events mean you can come as you are — pyjama bottoms and all.

It is already ramping up to be a busy year at the Institute, and I'm glad for this chance to remind you that we are listening to your feedback, we are developing our membership experience to better serve you, and we are working to keep our community connected.

I'd like to close this report by quoting Dr Julianne Jaques, QC, CTA. Julianne was named our Chartered Tax Adviser of the Year in 2020, at the gala dinner of The Tax Summit. Many of you will remember what a wonderful night full of inspiring colleagues and celebration that was.

Julianne's words from her acceptance speech are an excellent reminder that being a part of the Institute is to be part of something big, powerful and meaningful. It is to be part of a force for change, and a community of generous, brilliant professionals. She said:

> "I do thank The Tax Institute very, very much for this award, but also for the opportunity that they have given me over all of the years of my career to meet with, learn from and work with some of the very, very best practitioners in the country over the last 25 years. It's an opportunity that one cannot get anywhere else in Australia, to work with such an amazing group of people."

Here's to building strong professional connections, to future groundbreaking events, and to advocacy that matters for you and your clients. Here's to making change in a meaningful way.

Tax Counsel's Report

by Angie Ananda, CTA

Committee engagement and participation

All Institute members can engage and participate with the TPA team and the national technical committees to voice their concerns about tax law, policy and administration issues.

The Tax Institute firmly believes that 2021 should be a year that focuses on necessary tax reform to assist economic recovery and protect future generations. Following this line of thinking, the Tax Policy and Advocacy team (TPA team) has been considering internal reform opportunities to enhance member engagement and participation, starting with our national technical committee structures.

Currently, the TPA team is responsible for seven national technical committees, in the following areas:

- dispute resolution;
- FBT and employment taxes;
- GST;
- large business and international;
- not-for-profits;
- SMEs and tax practitioners; and
- superannuation.

The purpose of the committees is to work with the TPA team to address issues raised internally, externally or by Institute members about tax law, policy and administration. The committees consider, analyse, debate, prepare submissions and report on the development, implementation and administration of tax technical and policy issues related to their specific area of tax law.

The TPA team has been consulting with all of our current committee members to discuss how we can enhance their operation and ensure that they have the best possible structure to fulfil their function in the most effective manner.

We welcome feedback and suggestions from all members of the Institute in relation to this topic. Please send feedback and suggestions to taxpolicy@taxinstitute.com.au.

Transparency

During our review process, it has become abundantly clear that we need to improve the transparency between the committees themselves and between the committees and our broader membership.

Our committees perform an invaluable function for the Institute's members and for the benefit of the tax system as a whole. They work tirelessly throughout the year reviewing and responding to draft legislation, ATO guidance and other material, member queries, and public and confidential reviews initiated by multiple external bodies. On average, the Institute prepares around 60 submissions each year.

In addition, committee members, together with the TPA team, represent the Institute at consultations with numerous external stakeholders, including the government, Treasury, the ATO, the Board of Taxation, the Inspector-General of Taxation and the Tax Practitioners Board. Each year, the TPA team and committee members attend well in excess of 100 external consultations.

We need to make sure that our members know about the invaluable work that the national technical committees perform on behalf of the Institute's members and for the benefit of the tax system as a whole. We also need to make sure that all members of the Institute have access to and can engage with the TPA team and the committees to put issues forward for the committees to consider and address.

Membership diversity

The TPA team wants to be more proactive in encouraging diversity of members on our national technical committees so that the interests of all of the Institute's members are represented. Ultimately, we want the membership of our committees to be as diverse as the members of the Institute.

To achieve this, the TPA team wants to remind members that you all have the opportunity to join our national technical committees. At times, we have heard certain misconceptions about the requirements that need to be satisfied to be a member of a committee. We want to work with you to debunk these misconceptions so that they do not create a roadblock to achieving greater diversity on our committees.

Focus areas

The TPA team is assessing whether the current committees cover the focus areas that are most relevant to the Institute's members.

One focus area that has been identified for consideration is the taxation of individuals. For many members of the Institute, this is a primary practice area. We are considering whether issues arising in relation to this focus area should be addressed by one of our current committees or whether a new committee should be established.

The objective is to ensure that all major tax-related focus areas for our members are being addressed by one of the committees.

Increasing engagement and participation

Ultimately, we want all of the Institute's members to know how they can engage and participate with the TPA team and the national technical committees to voice their concerns about tax law, policy and administration issues. Our review process is designed to ensure that we can achieve this objective.

Please remember to send any feedback in relation to this process to taxpolicy@taxinstitute.com.au.

We look forward to updating our members about the outcome of this review during the course of the year.

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Tax News – the details

by TaxCounsel Pty Ltd

March – what happened in tax?

The following points highlight important federal tax developments that occurred during March 2021.

The Commissioner's perspective

1. FBT: cents per kilometre rates

The cents per kilometre rates for calculating the taxable value of a fringe benefit arising from the private use of a motor vehicle other than a car for the FBT year commencing on 1 April 2021 are set out in TD 2021/4.

The rates to be applied are:

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

2. FBT: food and drink expenses

The Commissioner has released a determination that sets out the amounts that he considers reasonable (under s 31G of the *Fringe Benefits Tax Assessment Act 1986* (Cth) (FBTAA86)) for food and drink expenses incurred by employees receiving a living-away-from-home allowance fringe benefit for the FBT year commencing on 1 April 2021 (TD 2021/3).

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

- equal to or less than the amount that the Commissioner considers reasonable under s 31G(1)(b) FBTAA86; or
- substantiated in accordance with the requirements in s 31G(2) FBTAA86.

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

The determination sets out the weekly amounts that the Commissioner considers reasonable amounts for food and drink:

- within Australia; and
- overseas.

3. Allocation of professional firm profits: ATO compliance approach

The Commissioner has released a draft practical compliance guideline that sets out the ATO's proposed compliance approach to the allocation of profits by professional firms (PCG 2021/D2).

PCG 2021/D2 sets out how the ATO intends to apply compliance resources when considering the allocation of professional firm profits or income in the assessable income of the individual professional practitioner (IPP). The guideline is also intended to assist the IPP to self-assess their risk against risk assessment factors.

It is explained that, historically, most professional firms were partnerships of natural persons. Professional firms are now structured in a variety of ways, reflecting the economic and legal choices made by the owners of those firms. In some cases, these structures may be used in ways that give rise to different tax consequences and resulting tax compliance risks.

The ATO is concerned about arrangements involving taxpayers who redirect their income to an associated entity from a business or an activity which includes their professional services, where it has the effect of altering their tax liability.

The use of companies, trusts and other business structures does not, of itself, give rise to avoidance concerns. Further, the profit generated by the business may not be wholly generated by the individual and there may also be good non-tax reasons as to why the controller of a business receives significantly less of the business' profits than would otherwise be the case. However, the use of those structures can provide the controllers of a business with an opportunity to redirect income from them. When the business involves the provision of services, the ATO will be concerned with arrangements where the compensation received by the individual is artificially low while related entities benefit (or the individual ultimately benefits), and commercial reasons do not justify the arrangement.

The ATO's view is that the profit or income of a professional firm may comprise different components, reflecting a mixture of income from the efforts, labour and application of skills of the firm's IPPs (that is, personal exertion) and income generated by the business structure.

The ATO is aware that, in some cases, professional firm income has been treated as being derived from a business structure, even though the source of that income remains, to a significant extent, the provision of professional services by one or more individuals. In that context, the ATO may apply the general anti-avoidance provisions (Pt IVA of the *Income Tax Assessment Act 1936* (Cth) (ITAA36)) where income is redirected away from the individuals, despite the existence of a business structure.

PCG 2021/D2 explains the ATO's risk-based approach to IPPs and how their professional firms allocate profits. In order for the draft guideline to apply, two "gateways" must be passed. First, the ATO expects there to be a sound commercial rationale for entering into and operating the arrangement or structure (gateway 1). Second, there must not be certain "high-risk features" (gateway 2).

Where an IPP's circumstances pass gateways 1 and 2, the risk assessment framework explained in the draft guideline may be used by the practitioner and the ATO to understand what compliance attention will generally be given to the arrangement. Where an IPP's circumstances do not pass gateways 1 and 2, the risk assessment framework is not available to them.

Overall, schemes which are designed to ensure that the IPP either is not directly rewarded for the services they provide to the business or receives a reward which is substantially less than the value of those services, are considered high-risk by the ATO. Where an IPP attempts to alienate amounts of income flowing from their personal exertion (as opposed to income generated by the business structure), the Commissioner will consider applying the general anti-avoidance provisions.

Once finalised, it is envisaged that PCG 2021/D2 will apply prospectively from 1 July 2021.

4. Employee transport expense deductions

The Commissioner has released a final ruling which sets out when an employee can deduct transport expenses (including the cost of travel by airline, train, taxi, car, bus, boat or other vehicle) as general deductions (under s 8-1 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97)) (TR 2021/1).

TR 2021/1 explains that transport expenses incurred for ordinary travel between home and a regular place of work are not deductible. In contrast, transport expenses incurred by an employee when travelling between work locations usually are deductible. Further, the ruling explains a number of special cases or exceptions to these general rules.

The ruling also applies for the purposes of the FBTAA86 when determining whether such expenses paid by the employer would have been "otherwise deductible" if incurred by the employee.

TR 2021/1 states that determining whether a particular transport expense is incurred in gaining or producing assessable income involves consideration of the proper scope of the particular employee's work activities to determine whether the circumstances of the transport expense have a sufficiently close connection to earning the employment income. It is important to have regard not just to the duties in the contract of employment, but to the nature of the work as a matter of substance.

While transport expenses will only be deductible if they satisfy the requirements of s 8-1 ITAA97, the following factors (based on relevant case law) would support a characterisation of transport expenses as being incurred in gaining or producing assessable income:

– the travel fits within the duties of employment, that is, the obligation to incur transport expenses arises out of the employment itself and not the employee's personal circumstances; and
– the travel is relevant to the practical demands of carrying out the employee's work duties or role, that is, the transport expenses are a necessary consequence of the employee's income-producing activity.

In addition to these factors, the following factors (based on relevant case law) may also be relevant when determining whether a transport expense is incurred in gaining or producing assessable income:

– the employer asks for the travel to be undertaken;
– the travel occurs on work time; and
– the travel occurs when the employee is under the direction and control of the employer.

The factors identified above need to be considered in the context of both the form and substance of the specific employment arrangement. No single factor on its own will necessarily support a conclusion that an expense is deductible. For instance, the mere fact that an employer asks the employee to attend their regular place of work on a particular day does not change the conclusion that such travel is a prerequisite to the employment, rather than being incurred in gaining or producing assessable income.

Reaching a conclusion as to the deductibility of a transport expense requires a holistic assessment of the relationship between the employment and the expense. The fact that an employee considers that a transport expense serves an employment-related purpose is not sufficient to establish the deductibility of the expense.

TR 2021/1 considers the deductibility of employee transport expenses in a range of common circumstances. However, it does not purport to deal exhaustively with all situations. The deductibility of employee transport expenses ultimately requires a judgment in any case about whether the expense is incurred in the course of gaining or producing assessable income.

5. Allowances or benefits provided to an employee: ATO compliance approach

The Commissioner has released a draft practical compliance guideline that outlines the ATO's compliance approach to determining whether employees in certain circumstances are travelling on work or living at a location away from their normal residence (living at a location) (PCG 2021/D1).

In order to determine the nature of an allowance paid, employers are required to consider all relevant circumstances to determine whether the employee is travelling on work or living at a location. The nature of an allowance is not to be determined by reference solely to its name or the period for which it is paid. As such, there will be circumstances in which it may be difficult for an employer to conclude whether an employee is travelling on work or living at a location.

In para 3 of PCG 2021/D1, it is stated that the draft guideline is focused on providing practical guidance to assist in determining whether:

- an allowance paid by an employer to an employee is paid for:
  - travelling on work, which will be a travel allowance that is assessable to an employee and will not incur FBT; or
  - living at a location which may be a living-away-from-home allowance fringe benefit; and
- amounts reimbursed or paid by an employer would have been deductible to the employee had they purchased the goods or services (that is, the expenses would be otherwise deductible for the purposes of the FBTAA86).

The draft guideline states that expenses for living at a location are usually not deductible. However, expenses incurred on accommodation and food and drink are usually deductible, or otherwise deductible, where an employee is working away from home for short periods of time. In these situations, an employee is generally travelling on work.

In many cases, short periods of travel can be consistent with an employee travelling on work in the course of their employment and incurring deductible expenses. When applying the approach in PCG 2021/D1, the concept of "reasonably short" is used. When considering whether an employee's presence at a work location is reasonably short, consideration needs to be given to:

- the time spent working away from home; and
- the pattern of visits to that location compared with visits to other locations.

Where an employee maintains a continuous presence at a work location, their presence will be reasonably short if all of the criteria set out in para 10 of PCG 2021/D1 are met. That paragraph sets out the circumstances in which the Commissioner will accept that an employee is travelling on work and will generally not apply compliance resources to determine if benefits referred to in para 3 relate to expenses for living at a location.

All employers who provide benefits referred to in para 3 of PCG 2021/D1 (see above) to their employees (who do not work on a fly-in fly-out or drive-in drive-out basis) may rely on the draft guideline.

If an employer chooses not to rely on PCG 2021/D1 or does not meet the requirements in para 10 of the draft guideline, they will need to apply the relevant FBT provisions to determine whether an FBT liability arises for the benefit provided (or if an exemption or concession applies) and ensure that they substantiate (through obtaining relevant declarations or documentation) how they determined the taxable value of the benefit.

6. Employee expenses and allowances

The Commissioner has released a draft ruling which considers income tax and FBT issues relating to employee accommodation and food and drink expenses, travel allowances, and living-away-from-home allowances (TR 2021/D1).

In particular, TR 2021/D1 explains:

- when an employee can deduct accommodation and food and drink expenses as a general deduction (under s 8-1 ITAA97) when they are travelling on work, including where it is necessary to apportion;
- the FBT implications, including the application of the "otherwise deductible rule", where an employee is reimbursed for accommodation and food and drink expenses, or where the employer provides or pays for these expenses; and
- the criteria for determining whether an allowance is a travel allowance (as defined in s 900-30(3) ITAA97) or a living-away-from-home allowance fringe benefit (see s 30 FBTAA86)), and the differences between them.

Whether accommodation and food and drink expenses are deductible depends on the facts and circumstances of each case. TR 2021/D1 uses examples to show how to determine the deductibility of these expenses in a range of situations.

Recent case decisions

7. Employee option and incentive scheme cancellation payments

The Federal Court (Colvin J) has held that an amount of just over $15m paid by the taxpayer company to employees in the 2014 income year in consideration for the cancellation of employee entitlements under an employee option plan and an employee incentive scheme was not deductible as a general deduction (under s 8-1 ITAA97) because the positive limbs of the section were not met (*Clough Ltd v FCT*[1]).

The positive limbs of s 8-1 require that, for an outgoing to be potentially deductible, it must be characterised as being incurred in gaining or producing assessable income or necessarily incurred in carrying on a business for the purpose of gaining or producing such income. Colvin J said that this task of characterisation requires a focus on the connection between the outgoing and the particular process by which income is derived in the instance under consideration. Where the case advanced is that the expenditure relates to a business that is being conducted, it is necessary to make both a wide survey and an exact scrutiny of the taxpayer's activities such that the whole of the operations of the business are considered in forming a view as to the proper characterisation of the outgoing.

Colvin J said that the payment of an amount to cancel rights under a scheme to incentivise employees to stay with an employer is a step that may be taken for a range of different reasons. Those reasons will be evident from an examination of the commercial context. It is the examination of those actual contextual reasons that will reveal the character of the cancellation payment, particularly whether its character is such that it may be described as having been made to gain or produce income.

Without being exhaustive, the payment of a lump sum may occur in order to compromise a dispute with an outgoing employee or a dispute with employees generally about the nature of the relevant scheme. It may be done as part of the restructure of arrangements with employees by which they were to receive options on different terms for the purpose of increasing the incentive created by the scheme for employees to remain with the taxpayer. It may be done with a view to making it easier to raise capital, or to satisfy the terms of issue of convertible notes, or it may be seen to be in the interests of shareholders generally because it would make a bid for shares in the company more attractive to a bidder seeking to secure control of the company.

In the present case, on the evidence, the payment of the amount claimed as a deduction was made to satisfy a requirement of a bid by Murray & Roberts (the existing majority shareholder) for shares in the taxpayer and because of a view that employees were entitled to the payment by reason of the change in control. It was also done to facilitate the acquisition of 100% control of the taxpayer by Murray & Roberts. It was not done to reward employees or to retain them. It was not done with a view to the taxpayer gaining or producing income.

Therefore, the payment of the amount was not incurred by the taxpayer in gaining or producing assessable income or necessarily incurred in carrying on a business for the purpose of gaining or producing such income. If the scheme of arrangement by which Murray & Roberts acquired the shares in the taxpayer had not occurred, the amount would never have been paid. The incurrence of the outgoing was not involved in or connected to an activity that may be described as carrying on the taxpayer's business. Its incurrence was part of the activity by which Murray & Roberts acquired the shares in the taxpayer. The taxpayer did not pay the lump sum to produce income. Nor did it pay the lump sum as a necessary part of what was required in carrying on its business.

It should be noted that, by the time the taxpayer's appeal was heard, the Commissioner accepted that the amount in question was allowable as a deduction under s 40-880 ITAA97, which allows for the deduction of business capital expenditure over five years.

8. Scheme promoter penalties

The Federal Court (Thawley J) has fixed the civil penalties that are payable by the respondents for contraventions of the tax exploitation scheme promoter provisions of the *Taxation Administration Act 1953* (Cth) (TAA53) (*FCT v Bogiatto (No. 2)*[2]).

On 3 September 2020, Thawley J made declarations that each of the four respondents (an individual and three companies) had contravened the scheme promoter provisions (and, in particular, s 290-50(1), Sch 1 TAA53) by engaging in conduct that resulted in that respondent or another entity being a promoter of tax exploitation schemes. His Honour declared that the individual and one of the companies both contravened s 290-50(1) on 21 occasions, another company contravened s 290-50(1) on 15 occasions, and the third company contravened s 290-50(1) on 11 occasions. These declarations gave effect to a judgment delivered by Thawley J on 7 August 2020 (*FCT v Bogiatto*[3]).

The tax exploitation schemes which were the subject of the declarations each involved claims under Div 355 ITAA97 in respect of purported R&D activities. The declarations related to 21 different tax exploitation schemes involving 12 taxpayers in the 2012, 2013 and 2014 financial years.

The total monetary consideration received by the respondents from their various taxpayer clients was around $4.5m. The total consideration in the form of promises to pay was higher, but some clients never paid. The Commissioner submitted that the appropriate penalties should total $83,871,449. However, Thawley J considered that the total penalties to be imposed should be $22,680,000.

Thawley J made these observations about the penalties:

1. the penalties were imposed at least in the amount of the monetary consideration received, in order for the imposition of the penalties to achieve the desired deterrent effect;
2. although the monetary consideration was received, at least in the first instance, by one of the respondents, that consideration was relevant to all of the respondents for the purposes of determining: (a) whether there was a contravention (consideration must be received by the entity or an associate); and (b) the maximum penalty under s 290-50(4)(b) (this maximum is twice the consideration received by the entity and its associates and the respondent which received the consideration was an associate of each of the other respondents). The respondents did not appear or adduce any relevant evidence; and
3. although the respondents were not ultimately paid by their clients in respect of some of the schemes, it remained necessary to impose a penalty to deter the conduct and to reflect, where relevant, the matters to which regard may be had under s 290-50(5).

9. Tax agent registration cancellation affirmed

The AAT has upheld the decision of the Tax Practitioners Board to cancel the registration of a corporate tax agent for breaches of the Code of Professional Conduct in Div 30 of the *Tax Agent Services Act 2009* (Cth) and, in particular, the Code principle that a registered agent must ensure that a tax agent service that the agent provides, or that is provided on the agent's behalf, is provided competently (*S & T Income Tax Aid Specialists Pty Ltd Trading as Alpha Tax Aid and Tax Practitioners Board*[4]).

The particular breaches relied on to make the deregistration decision were revealed by ATO audits of the work-related expense claims made for eight taxpayers in respect of returns lodged for the 2016 income year. As a result of these audits, the total amounts claimed as deductions ($104,903) were reduced to $22,166, resulting in a tax shortfall of $30,288.

The tribunal examined the factual situation in relation to the claims made in the return of each of the taxpayers and concluded that the conduct of the applicant in respect to the preparation and lodgment of the returns for the eight taxpayers demonstrated that, in 2016, the applicant failed to ensure that a tax agent service it provided, or that was provided on its behalf, was provided competently. The applicant repeatedly claimed work-related expense deductions without first obtaining or satisfying itself that there was appropriate evidence to support the claims; the applicant failed to properly ascertain through its own enquiries and failed to obtain sufficient evidence to support the required nexus between the expense claimed and earning assessable income; and the applicant incorrectly applied the relevant tax law with respect to several of the taxpayers.

The evidence, the tribunal said, showed that Mr McGuid (the managing director of the applicant) often failed to make sufficient enquiries of the taxpayers in order to substantiate the work-related deductions claimed. The evidence demonstrated that, in 2016, Mr McGuid had a flawed understanding of relevant tax law and ATO requirements regarding work-related expense deductions, nexus and substantiation, and he incorrectly applied the relevant tax law to a taxpayer's circumstances. Mr McGuid was unfamiliar and/or unaware of relevant key tax rulings and law administration practice statements published by the ATO.

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References

1 [2021] FCA 108.

2 [2021] FCA 98.

3 [2020] FCA 1139.

4 [2021] AATA 161.

Tax Tips

by TaxCounsel Pty Ltd

CGT small business relief: active asset

A determination released by the Commissioner in February 2021 considers some issues relating to how the "active asset" definition operates.

Background

The Commissioner has recently issued a final determination (TD 2021/2) which considers whether a company that carries on a business in a general sense (as described in TR 2019/1), but whose only activity is renting out an investment property to unrelated third parties, can claim CGT small business relief provided for in Div 152 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) in relation to a capital gain that arises from a CGT event that happens in relation to the investment property.

TD 2021/2 concludes that CGT small business relief would not be available. While this conclusion is correct, the way that the answer to the question is approached appears, with respect, to be a little puzzling.

This article considers some aspects of the operation of CGT small business relief in the context of TD 2021/2. Also, two of the three issues raised during the consultation that took place in relation to the determination in its draft form, and which are set out in the compendium that was released with the determination (TD 2021/2EC), are noted.

The relevant legislation

The following provisions of Div 152 are directly relevant to the facts as assumed in TD 2021/2:

"**152–10 Basic conditions for relief**

(1) A capital gain (except a capital gain from CGT event K7) you make may be reduced or disregarded under this Division if the following basic conditions are satisfied for the gain:

(a) a CGT event happens in relation to a CGT asset of yours in an income year;

Note: This condition does not apply in the case of CGT event D1: see section 152-12.

(b) the event would (apart from this Division) have resulted in the gain;

(c) at least one of the following applies:

…

(d) the CGT asset satisfies the active asset test (see section 152-35).

Note: This condition does not apply in the case of CGT event D1: see section 152-12.

…

152–40 Meaning of *active asset*

(1) A CGT asset is an ***active asset*** at a time if, at that time:

(a) you own the asset (whether the asset is tangible or intangible) and it is used, or held ready for use, in the course of carrying on a business that is carried on (whether alone or in partnership) by:

(i) you; or

(ii) your affiliate; or

(iii) another entity that is connected with you; or

(b) …

…

Exceptions

(4) However, the following CGT assets cannot be ***active assets***:

…

(e) an asset whose main use by you is to derive interest, an annuity, rent, royalties or foreign exchange gains unless:

(i) the asset is an intangible asset and has been substantially developed, altered or improved by you so that its market value has been substantially enhanced; or

(ii) its main use for deriving rent was only temporary.

Example: A company uses a house purely as an investment property and rents it out. The house is not an ***active asset*** because the company is not using the house in the course of carrying on a business. If, on the other hand, the company ran the house as a guest house the house would be an ***active asset*** because the company would be using it to carry on a business and not to derive rent.

Note: The meaning of ***connected with*** is affected by section 152-78.

(4A) For the purposes of paragraph (4)(e), in determining the main use of an asset:

(a) disregard any personal use or enjoyment of the asset by you; and

(b) treat any use by your affiliate, or an entity that is connected with you, as your use.

Note: The meaning of ***connected with*** is affected by section 152-78."

The determination

TD 2021/2 gives the following example (which forms part of the ruling section of the determination):

Example

InveproCo is a company incorporated in Australia. InveproCo owns a commercial property, which it has rented to unrelated third parties at market rates on normal commercial terms since its inception. InveproCo provides no other services in relation to the property and conducts no other activities. InveproCo has produced a profit in each of the income years it has rented out the property. InveproCo is engaged in ongoing activities that have a purpose and prospect of profit, namely letting out the property.

Example (cont)

In this situation, InveproCo derived rental income from the leasing of a property to an unrelated third party. Accordingly, the company carries on a business in a general sense described in TR 2019/1. However, the main (only) use of the property is to derive rent and it is therefore excluded from being an active asset under s 152-40(4)(e) regardless of whether the activities constitute the carrying on of a business in a general sense. Therefore, the investment property would not satisfy the active asset test in s 152-35 and InveproCo would not meet the requirement in s 152-10(1)(d) to be eligible for CGT small business relief in relation to the disposal of the investment property.

The explanatory section of TD 2021/2 states that, while a company may be considered to be carrying on a business under TR 2019/1 where its investment property is used to derive rent, the question of whether the investment property is an active asset under s 152-40 ITAA97 and satisfies the active asset test in s 152-35 ITAA97 is a separate consideration for the purposes of CGT small business relief in Div 152.

It is also pointed out in TD 2021/2 that s 152-40(4)(e) excludes, among other things, assets whose main use is to derive rent (unless such use was only temporary). Such assets are excluded even if they are used in the course of carrying on a business.[1]

Some observations

The reason why CGT small business relief is not available in the kind of case envisaged in TD 2021/1 is that, *even if* the CGT asset is used, or held ready for use, in the course of carrying on a business in the relevant sense (whatever that may be), it is a requirement, for CGT small business relief to be available, that the asset is an active asset (s 152-10(1)(d) ITAA97). An asset whose main use by the taxpayer is to derive rent cannot (subject to a qualification in s 152-40(4A)(b) ITAA97) qualify as an active asset, unless its main use for deriving rent was only temporary (s 152-40(4)(e) ITAA97).

It will be seen that, as pointed out above, the question of whether a business is being carried on in the circumstances postulated in TD 2021/2 is, in one sense, not of particular relevance because of the main use to derive rent exclusion. The question of whether a business is carried on will be of fundamental importance in other factual situations.

The puzzling approach

It is submitted that, as stated above, the way the question that is the subject of TD 2021/2 is expressed is a little puzzling. The question assumes that whether the postulated company is carrying on a business for the purposes of the definition of "active asset" can be determined by reference to what is set out in TR 2019/1. But it is somewhat difficult to see how that ruling could be relevant, or at least directly relevant. This is because it is stated in TR 2019/1 that:

> "1. This Ruling sets out the Commissioner's views on when a company carries on a business within the meaning of:
>
> – small business entity in section 23 of the *Income Tax Rates Act 1986* (ITRA 1986) as applicable in the 2015-16 and 2016-17 income years
>
> – section 328-110 of the *Income Tax Assessment Act 1997* (ITAA 1997)."[2]

And:

> "4. This Ruling considers when a company carries on a business within the meaning of small business entity in section 23 of the ITRA 1986 as applicable in the 2015-16 and 2016-17 income years, and section 328-110 of the ITAA 1997.
>
> **Applying this Ruling**
>
> 5. The concept of 'carrying on a business' is a longstanding feature of the income tax law and is relevant to various provisions of general and specific application.
>
> 6. However, this Ruling only applies to and binds the Commissioner in relation to section 23 of the ITRA 1986, as it applied in the 2015-16 and 2016-17 income years, and section 328-110 of the ITAA 1997."

Where a tangible asset is involved, the basic CGT small business relief issue in the kind of case postulated in TD 2021/1 arises under s 152-40(1)(a) ITAA97. The issue is whether the particular asset is used, or held ready for use, in the course of carrying on a business. Because of the parameters within which TR 2019/1 operates, it is suggested that this issue would need to be considered without reference to that ruling. The only reason that TR 2019/1 could be relevant is because of the way that s 328-110 may impact on the operation of the CGT small business relief provisions, for example, in determining whether an entity is a CGT small business entity for the purpose of s 152-10(1)(c)(i) ITAA97. Such a determination is not relevant to the question as formulated in TD 2021/2.

It is beyond the scope of this article to consider in any detail whether a company in the circumstances assumed in TD 2021/1 would be carrying on a business within the ordinary meaning of the concept of business as affected by any relevant contextual considerations. But several observations may be briefly made.

First, there does not appear to be any authoritative judicial pronouncement in Australia in relation to the operation of the general concept of business in the context of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) or the ITAA97 where there is the leasing of a single property. It may be noted, however, that, in *Kennedy Holdings and Property Management Pty Ltd v FCT*[3] where the question was whether a payment by the lessors of commercial premises to the lessee to end an uneconomic lease was allowable as a general deduction, Hill J said:

> "17. It cannot be said on the evidence of the present case that the applicant is, for purposes relevant to s.51(1) [ITAA36],[4] carrying on a business."

Second, in *Mould v Commissioner of State Revenue*,[5] the Victorian Court of Appeal held that the renting out of a number of residential properties by the trustee of a deceased estate constituted the carrying on of a business for the purposes of s 67(2)(c)(i) of the *Land Tax Act 2005* (Vic). In the relevant year, the estate derived income from three sources: from primary production, from rent, and from interest on bank deposits. The issue was whether the estate conducted a separate business of renting residential properties which would mean that primary production was not its sole business and there would be no land tax exemption. The Court of Appeal unanimously held that a separate business was being carried on.

Warren CJ (Tate JA agreeing) said that she considered that "business" in s 67 of the *Land Tax Act 2005* bore its ordinary, general meaning and that there was no rule that the mere holding of residential properties for lease could not, without more, constitute a "business" for the purposes of that section.[6]

Digby AJA (Tate JA agreeing) said that he did not accept the appellant's assertion that the existence of a business can be tested by whether the relevant activities are "passive" or "active", nor that, without a specific statutory context, the receipt of rental simpliciter from a capital asset is not, or is probably not, an activity in the nature of carrying on a business. What amounts to a business, and what does not, will in most cases depend on the context and the existing legal perspective often arising as a result of relevant legislation, and the particular facts of the case.[7]

Third, there may be an argument that the express exclusion (from CGT small business relief) of a CGT asset, the main use of which is to derive rent, carries the implication that, in the context of Div 152 ITAA97, there may be the carrying on of a business where what is involved is the derivation of rent under a lease of real property.

Fourth, the statutory example given in relation to s 152-40(4)(e) is of a house that is owned by a company as an investment, and which is rented out. The example states that the house is not an active asset because the company is not using the house in the course of carrying on a business. This prompts the question of why there should be any difference where a commercial property, not a house, is the CGT asset.

Fifth, for the purpose of applying the main use to derive rent exclusion from the definition of "active asset", s 152-40(4A)(b) treats the use by an affiliate of, or an entity connected with, the taxpayer as being the taxpayer's use. But it would seem that it would still be necessary to determine the anterior question whether the taxpayer was in any event carrying on a business.

Practical point

It is certainly not uncommon for a taxpayer to rent out a CGT asset (such as factory premises) to an affiliate or a connected entity which uses the asset for business purposes. Often the taxpayer will envisage that not only will there be an income stream, but also that CGT small business relief will be available in respect of a capital gain that may arise on the disposal of the asset. In such a case, it may be prudent to obtain a binding private ruling from the Commissioner on the operation of CGT small business relief in the circumstances, including on the issue of whether the taxpayer is carrying on a business

Construction issues

To the extent that there are issues of statutory construction involved when applying the CGT small business relief provisions, it is important to keep in mind the approach of the Full Federal Court in *Eichmann v FCT*[8] to the construction of those provisions. In a joint judgment, the full court (McKerracher, Steward and Stewart JJ) said:[9]

> "*Secondly*, contrary to the Commissioner's submissions, in our view the provisions conferring small business relief … should be construed beneficially rather than restrictively in order to promote the purpose of the concessions conferred by that Division …
>
> It follows that because s. 152-40(1)(a) is beneficial in nature, 'its language should be construed so as to give the most complete remedy which is consistent "with the actual language employed" and to which its words "are fairly open"': *Khoury v. Government Insurance Office of New South Wales* [1984] HCA 55; (1984) 165 C.L.R. 622 at 638 per Mason, Brennan, Deane and Dawson JJ. In that respect, a beneficial construction of legislation may, in our view, legitimately influence constructional choices in a given case which arise from the use of generalised language to describe a necessary connection between two things; here those two things are the use of an asset and the carrying on of a business."

The compendium

As noted above, a compendium (TD 2021/2EC) was released along with the issue of TD 2021/2. The compendium addresses three issues, two of which are as follows:[10]

> **Issue raised:** The determination does not acknowledge the application of s 152-40(4A) to the use of an asset by an affiliate or an entity connected to you, which treats this as your use.
>
> **ATO response:** The example in para 2 of the final determination has been updated to reflect that the investment property is leased to an unrelated party.
>
> **Issue raised:** The purpose of the determination was queried, as it was believed that this was a straight-forward application of the law.
>
> **ATO response:** The purpose of the determination is to make clear the Commissioner's view that, while a company may be considered to be carrying on a business (as described in TR 2019/1) where its investment property is used to derive rent, for the purposes of the CGT small business concessions in Div 152, whether the property satisfies the active asset test under s 152-40 is a separate consideration.

In relation to the first issue above, it is suggested that it would have been helpful if TD 2021/2 had considered the operation of s 152-40(4A), rather than simply modifying the example with no actual reference to the provision so that the significance of the reference to unrelated third parties is left obscure.

The second issue raised above is correct, so a reader may well wonder why TD 2021/2 was issued.

Conclusion

It will be seen that a number of CGT small business relief issues are raised where the activities involved are the leasing of premises. It is to be hoped that the Commissioner issues further binding guidance on some of these issues.

TaxCounsel Pty Ltd

References

1 The determination points out that TD 2006/78 provides examples of when the Commissioner considers property is for the main use of deriving rent.

2 Section 328-110 ITAA97 defines what is meant by the expression "small business entity". That definition is relevant to the provisions of Div 152 ITAA97 that refer to a "CGT small business entity".

3 [1992] FCA 645.

4 See now s 8-1 ITAA97.

5 [2015] VSCA 285, in particular, at [97] and [201].

6 [2015] VSCA 285 at [84].

7 [2015] VSCA 285 at [203].

8 [2020] FCAFC 155.

9 [2020] FCAFC 155 at [38] and [40].

10 These are in fact issues 2 and 3 in the compendium.

Mid Market Focus

by Andrew Burns, CTA, HLB Mann Judd

Permanent establishments: COVID-19 and beyond

COVID-19 has changed the workplace and may also affect permanent establishments. Now is a good time to review their operation.

Travel restrictions have been successful in reducing the spread of COVID-19 in Australia, but they can lead to unintended tax consequences. This is particularly true for foreign businesses which may be deemed to have a permanent establishment in Australia due to the presence of staff who would otherwise be located outside of Australia.

To assist taxpayers caught in this situation, the ATO has issued guidance stating that it will not deem a foreign business to have a permanent establishment in Australia if employees are temporarily located in Australia due to COVID-19 travel restrictions.

For those non-resident taxpayers which already have a permanent establishment in Australia, changes to work practices in response to COVID-19 may prompt an evaluation of whether they still need to maintain a permanent establishment in Australia.

Importance of permanent establishment

Generally, non-residents are taxable in Australia on their Australian-sourced income. However, where there is a double tax agreement (DTA) between Australia and the taxpayer's country of residence, the provisions of the DTA will overwrite the general rules.

While the specific provisions vary from DTA to DTA, and therefore it is necessary to consider the provisions of the relevant DTA, for simplicity, the DTA between Australia and New Zealand will be used in this article as a substitute for all DTAs.

Article 7 of the Australia–New Zealand DTA provides that the business profits of a taxpayer will only be taxable in the country where it is a resident, unless it carries on business in the other country through a permanent establishment. That is, a resident of New Zealand would only be taxable in Australia on the profits attributed to a permanent establishment in Australia.

Definition of permanent establishment

Article 5 of the DTA defines a permanent establishment as a fixed place of business, and specifically includes the following:

- a place of management;
- a branch;
- an office;
- a factory;
- a workshop;
- a mine, an oil or gas well, a quarry or any other place of extraction of natural resources; and
- an agricultural, pastoral or forestry property.

In addition to these physical locations, para 4.a)(i) of art 5 extends the definition of permanent establishment to include circumstances where a business provides services through an individual who is present in the other country for more than 183 days in any 12-month period, and more than 50% of the gross revenues attributed to the business are derived from the services provided by that individual in the other country.

Paragraph 4.a)(ii) further provides that a business will have a permanent establishment if it provides services in the other country in relation to a single project or multiple connected projects where the individuals providing the services are present in the country for more than 183 days in a 12-month period.

The mere presence of the taxpayer's employees in Australia for more than 183 days will not necessarily create a permanent establishment. The additional requirements that they generate at least 50% of the gross revenue of the business, or work on a single project, must also be met.

A non-resident taxpayer with Australian resident employees who generate only a small percentage of the business income from working on a large number of small, unrelated projects will not have a permanent establishment under para 4.a)(i) and (ii).

Following the introduction of restrictions on people coming to Australia, and quarantine requirements, many foreign businesses may have chosen to have any workers in Australia remain for an extended period of time, causing them to exceed the 183-day threshold under the subparagraphs mentioned above. This in turn may cause the business to have a permanent establishment in Australia where it otherwise would not.

ATO guidance

In response to concerns about the unintended consequences of COVID-19 travel restrictions, the ATO has provided guidance stating that it will not apply compliance resources to determine that a taxpayer is carrying on business through an Australian permanent establishment in the following circumstances:

- the business did not have a permanent establishment in Australia prior to the introduction of the COVID-19 restrictions;
- the temporary presence of employees in Australia continued solely due to the COVID-19 related travel restrictions;
- those employees temporarily in Australia will relocate overseas once the travel restrictions are relaxed; and

– the business has not recognised the employees temporarily in Australia as creating a permanent establishment in Australia for the purpose of foreign tax laws.

This last requirement is important as the tax laws of many countries exempt profits earned by foreign permanent establishments from local tax. If a non-resident taxpayer was able to deem that it has a permanent establishment in Australia under the laws of its home country, exempting it from tax, it would be unreasonable to exempt it from Australian tax by deeming that it did not have a permanent establishment for Australian tax purposes.

Where one or more of these circumstances are not satisfied, the taxpayer will be treated as having an Australian permanent establishment, and will be taxable in Australia on the permanent establishment's profits.

It should be noted that this guidance only applies in circumstances where the presence of a taxpayer's employees deemed it to have an Australian permanent establishment. If it is deemed to have a permanent establishment due to the application of other provisions within the relevant DTA, such as establishing an office in Australia, this guidance will not apply.

The approach set out in the ATO's guidance is applicable until 30 June 2021. After that date, taxpayers will be required to determine if their activities constitute a permanent establishment based on the provisions set out in the relevant DTA.

Re-evaluating an existing permanent establishment

With many employees working from home for extended periods, and the increase in online meetings due to COVID-19 restrictions, non-resident taxpayers may wish to review their existing permanent establishments. They may wish to consider whether they need a permanent establishment in Australia, or whether they still have a permanent establishment in their current circumstances.

Where a taxpayer has a factory, workshop, mine site, or agricultural property in Australia, it is clear that it must continue to utilise these sites, and therefore will have a permanent establishment as defined in para 2.d), e), f) and g) of art 5 of the DTA. However, if the permanent establishment consists of an office in Australia (as per para 2.c) of art 5), changes to work practices may make that office obsolete.

An example of this may be a foreign company that maintains an office for its sales team in Australia. However, due to COVID-19, all of the sales people now work from home, only coming into the office for occasional meetings that cannot be conducted online. If the company was to find an alternative location for these face-to-face meetings, it could close the office, ceasing to have an Australian permanent establishment.

Without a permanent establishment in Australia, any Australian-sourced profits will only be taxed in their home country in accordance with the terms of the DTA.

When determining whether a taxpayer still has a permanent establishment in Australia, it should be noted that, under para 7. of art 5 of the DTA, a physical location will not be deemed to be a permanent establishment where it is merely used for the storage, display or delivery of goods, or for activities that are preparatory or auxiliary to the main activities of the taxpayer's enterprise.

Therefore, if the taxpayer in the previous example was to withdraw its sales team from Australia but keep a warehouse to allow goods to be delivered to customers in a timely manner, it will not have a permanent establishment in Australia.

Care should be taken before concluding that the closure of an Australian office will cause the taxpayer to cease to have a permanent establishment in Australia, as the presence of a place of management will create a permanent establishment under para 2.a) of art 5 of the DTA. A place of management is not defined in the DTA, so it can be defined quite broadly.

Countries without a DTA

It should be noted that the exemption of Australian-sourced income that does not relate to a permanent establishment is contained in the DTAs that exist between Australia and a number of other countries, not in Australian tax law.

Therefore, if a taxpayer which is a resident of a country without a DTA has Australian-sourced income, they will be subject to Australian tax on that income regardless of whether they have a permanent establishment or not.

Care should also be taken when reading DTAs to ensure that taxpayers are covered. For example, the DTA between Australia and China specifically excludes Hong Kong. Therefore, a resident of Hong Kong will be treated as any other taxpayer resident in a country without a DTA.

Foreign permanent establishments of Australian residents

Section 23AH of the *Income Tax Assessment Act 1936* (Cth) provides an exemption from Australian tax for profits earned by an Australian resident company through a foreign branch.

This exemption applies independently to the permanent establishment provisions contained in the DTAs and will apply regardless of whether there is a DTA between Australia and the country where the branch is located or not.

However, there are different tests for the exclusion of income that fails the active income test based on whether the branch is in a listed or an unlisted country. Listed countries are set out in Sch 10 to the *Income Tax Regulations 1936* (Cth) to be: Canada, France, Germany, Japan, New Zealand, the United Kingdom and the United States. All other countries are unlisted countries.

For the purposes of s 23AH, a foreign branch is defined more generally than the definitions given for a permanent establishment under most DTAs.

Conclusion

In a world that is changing due to COVID-19 and the responses of various governments and businesses, taxpayers with international activities should consider their new circumstances to determine whether they have a permanent establishment, and consider the resulting tax consequences.

Andrew Burns, CTA
Manager
HLB Mann Judd

Higher Education

Managing and distributing generational wealth

The dux of Tax for Trusts in Estate Planning and Wealth Management for 2020 study period 2 shares how study has deepened her understanding of this topic.

Mariana Khuszana-Knight, Manager, Ernst & Young, Queensland

Please provide a brief background of your career in tax.

I have spent most of my career in tax in chartered accountant firms, servicing a diverse portfolio of corporate tax clients, as well as SME and high net worth private clients. After taking a big career break to give commercial a try and to start a family, I came back to the profession a few years ago.

What have you taken away as the most valuable aspect of studying this subject?

The Tax for Trusts in Estate Planning and Wealth Management subject covers an area that I have not had extensive experience in. As such, studying this subject has increased my confidence and deepened my understanding of this topic.

What are your areas of new confidence?

Navigating and assisting clients within the complex landscape of managing and distributing generational wealth as a legacy to leave behind after passing on.

What was the reason for undertaking this specific subject?

I chose this elective subject within the Graduate Diploma program to broaden my knowledge and increase my professional competence within this field because, in an era of ageing populations, complicated family relationships and continuing growth in private market and private wealth, I'm seeing more opportunities in this sector.

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

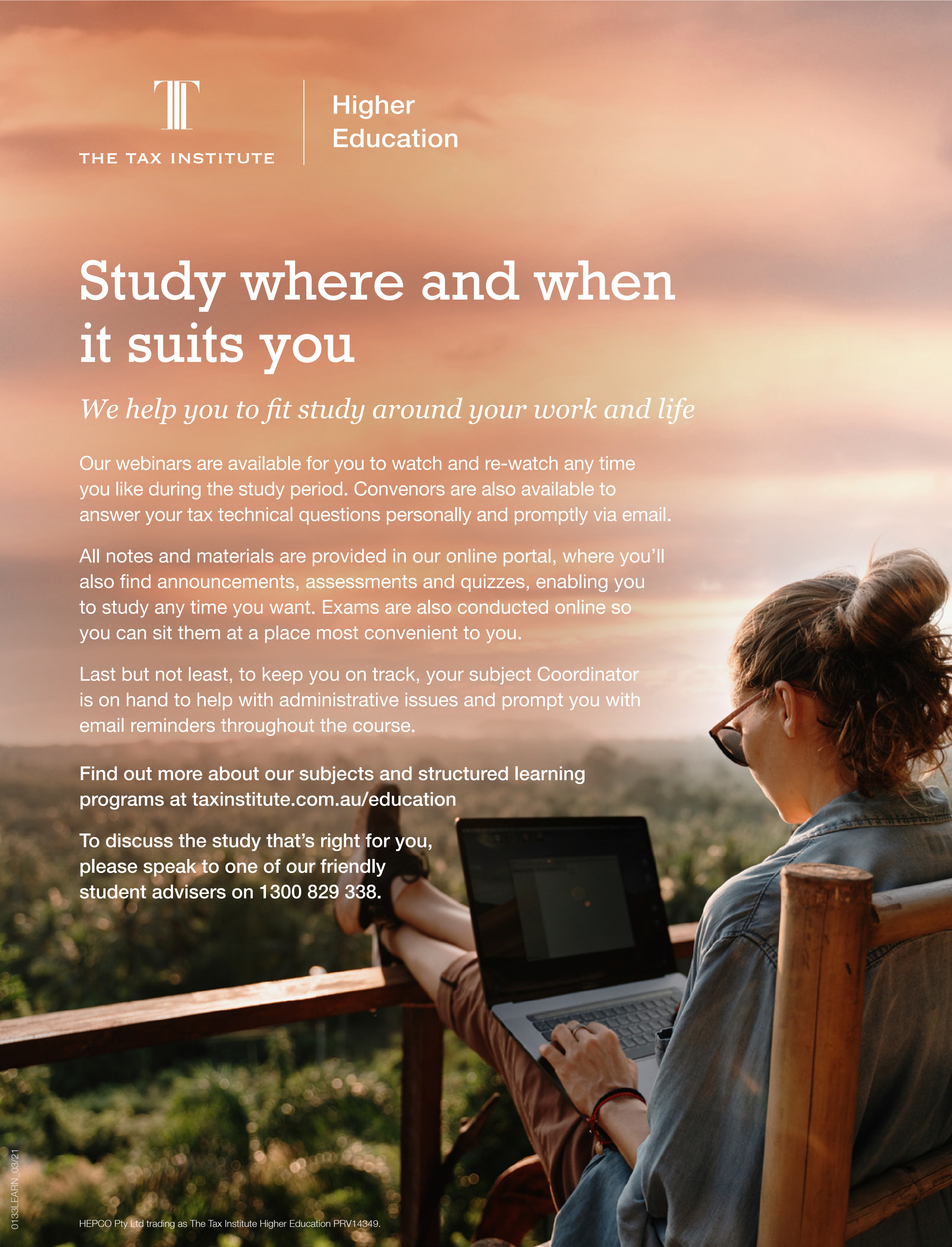
Finishing off both my Graduate Diploma of Applied Tax Law and Chartered Tax Adviser programs with The Tax Institute.

What are some challenges of juggling study and work?

Work, study and family needs all require time and attention. The challenge is balancing these needs to ensure that each area is not cheated one way or another. My top tip would be to respect the time spent on each area (whether it is your time or others) and to be completely present for the allocated time and key moments.

What advice do you have for other tax professionals considering the Graduate Diploma of Applied Tax Law?

The Graduate Diploma of Applied Tax Law is a great course that allows you to deepen your tax knowledge and skills. It also provides practical application of the topics covered.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Member Profile

This month's column features Kim Reynolds, CTA, from Vincents, Queensland.

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1998

Areas of specialty

I provide specialist tax advice principally in the areas of income tax, CGT and GST as they apply to privately held family groups and high net worth individuals. I have a particular interest in helping clients deal with business restructures, family succession and estate planning, as well as assisting clients and their legal advisers in understanding the tax issues related to family law and dispute matters.

What made you choose tax as a career and join The Tax Institute?

I wanted to have a career that would continue to challenge me; tax is ever-changing so it fits the bill nicely. I enjoy the technical analysis involved in my day-to-day work and seeing how that applies practically. Helping others piece together the constantly changing and increasingly complex world of tax keeps me on my toes and brings with it a lot of job satisfaction. The exposure I get to many aspects of a client's life (starting out, investing, setting up business, succession and estate planning) allows me the privilege of a "front row seat" to witness how the right tax solutions can truly make a difference in personal and professional life journeys.

How is your membership beneficial to your practice and clients?

My membership with The Tax Institute allows me to stay connected with other tax professionals, locally and around Australia, and ensures that I have the resources available to stay up to date with the continually changing tax landscape. In this profession, it is important to not only have a detailed understanding of the tax law, but also how to apply this (sometimes quite complex) legislation to practical and commercial situations.

What is your most memorable career achievement to date?

A career of almost 30 years brings with it many memorable moments. However, being promoted to Director and heading up the Taxation Advisory arm of Vincents are both significant milestones for me.

What do you see being the main challenges for tax practitioners this year?

As Australia and the world emerges from the disruption of 2020, businesses and regulators will be looking to get back to some sort of "normal". Tax practitioners will need to remain focused on continuing to help their clients manage, mitigate and move forward, while staying on top of the tax law changes and regulatory compliance that are likely to continue to unfold for some time to come.

What do you see as the key attributes of an effective leader in the tax profession?

In my opinion, the key attributes of an effective leader in the tax profession are:

- awareness: always learning and staying abreast of the latest developments that may impact the tax landscape, and maintaining a good understanding of what is happening in the world around us;
- adaptability: being ready to embrace these changes in our profession in a proactive manner; and
- critical thinking: recognising that the world of tax is not just limited to numbers, reporting, laws and regulations, and thinking outside the box when analysing data, looking for trends and formulating strategies.

Do you have any advice for young professionals just beginning their career in tax?

Be curious. Ask questions. Never curb your appetite to learn!

What does work–life balance mean to you and what are your interests outside of work, how do you relax?

Maintaining a healthy work–life balance is not only important for my health and relationships, but it can also enhance my performance — hobbies can provide added insights or angles on your work that you may not have thought of otherwise! I unwind by reading fiction and non-fiction books, listening to music and podcasts, and watching favourite TV series — all on an eclectic mix of topics, including politics, science, history and business.

High wealth private groups: risk reviews

by Sue Williamson, CTA (Life), Partner, and Damien Bourke, Partner, Holding Redlich

The ATO has turned its focus to high wealth private groups (HWPGs) with the implementation of the Next 5,000 tax performance program. Every HWPG will be reviewed over the next four years. This article summarises what HWPGs can be doing now in preparation for a review. This includes identifying risks, getting evidence together to support the positions taken, and considering whether a voluntary disclosure of any errors is necessary. It will also include ensuring that there is a formal documented tax governance policy in place. There is a recognition that this does not mean a policy of the kind that the Commissioner of Taxation requires of large corporates. However, HWPGs are expected to have tax governance policies. High wealth private groups and their advisers are encouraged to take the opportunity to get themselves ready so that they avoid exposure to an audit or ongoing ATO reviews because of a lack of confidence in taxpayer systems.

All high wealth private groups (HWPGs) will be subject to a streamlined assurance review (SAR) at some point over the next four years. This means that the Australian Taxation Office will test whether the correct amount of tax has been paid during the period under review, assess the HWPG's approach to tax risk management, and assess its tax governance (TG) structure. If the ATO determines that the correct amount of tax has not been paid, it will seek to recover it and, possibly, a dispute will ensue. If the HWPG's approach to tax risk management and/or TG are assessed as being inadequate, the ATO will take the view that it does not have justified trust in the HWPG's systems. The consequence of this is that the HWPG will be subject to ongoing reviews and interactions with the ATO until it is satisfied with the HWPG's approach to tax risk management and its TG processes.

In this article, we look at what can be done in advance of the commencement of an HWPG SAR to reduce the possibility of a tax dispute and to reduce the cost and inconvenience of ongoing ATO review due to perceived inadequate TG processes.

In summary, the authors' recommendations are:

- identify who in the group will be responsible for the SAR process and be the key contact person with the ATO;
- determine who will be used as an adviser during the SAR process. This will depend on the nature of the tax risks (if any) that the HWPG is concerned about. It will generally need assistance from the adviser who assisted in preparing its returns as they will have a lot of the relevant information. It might also need advice from an adviser with expertise in ATO reviews/disputes;
- check the HWPG's information technology (IT) systems against the ATO's expectations by downloading the ATO information system risk assessment (ISRA) tool and make any enhancements that are necessary;
- use the time before being notified of the commencement of the SAR to identify risks and start gathering evidence to support the position taken in relation to these issues. The key risk areas for HWPGs are listed below, together with action that can be taken in relation to the issues likely to be raised in the SAR;
- consider making a voluntary disclosure if an error is identified. This should reduce the exposure to penalties and interest. If done properly, it might also assist with ongoing engagement with the ATO;
- review the HWPG's TG system(s). If it is documented, check whether it needs to be updated and that it is being complied with. If it is not documented, start the documentation process. A taxpayer will not get through the SAR process on a positive basis without a working documented TG program;
- if the HWPG relies on external advisers for all tax matters, those advisers need to be included in the TG documents and processes;
- a company is not excluded from requiring a TG program because it only has one director/influencer. As discussed below, the TG documents need to reflect this and what it means to everyone else working in the group in terms of the expectations of them and responsibilities for tax compliance and tax risk management; and
- the HWPG should review its audit insurance — check whether it applies to SARs (as opposed to audits). Also, check whether it needs upgrading and what the notification obligations are. Do not risk having a claim rejected because of a failure to comply with reporting obligations.

Next 5,000 tax performance program

The ATO kicked off the "Next 5,000 tax performance program" (the program) last year. The ATO states that the aim of the program is:[1]

> "… to increase ongoing willing participation by applying our justified trust methodology in our one-to-one tailored engagements. The program also focuses on prevention rather than correction through providing public advice and guidance on issues relevant to the Next 5,000 population."

It is further stated that there will be tailored and targeted approaches to taxpayers in the program, including:[1]

> "– letting you know about issues that attract our attention
>
> – publishing public advice and guidance on relevant issues

– providing certainty about significant commercial deals through early engagement and pre-lodgment agreements

– engaging through tailored reviews (primarily through streamlined assurance reviews) and, where appropriate, audits."

The reality is that the approaches identified in the first three points above are available to all taxpayers. That leaves us, from a practical perspective, with the program focus being on SARs of HWPGs.

The program is scheduled to run for four years until 2022-23. Of course, COVID-19 could see that time frame push out.

In this article, the authors provide an overview of what can be expected from a SAR that is conducted under the authority/remit of the program and what the ATO expects of HWPGs in relation to TG.

The HWPG tax gap

In October 2020, the ATO published data on the HWPG tax gap.[2] It estimates that there was a tax gap of 7.4% in the 2017-18 financial year. That is, 7.4% of tax receipts that it is estimated should be collected from HWPGs is not collected.

It concludes that the majority of HWPGs are paying the right amount of tax but identifies that some HWPGs make errors and some deliberately avoid tax. It is noted:[2]

"Where high wealth private groups are getting their tax right, they:

– have strong tax governance practices and system controls

– seek advice from tax professionals when considering making changes to their business or wealth management structures

– talk to us to gain greater certainty about the tax consequences of significant transactions or changes in structure before they happen.

When business owners and wealthy individuals make mistakes, it is usually in how they interpret tax law or because they don't understand their tax obligations.

The most common issues we see from taxpayers include:

– incorrectly recording transactions or not reporting transactions that are outside the normal course of business

– not accounting for private use of business funds or assets

– omitting domestic or foreign-sourced income."

This information drives the program and the ATO's approach to SARs, in particular, the increased focus on the need for a documented TG process that underpins a group's approach to tax risk management.

Individuals and groups that fall within the program

The program applies to HWPGs, being "Australian resident individuals who, together with their associates, control wealth of more than $50 million".[1] It does not apply to HWPGs covered by the "Top 500 private groups tax performance program".

The Top 500 includes private groups that are not public groups or foreign owned that:[3]

"– have over $350 million in turnover, regardless of asset value

– have over $500 million in net assets, regardless of turnover

– have over $100 million in turnover and over $250 million in net assets

– involve a company with total business income of over $250 million and are included in the large company tax gap population

– are market leaders or of specific interest."

The concept of the HWPG is an ATO creation rather than a statutory concept. There is a lot of fluidity in the definition, particularly in relation to the concepts of "associates", "control" and "wealth". Associates include companies, trusts and partnerships. Control is said to refer to effective control "where an individual has the primary decision-making role for the group".[4]

The ATO uses data mining techniques to detect relationships between the associated individuals and organisations.

Given that it is an ATO construct, there is no formal avenue to have a group excluded from being classified as an HWPG because it does not fall within the definition, for example, because it is not accepted that certain organisations identified by the ATO as associates are under the control of an organisation and are therefore associates of that organisation. The authors have seen occasions where it has been agreed to remove purported members of groups from the program due to an error being identified in the information used to underpin the decision to include them in the program. However, that is difficult to achieve, particularly when the disagreement is about the level of control over organisations. The reality is, if the ATO states that an HWPG falls within the program, it will generally have to be accepted that this is the case unless material objective errors in the ATO classification can be identified.

The SAR process

A SAR involves a review of the income tax consequences of a taxpayer's group structure, governance, systems, significant transactions, events and activities. For some taxpayers, the SAR will be also extended to GST issues.

The general SAR process is as follows:[1]

ATO issues notification letter followed by letter of commencement

The general policy is for the notification letter to provide three months' notice before commencement of the SAR. Taxpayers can agree to a lesser period of notice. A new option has been introduced to assist taxpayers that are having difficulty due to COVID-19. Taxpayers who opt in can agree for the SAR to commence immediately, with taxpayers providing readily available information up-front (for example, bank statements, tax reconciliations, group structures). Additional time (10 weeks) is then provided to respond to the ATO request for information (RFI).

The notification letter also encourages taxpayers to review records and, if a mistake is identified, to make a voluntary disclosure. The benefit of this is the potential reduction in penalties (up to 80%) and interest.

Meeting (face-to-face or phone)

The purpose of the meeting is for taxpayers to provide an overview of their business and any issues, and, if necessary, to discuss the possibility of voluntary disclosures. The ATO will also discuss time frames and the information required. Broadly, there should be agreement on the way forward.

ATO issues RFI providing the client with 28 days to respond

It is possible to get an extension of time to respond. However, this is usually subject to information being made available as it becomes available. The short time frame (28 days) reinforces the need for taxpayers that fall within the program to start getting ready for a SAR before they are even notified of the SAR. This is also important because it might demonstrate that a voluntary disclosure should be made to limit penalties. It is possible to prepare in advance because the first RFI for each SAR generally has the same questions, typically requesting:

- group structure;
- an explanation of misalignment between accounting and tax results;
- information on dealings with international associates;
- details of approach to tax governance and risk management;
- transactions, acquisitions and disposals; and
- details of transactions that are covered by practical compliance guidelines or tax alerts.

In addition, prior to issuing the RFI, the ATO will have undertaken a review of the HWPG and, if specific issues are identified, will raise those matters in the RFI. It is obviously harder to prepare for these questions. However, if taxpayers are aware of a high-risk issue, the best advice would be to start thinking about how they are going to respond to an RFI on that issue and, if appropriate, to start gathering supporting evidence.

Taxpayer sends RFI response to ATO

The general position in the initial response to the RFI is that taxpayers should use this opportunity to present the best case they can on the relevant issues. Do not just respond to the question. Understand the tax issue and provide everything necessary to support the position taken. If available and useful, get a witness statement. The best time to limit the risk of an extended review/dispute is when the first question is raised. It is always harder to move someone once they have formed a view on something, even if that view is based on incomplete information.

Once the ATO has reviewed and synthesised the information provided, it may (and typically does) conduct ongoing discussions or issue a further RFI.

ATO issues streamlined tax assurance report to taxpayer

The ATO will issue a streamlined tax assurance report (STAR) at the end of the SAR. Adopting a traffic light system, this outlines the transactions, events and activities that the ATO has no issue with, highlights areas for improvement, and outlines any risks that are to be further considered (unassured risks).

Discuss next steps

Any discussion on the way forward obviously depends on the outcomes reported in the STAR. Items that are given a red outcome are likely to be referred to audit. Once a SAR is completed, any future reviews will exclude the years to which the SAR related, except for unassured risks or if the ATO becomes aware of new information.

The ATO objective is to ensure that reviews will be completed within four months of all of the information requested. There is certainly a lot of effort by ATO teams to comply with this time requirement. However, sometimes the time frame does extend out. (Recent experience is that time frames are being extended, perhaps due to increased workloads brought about by the pandemic.)

HWPGs get ready for SARs now

Based on the Top 500, in the context of HWPGs, it is expected that SARs will focus on:

- Div 7A of the *Income Tax Assessment Act 1936* (Cth) issues;
- trust taxation;
- taxation of financial arrangements;
- GST;
- CGT, consolidations and restructures (particularly those with little economic impact but resulting in substantial tax benefits);
- transfer pricing and related party financing; and
- methods used to allocate R&D expenditure, particularly the allocation of overheads, as well as consolidation and restructuring.

In view of this, and because the standard questions for SARs are known, HWPGs should start preparing now, even if the letter of notification has not yet been received. Use this time to identify the technical issues that are likely to be tested and to make sure you have all of the contemporaneous documents needed to validate the position and evidence the commercial rationale for transactions.

It is suggested that this time is used to:

- review tax governance practices — ensure that written policies are in place;
- update group structure diagrams and organisational charts;
- gather all trust deeds (including amendments), trustee distribution resolutions, company constitutions and other constituent documents;
- review trust deeds to ensure that the beneficiary structure is understood and make sure that all minutes are valid;
- gather financial accounts and tax and accounting reconciliations;
- review any recent significant transactions, related party transactions and restructures;
- gather details of transactions that are covered by practical compliance guidelines or tax alerts;
- ensure that there is a proper understanding of the pricing of related party international dealings and there is documentary support for same; and
- get an understanding of the robustness of the group's systems.

Audit insurance and SARs

An increasing number of organisations are obtaining tax audit insurance. Taxpayers should check their policies to see if they are covered for the cost of a SAR and, if not, to identify if there is anything they need to do in relation to the SAR process to ensure that they will be covered for the cost of an ATO audit that results from the SAR.

Many policies do not apply to SARs as they are limited to audits. If that is the case, it might be opportune to get an issue moved to audit as soon as it is identified that it is likely to become a significant dispute issue. Regardless, policies should be checked to understand what is required to be disclosed to an insurer and the time frame for doing so. An adviser would not want to be responsible for precluding a claim because of failing to advise in accordance with the requirement of the policy.

Focus of SARs

A SAR is undertaken in accordance with the justified trust methodology to assure the ATO that the taxpayer has paid the right amount of tax and there are no risks requiring further follow up. That methodology has a focus on the following four areas:

1. **tax governance:** the ATO will review the design of the taxpayer's TG documents to assess whether it can be confident that there is sufficient robustness to ensure that tax outcomes are correct. The ATO's expectations of governance for HWPGs is discussed below;
2. **tax risks flagged to market by the ATO:** the ATO is flagging risks to the market through practical compliance guidelines and tax alerts, basically saying, "we think these types of transactions/events might not be providing the tax outcomes expected and should be reviewed". The SAR RFI will ask for disclosure of all transactions/ events within the HWPG that fall within matters described in practical compliance guidelines and tax alerts. Care needs to be taken when responding to this as practical compliance guidelines and tax alerts usually deal with specialised areas. Prior to responding on these issues, the taxpayer should obtain advice from someone who is experienced in dealing with the ATO to ensure that technical and evidentiary issues are properly covered, as well as to consider the best strategic approach to respond to these questions;
3. **tax outcomes of new and significant transactions:** this is about the ATO getting a proper understanding of the HWPG's operations and tax risk profile; and
4. **reconciliation of book to tax results:** this is about the ATO getting an understanding of why book performance and tax performance differ (if they do). This is undertaken across the HWPG and includes looking at all entities, including trusts and partnerships. Taxpayers generally identify things like R&D claims, exempt income, deemed income, timing differences, and transfer pricing adjustments. It should be expected that the identified matters will be reviewed to determine whether they are acceptable to the ATO.

Tax governance

The term "governance" is defined by the Governance Institute of Australia as:[5]

> "Governance encompasses the system by which an organisation is controlled and operates, and the mechanisms by which it, and its people, are held to account. Ethics, risk management, compliance and administration are all elements of governance."

Governance applies to every aspect of an organisation's operation and rightfully extends to tax, given the legal and social importance of ensuring that tax obligations are met. It is also important from the personal perspective of directors as they can become personally liable for unpaid PAYG withholding amounts, unpaid superannuation guarantee charge obligations, GST, wine equalisation tax, and luxury car tax obligations of the company.

Tax governance is often considered by taxpayers and advisers as a burden imposed by the ATO on taxpayers. This is correct if the only reason you implement a documented TG policy is to "pass" a SAR. However, this is a narrow view. In the process of establishing a TG policy for a SAR, many acknowledge the benefits for the business moving forward. What are those benefits? That is probably best put by Fiona Moore and Victor Nguyen in a recent article:[6]

> "In the ever-increasing tax transparent landscape, one best practice to adopt to identify, escalate and mitigate tax risks (and the inherent reputational risk) is a tax corporate governance (TCG) (or tax risk management) framework."

Broadly, in putting together a documented TG policy, an organisation needs to reflect on its attitude to tax risk. It can range from being willing to take a risk no matter how significant that risk is, to not being willing to be exposed to any risk, or anything in between. No position is wrong. What is important is that it needs to be a properly informed decision. A taxpayer can choose not to be risk averse — but understand the possible consequences, including potential penalties, reputational risk from media attention, exposure to increased ATO reviews and audits (resulting in increased time commitment and costs), and stakeholders (including investors, employees and customers) choosing not to deal with the HWPG. A taxpayer can choose to be risk averse — with possible consequences including paying more tax than otherwise would be properly payable, increased costs of advisers, and delays in implementing transactions because of the need for rulings to support positions.

Another benefit of a documented TG policy is the clear identification of who is responsible for each area that impacts tax. This is beneficial to the taxpayer, employees and advisers. Several times over the years, the authors have seen, midway through an ATO review or transaction, a question arise about employment tax issues or stamp duty. And the response is: "I'm not sure who handles that." Sometimes nobody does or sometimes human resources might have loose control over employment tax issues. A documented TG policy ensures that all taxes, system issues, and lodgment issues have a home. Someone is accountable. This is of benefit not only for the taxpayer group to know that it will be covered, but also for employees and advisers to understand their roles.

The ATO's approach to TG for larger corporate taxpayers is set out in *Tax risk management and governance review guide* (the guide).[7] Before an HWPG rushes to the guide and panics about the expectations, the guide contains what the ATO considers to be "better practices" for large companies.

It is not expected that it will translate to an HWPG in its entirety. Instead, it is acknowledged that there is a need to step back and consider what makes sense for each HWPG; that a documented TG policy is necessary, and will reflect the principles of the guide but it will look very different to the documented TG policy contemplated by the guide:[8]

> "We expect private groups to have effective tax governance practices in place to identify and manage tax and superannuation risks. The right governance for your business will depend on a range of factors, including its size, complexity, history and culture.
>
> If you're a privately owned group, investing in effective tax governance that supports appropriate tax outcomes can influence your tax profile with us, with the potential to save you time, money and effort."

The fact that an HWPG does not have a documented TG policy does not mean that it does not have a TG system. A TG policy can exist without being formally documented. It can be derived from a myriad of places, for example, the combination of requirements of directors to be told about exposures, the practices of employees (sometimes in their employment contracts), and IT systems. Yes, it will be necessary to document the TG policy to get a green light assessment from the ATO. However, do not concede that there is no TG policy just because it is not documented in one convenient place. If it can be shown that the TG policy can be derived from a number of different places, and that this has been effective as a tax risk management tool, this should assist in the TG rating. High wealth private groups will still be expected to introduce a documented policy but will be given time.

ATO approach to assessment of TG for HWPGs

To assess the effectiveness of an HWPG's TG, the ATO looks for evidence that a taxpayer has applied the following seven principles of effective tax governance in six key focus areas (see Table 1, the content of which is reproduced from the ATO website).[9]

The six key focus areas are:

1. roles and responsibilities;
2. control framework;

Table 1. Seven principles of effective tax governance[9]

Accountable management and oversight	Roles and responsibilities are clearly defined and understood in terms of accountability for tax administration and decision-making. You understand your tax and super obligations, including registrations, lodgment, reporting, payment and record keeping obligations. Where responsibility for tax governance is shared with your tax advisers, ultimately you as the business owner are confident that you understand the tax risks and are meeting your tax and super obligations.
Recognise tax risks	Appropriate controls and processes are in place to support compliance with tax and super obligations and identify, assess and mitigate commercial and tax risks. Tax considerations are included in your decision-making processes and you're alert to the consequences of decisions made. Material transactions are well documented and subject to appropriate review and sign-off for tax risk purposes. Where commercial and tax risks have been identified, there is a plan to manage the risks and limit the impact on your business. A thorough review process considers the ATO's published view and identifies potential differences of opinion that may give rise to a dispute. Risk of dispute with the ATO over a difference in law or factual interpretation is identified early and steps are taken to engage with us.
Seek advice	Clearly defined arrangements are in place for escalating tax issues and seeking tax advice. Consulting published ATO guidance and advice helps you assess tax outcomes for your business in adopting a particular position. You get advice from tax professionals and advisers, and engage with us early for tailored advice where more certainty is needed.
Integrity in reporting	Owners or managers are able to form the view that the financial records of the business, including tax reporting, reflect a true and fair view of that business. Tax positions align with the law. Tax outcomes either reflect economic performance or are understood and can be explained by other factors. Systems and controls are in place to ensure accurate reporting, and these controls are reviewed periodically to ensure they remain effective. Good record keeping practices are followed to maintain important documentation for the relevant periods so that it is easily accessible.
Professional and productive working relationship	You have an open, transparent, respectful and professional working relationship with the ATO. Through our engagement with you or your advisers we aim to create a seamless working relationship to resolve any issues and avoid disputes.
Timely lodgments and payments	Effective tax governance is demonstrated by meeting obligations including lodgment and payment obligations in full and on time. Time frames are set for tax lodgments and payments. Tax liabilities are well managed and paid on time. Efforts are made to engage with us when you're unable to pay on time.
Ethical and responsible behaviour	Acting ethically and responsibly – with honesty, integrity and in a way consistent with the reasonable expectations of the broader community and the taxpayers' charter. Ethical and responsible behaviour involves more than mere technical compliance with the law. Effective tax governance not only ensures accurate reporting, but helps avoid behaviours associated with tax manipulation, avoidance and schemes.

3. control testing;
4. risks flagged to market;
5. significant or new transactions; and
6. tax and accounting results.

The ATO states that TG ratings are determined by applying these seven principles (see Table 1) across these six focus areas. Each of these six focus areas is rated using a traffic light system (giving a rating of green, amber or red for each focus area). These ratings feed into an overall rating for the effectiveness of the TG framework as a whole. Based on experience with the Top 1,000 and Top 500, many taxpayers will receive a red rating and most will receive an amber rating for their TG. It would be surprising if any received a green rating in their first SAR, except possibly those at the end of the program that have had time to put systems in place based on the learnings from the earlier SARs of others.

TG and IT systems

Clearly, good TG involves careful checks and controls of taxpayers' IT systems. This is why the SAR TG check will include a review of IT systems — whether the right internal controls are in place to ensure the accuracy and completeness of tax reporting and lodgment activities.

The ATO uses the ISRA tool to assess the integrity of taxpayer IT systems. This tool has been used in all Top 500 private groups' tax performance program reviews and will be used in Next 5,000 reviews.

Taxpayers and their advisers can now self-assess the integrity of their IT systems using ISRA.[10]

Building a documented TG policy

High wealth private groups are not required to have a documented TG policy. However, they are required to present evidence to show that their TG is effective. The ATO acknowledges that you can satisfy that requirement in various ways, depending on the nature of your business. However, from a practical perspective, it would be difficult to satisfy the ATO of an effective TG approach without a documented policy.

The starting point for a documented TG policy is that an organisation cannot meet its obligations by simply buying a policy off the shelf — documents need to be personalised to the taxpayer group. Yes, there are template documents. However, they are really no more than a road map as to the issues that need to be considered. They trigger the questions, and the answers to those questions determine what go into the policies.

The establishment of an effective documented TG policy requires specialist input. This is evident from the high level of "red" outcomes received for TG on SARs to date.

An organisation's governance obligations are not limited to TG. It has governance policies that cross all areas of operation, from risk management, litigation, human resources, whistleblowing to IT systems. Tax governance policies cannot be formulated independently of these other policies. When making decisions about TG, it is essential that there be a cross-reference to similar policies to try to get consistency whenever possible and, if not possible, to be able to explain the differences. For example, when putting together a documented TG policy, one of the questions to consider is who is responsible for making a decision about whether to litigate a tax dispute. Before deciding who that is to be, it would be appropriate to check the general governance policy on litigation to see who is responsible for decisions about litigation generally. If that policy says that, for disputes of over $5m, the Board must endorse the decision, the default position should be that the Board is required to sign off on tax litigation relating to that amount.

It is also important to remember that TG does not drive the organisation or the group. For example, while there needs to be a strong IT system with relevant controls testing, tax should not be dictating what the IT system should be. That is a role for the IT experts. The role of the tax person is to inform the IT department of specific tax requirements that need to be included in the system if possible.

Issues specific to HWPGs when building a documented TG policy

The rule that you cannot buy an off-the-shelf TG policy applies tenfold to HWPGs. This group of taxpayers is incredibly diverse. Many have one director and/or "controlling influence". Some have offshore parents that want to impose their governance structure on the Australian subsidiary. Some have in-house tax specialists, some rely solely on third party advisers. All of these things influence what is needed for an effective TG policy.

Entities that have the one "controlling influence" (let's call them "X") can struggle with setting up a documented TG policy because all roads tend to lead to X or else X tries to put the responsibility on someone who is reluctant to take on the responsibility. It is for this very reason that a documented TG policy is necessary. It may be asked: who is responsible for signing off on tax risks greater than $10,000? X may say, "me" or the "junior accountant". The role of an effective TG adviser is to challenge that, with questions like: do you have time to attend to every risk of $10,000 or more, or does a junior accountant have the experience to assess this? Also, the whole point of governance is not to have one person responsible for everything. It is to set up a system that ensures that the appropriate level of consideration is given to matters by the correct group of people before final decisions are made. There can be an educational aspect to this.

The offshore parent can be a difficult scenario when they do not want to give up control. They want to nominate the offshore officers as the responsible parties for the Australian subsidiary. In this case, you need to look at the offshore governance arrangements and assess whether they work in an Australian context. Australian directors need to understand their legal responsibilities and exposures.

High wealth private groups need a documented TG policy even if they have outsourced their tax affairs to third-party advisers. It is important because it ensures that both the taxpayer and the adviser understand their responsibilities. For example, the adviser needs a clear understanding of the taxpayer's approach to risk. Does it want to avoid risk of any kind? When will the taxpayer be satisfied with a senior barrister's sign-off on advice, rather than an ATO ruling?

Who is attending to GST? Who is attending to systems? Who at the adviser's office is doing the work? When should a partner sign-off be required?

If an organisation/group is relying on third-party advisers for their tax obligations, they should have the governance arrangement drafted by someone other than the third-party adviser. It is recommended that an independent party (ie not the adviser) should draft the documented TG policy, as they would be better placed to assess the situation and make sure that the correct protections are included. For example, including the required obligations/expectations of the advisers and the circumstances in which their appointment could be terminated, and making sure that the Board has oversight of specified levels of tax risk.

The benefit of this work is that it enables an assessment as to whether the current arrangements work or whether further resources are required to ensure compliance.

The ATO understands that a documented TG policy for HWPGs will be less formal than what it expects for large corporates or even Top 500 private entities. It requires that the framework ensures that the taxpayer can identify tax risks and has effective controls to mitigate those risks.

Recommended TG documents for HWPGs

As noted above, HWPGs are diverse. There is no one-size-fits-all approach. Subject to this caveat (ie that there will be exceptions for certain groups), it is recommended that the TG be evidenced by a Board policy and a tax risk management framework. The matters to be included in each document is discussed below.

The documents should cover all of the entities in the HWPG if possible. The reality is that sometimes entities have good reason not to be included in the documents. If that is the case, it will be necessary to establish separate documents for the entities that are not included and provide all sets of TG to the ATO in the course of the SAR.

Board policy

The Board policy does not need to be long. It can cover everything that needs to be covered in two to four pages. That said, if an organisation's approach is to explain everything in detail, it will be longer. As discussed above, the TG documents do not stand alone. They are part of the broad governance documents of the organisation/group and therefore should be structured for consistency.

The Board policy can seem like overkill for a company with one director. The only difference between a one director company and a company with several directors is that there will not be a debate between directors as to what should be included in the Board policy. It is still important for the sole director to set the standard, to let all employees know what the group's approach to tax risk management is, and the expectations in terms of reporting into the Board/director in terms of identified events. For example, if the tax treatment applicable to a proposed transaction is unclear and the tax at risk is in excess of $100,000.

The board policy should state the following:

1. **the broad approach to tax:** this statement sets the "tone". It puts everyone on notice as to the how the group is going to interact with the ATO and the acceptable level of tax risk. There is a tendency to write what everyone thinks the ATO wants to see. Wrong. This document needs to be actioned. It must reflect the group's approach to tax risk. As noted above, there is no wrong approach, there are simply repercussions for the approach selected. As long as there is an informed decision (ie knowing and understanding the repercussions), it is not a wrong decision. This document will include statements about compliance with tax laws and will identify the approach to tax, for example, by committing to only adopting positions that are at least reasonably arguable positions or committing to adopting positions that have at least a 30% chance of being correct;
2. **responsibilities for tax risks:** this usually identifies who is responsible for various levels of tax risk. Broadly, there is an identification of risk levels (usually by reference to the value of the tax risk and whether it is of a routine or contentious nature) and clear identification of the person (role) responsible for each level of risk. For example, it might be stated that contentious tax risks of $100,000 or more must be supported by the opinion of a senior barrister and signed off by the Board. There is usually a list of the key tax tasks and the person (role) responsible for those tasks, for example, the CFO is responsible for tax compliance including ensuring that all returns are lodged on time; and
3. **expectation with regard to updating Board:** it should be clearly stated how often management is to report to the Board on tax risks.

Tax risk management framework

The tax risk management framework is more detailed. It is a living document that management (including a third-party adviser if reliance is placed on that adviser to effectively act as the in-house tax resource) needs to follow to ensure that the Board policy is implemented and complied with. It also sets the guidelines for control testing, and for testing the operational effectiveness of a group's TG.

The tax risk management framework also expands on the Board policy, that is, it spells out how the broad approach to tax is going to be complied with on a day-to-day basis. For example, the Board policy might state that all tax laws are to be complied with. The framework will identify who is responsible to ensure that this happens and the general processes. This covers IT, human resources and accounting — all areas that have some impact on tax matters.

Generally, the framework will demonstrate how the group is going to identify, assess, report and monitor tax risk. It will include the controls necessary to ensure that the TG policy is being followed. It is not enough to put together TG documents. They must be reflected in the group's approach to tax, and this must be tested through various control tests prescribed by the framework.

Tax lodgment obligations will be identified, with guidance provided on how to ensure that they are complied with and are accurate.

Table 2. Suggested approach to documenting tax governance

Focus areas	Matters to be considered	Where to document
Roles and responsibilities	– Are roles and responsibilities clearly documented? – Are there clear lines of authorisation and sign-off for tax decisions and administration? – Do the owners, Board and management understand their tax and superannuation obligations, including registrations, lodgment, reporting, payment and record-keeping?	Board policy
Control framework	– Is there a formalised tax strategy documenting controls and processes that identify, assess and mitigate tax risks? – Are there controls to identify and manage tax risks integrated into IT systems and processes? – Is there a documented communication process to escalate tax risks?	Tax risk management framework
Control testing	– Are there audit plans for testing systems and controls relating to tax functions? – Are there documented process for retaining working papers, reconciliation processes and error exception processes?	Tax risk management framework
Risks flagged to market	– Is there a thorough review process considering published ATO views and identifying potential differences in law or factual interpretation that may give rise to a dispute? – Is there a process for potential risks of dispute to be identified early, with management informed and steps taken to engage the ATO?	Board policy and tax risk management framework
Significant or new transactions	– Is there a documented process to identify and map major categories of transactions to relevant tax classifications? – Are there plans to manage commercial and tax risks?	Tax risk management framework
Tax and accounting results	– Are there risk registers and escalation processes for risks? – Is there a reconciliation of accounting data to financial statements? – Are there audit reports?	Tax risk management framework

Six focus areas for TG for HWPGs

The ATO has stated that it will consider each of the factors listed in Table 2 for each of the six focus areas for TG for HWPGs.[11] Included in Table 2 is a suggestion as to the TG document that could deal with this requirement.

Conclusion

Adopting a documented TG policy has become a necessity for HWPGs. It can provide many advantages, including an improved approach to tax risk management and guidance for in-house and external advisers on what their role is, which can in turn create real value adds. Taking this into account, and the easier SAR process and ongoing ATO relationship, HWPGs are encouraged to take the time to implement and/or update their TG policy.

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8 See www.ato.gov.au/Business/Privately-owned-and-wealthy-groups/Tax-governance/Tax-governance-guide-for-privately-owned-groups.

9 See www.ato.gov.au/Business/Privately-owned-and-wealthy-groups/Tax-governance/Tax-governance-guide-for-privately-owned-groups/Corporate-governance-and-tax-governance/Seven-principles-of-effective-tax-governance.

10 Refer to the ATO website for information on downloading ISRA and the ISRA manual: www.ato.gov.au/Business/Privately-owned-and-wealthy-groups/In-detail/ISRA-tool-manual.

11 See www.ato.gov.au/Business/Privately-owned-and-wealthy-groups/Tax-governance/How-we-assess-tax-governance-for-privately-owned-groups.

Inbound interest-free loans: part 1

by Ellen Thomas, ATI, Partner, PwC

Interest-free loans are typically drafted as "debt interests" for the purposes of Div 974 of the *Income Tax Assessment Act 1997* (Cth) but are not included in the borrower's thin capitalisation calculations due to there being no interest expense. While interest-free loans are a common funding instrument and appear to be simple, many complexities in relation to their tax treatment can arise. The debt/equity characterisation is often more complex than anticipated due to the breadth of the related scheme provisions, as well as the reconstruction provisions in the transfer pricing rules. Further, the treatment of an interest-free loan for thin capitalisation has been thrown into doubt due to the ATO's conclusion in TD 2019/12 that a wide variety of costs can be "debt deductions" — if any of these costs are attributable to an interest-free loan, the loan can be included in the borrower's adjusted average debt.

Introduction

This article is part one of a two-part article on inbound related-party interest-free loans (IFLs). An IFL is typically treated as a "debt interest" and is not included in a company's adjusted average debt for thin capitalisation purposes.

Interest-free loans are a relatively common funding structure. Over the last few years, the ATO has increased its review of related-party debt. Inevitably, IFLs are in focus.

This article explores the myriad of issues that are typically navigated by an Australian corporate borrower in relation to IFLs, with a view to exploring whether the technical risks associated with IFLs are material or superficial.

Why are IFLs used?

Interest-free loans are often used as part of a company's capital structure where it is anticipated that a company will have excess cash but will be unable to pay franked dividends to its shareholders. Capital intensive investments often have excess cash which cannot be distributed as a franked dividend due to timing differences between tax and accounting depreciation.

Repaying an IFL is generally considered to be simpler than returning capital to shareholders due to corporations law requirements[1] and, importantly, an IFL that is a "debt interest" means that the tax risks associated with the potential application of s 45B of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) do not arise.

Other reasons IFLs are used include:

– some shareholders (especially minority shareholders that cannot control a company's distribution policy) like the certainty of receiving specific minimum cash distributions from the company;

– an IFL can give shareholders priority in a winding-up of a company (and will put them at the table with other lenders);

– an IFL might be used to provide short-term "at call" funding to a borrower, while the borrower seeks third party debt;

– an IFL might be provided by a parent company to a non-performing subsidiary, where the parent company has taken the view that the subsidiary's difficulties are cyclical and will be resolved;

– an IFL might be used by an investor that is restricted in the percentage of ordinary shares it is permitted to hold in the company; and

– an amount outstanding might arise due to payments by a subsidiary company to its parent being deferred.[2]

These are not the only reasons that IFLs are used — each case is fact specific.

Debt/equity rules

The first aspect to consider in relation to an IFL is whether the IFL is a "debt interest". An IFL that is drafted as a debt interest enables the company to repay the IFL over its term, without the need to consider the application of s 45B ITAA36. If an IFL is instead an equity interest, s 45B can potentially apply to the repayments of an IFL. This is because s 45B and related rules apply to a non-share equity interest in the same way as they apply to a share etc (s 45B(1) ITAA36). Therefore, an IFL that is an equity interest would negate a potentially key benefit of having the IFL in place and creates risk for the borrower.

There is an important question of timing in the debt/equity rules — the timing of transactions is a critical and often overlooked aspect of Div 974 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97). It is often assumed that the debt/equity treatment of financing arrangements such as an IFL needs to be considered when the arrangement is entered into. An IFL may be an equity interest when it is entered into, at the last time the last of a number of constituent schemes comes into existence, or when there is a material change under s 974-110 ITAA97. The provisions can require a fresh analysis when there is a change of circumstances. As discussed above, there are a range of commercial situations where an IFL may arise (including where debts arise and are allowed to stay unpaid) and the requirement to consider the impact of various arrangements under the debt/equity rules can arise at various points. As such, the debt/equity position ideally needs to be closely, and frequently, monitored. This article does not explore timing issues in detail.

Debt test

The initial debt/equity analysis for an IFL is simple. An IFL would typically have a term of less than 10 years and impose a legal obligation on the borrower to repay the principal. The ATO has issued a number of private rulings confirming that IFLs are debt interests.[3] These private rulings depend on the taxpayer's own circumstances but do indicate that the ATO is willing to accept, in some circumstances, that an IFL is a debt interest.

Related schemes

The obvious difficulty with the related scheme provisions is that the language is very broad; the arrangements only need to be related "in any way" (s 974-155(1) ITAA97). While schemes would not be related "merely because"[4] one refers to another or they have a common party, the term is defined "widely and unhelpfully".[5] The common party and "refers to" exclusions (in s 974-155(3)) would seem to seldom apply, since there might be many other connections between the IFL and other instruments besides having a common party or schemes referring to one another.

Ian Stanley, in his paper "Debt interests",[5] notes that:

> "The purpose of relating schemes is to ensure that the debt/equity distinction cannot be avoided through contract — and other arrangement — splitting techniques. This is reflected in the object described in s 974-10(3) when it refers to the necessity for aggregation of the schemes to ensure that the debt/equity distinction operates on an economic substance basis.
>
> However, in contrast, if the concept of a related scheme were permitted to operate unfettered, many commercially unrelated arrangements would be aggregated for the purpose of determining whether a debt interest is disclosed. It is also possible that an aggregation of inappropriate interests could lead to less debt interests being recognised or the creation of a 'manufactured' issuer for the purposes of the thin capitalisation provisions."

In relation to an IFL, instruments that may potentially be related to the IFL would include shares issued by the company and interest-bearing related-party debt (either all together, or the IFL being aggregated with either instrument[6]). Ordinary shares, interest bearing debt and an IFL are all relevant schemes in which the company and its shareholders participate and might be seen as related because the arrangements are commercially interdependent, especially where the instruments are issued on a proportionate basis and are governed by a shareholders agreement.

Further, an IFL is not typically observed between parties at arm's length, and this may also suggest that the entry of the IFL is related to the subscription for shares or the provision of interest-bearing debt to the company. In this regard, the IFL can be distinguished from an interest-bearing loan which "makes sense" without reference to the ordinary shares or the IFL.

In any case, the threshold of being related "in any way" means that it is likely that a conclusion could be reached that the IFL is related to any or all of the ordinary shares and related-party interest-bearing debt.

The difficulties with the related scheme provisions have been recognised for many years:

– on 10 May 2011, the government announced in the 2011-12 Budget that it would amend the debt/equity tax rules (effective from 1 July 2001) to restrict the application of an integrity provision that deems an interest from an arrangement that funds a return through connected entities to be an equity interest under certain circumstances;
– on 14 December 2013, the government announced that the 2011-12 Budget measure would proceed and that the design of the measure would be considered by the Board of Taxation as part of its review of the debt/equity rules;
– in December 2014, the Board of Taxation finalised its *Review of the debt and equity tax rules — the related scheme and equity override integrity provisions*. The review recommended that, to address the uncertainty around the operation of the existing provisions, both s 974-80 ITAA97 and the existing related scheme rules be repealed and replaced with a new scheme aggregation rule;
– on 2 April 2015, the government announced that it would proceed with the recommendations in the Board of Taxation's review;
– on 10 October 2016, exposure draft legislation and explanatory material were released by the government to provide greater certainty in relation to integrity rules regarding the taxation of debt and equity. It should be noted that, in the exposure draft of the *Income Tax Assessment (Debt and Equity Examples) Declaration 2016*,[7] shareholder loans are referred to as schemes which should not be aggregated in the example in Ch 2 of the exposure draft declaration; and
– no further action has been taken to date at the government level.

Aggregation of schemes

Statutory test. The statutory test for aggregation into an equity interest (in s 974-70(2) ITAA97) is that two or more related schemes are taken together to give rise to an equity interest in a company if:

– the company enters into, participates in or causes another entity to enter into or participate in the constituent schemes;
– a scheme with the combined effect or operation of the constituent schemes (the notional scheme) would satisfy the equity test in s 974-70(1) in relation to the company if the notional scheme came into existence when the last of the constituent schemes came into existence; and
– it is reasonable to conclude that the entity intended, or knew that a party to the scheme or one of the schemes intended, the combined economic effects of the constituent schemes to be the same as, or similar to, the economic effects of an equity interest.

A related scheme can be found regardless of whether the constituent schemes come into existence at the same time and even if none of the constituent schemes would individually give rise to that or any other debt or equity interest.

Economic effects of an equity interest. The company and its shareholders might all be expected to understand the likely returns on all of the instruments issued to shareholders, including an IFL, alone and in combination. However, in order to satisfy the related schemes test for an equity interest, more is needed — it must be reasonable to conclude not just that the parties understood the economic consequences of the scheme, but that they actually intended the combined scheme to be similar to the economic effects of an equity interest.

A curiosity is what the phrase "economic effects" means. In Division 974 ITAA97, there is a constant battle between "rights and obligations" and "legal form" on the one hand, and "economic substance" on the other. What can be discerned from the "economic effects" of equity interests listed in s 974-75 ITAA97?

Note 1 to s 974-10(2) ITAA97 provides that the basic indicator of the "economic character" of a debt interest is the non-contingent nature of the returns:

> "Note 1: The basic indicator of the *economic character of a debt interest is the non–contingent nature of the returns*. The basic indicator of the *economic character of an equity interest, on the other hand, is the contingent nature of the returns* (or convertibility into an interest of that nature)." (emphasis added)

Examples of the emphasis on whether or not there is a non-contingent right to receive returns can be found in ATO ID 2003/870 and TR 2005/5.

Will aggregated rights to receive financial benefits result in a debt or equity interest?

Once it is decided that instruments should be aggregated, there is a task of determining whether the aggregated non-contingent returns will exceed the amount invested.

When non-contingent returns are aggregated, it is possible for the calculations to reveal that there is a debt interest (at least, that was the case when interest rates were higher). In ATO ID 2003/870, ordinary shares were combined with loan notes, with the result that there was a related scheme that was a debt interest.

If the calculations of aggregated schemes result in a debt interest, typically this would lead to the loan and shares being recognised as separate interests under the debt/equity rules. Ordinary shares would seldom be treated as debt interests unless there are specific circumstances that require this conclusion.

The challenge in the current environment is that, because interest rates are so low, the combined instrument is unlikely to result in a debt interest. As a result, these issues, which for years have remained academic, are now more important.

Section 974-80 ITAA97

If s 974-80 ITAA97 applied, it may treat an IFL that is otherwise a debt interest as an equity interest.
Section 974-80 is an integrity provision that deals with financing arrangements that grant an investor an interest which is effectively an equity interest in a company. The provision applies when the equity-like returns that are paid to the ultimate recipient are funded from otherwise tax-deductible payments made by the company. This then causes the returns paid by the company in respect of those same interests to be non-deductible.

As discussed above, the government has announced that s 974-80 will be amended due to the material difficulties in applying the provision in a sensible manner.

Connected entities

The application of s 974-80 depends on finding that the shareholders providing the IFL are "connected entities". This is an important threshold question, and one which may be more keenly contested following *BHP Billiton Ltd v FCT*.[8]

Assuming that the shareholders are associates and therefore "connected entities" of the company, the relevant inquiry is whether the IFL ultimately funds an equity-like return to the company's shareholders in a way that attracts the operation of s 974-80.

Section 974-80(1)

One of the requirements in s 974-80 is the existence of a scheme, or a series of schemes, where the return is designed to operate so that the return to the connected entity is to be used to fund a return to another person.

The ATO has provided guidance on whether s 974-80 would apply to shareholder loans. TD 2015/2 provides that s 974-80(1)(d) would not be satisfied merely because a non-resident entity has chosen to invest indirectly in a debt interest (for present purposes, an IFL) issued by an Australian resident company and there is one or more equity interests interposed between the non-resident entity and the entity holding the IFL. In this regard, a relevant enquiry will be whether the shareholder or the relevant ultimate recipient has other investments and sources of income, such that the IFL is seen as one part of a pool of funds that provides returns to the ultimate recipient.

Section 974-80(2)

If s 974-80(1) is satisfied, the next step is to consider whether s 974-80(2) is also satisfied. The main challenge for taxpayers in applying s 974-80(2) is that a connected entity of the ultimate recipient may distribute the funds referable to the IFL repayments to the ultimate recipient. This may mean that it could be concluded that the return to the ultimate recipient depends on the economic performance of the connected entity or is at the discretion of the connected entity.

It has been argued that s 974-80(2) should be read down such that the only relevant "connected entities" should be those that are subsidiaries of the relevant issuer company. However, it is not clear whether this is possible.

At call loans

An IFL may be drafted as an "at call loan". If the at call loan meets the requirements in s 974-75(6) ITAA97, the IFL would not be an equity interest in a particular year.

The statutory requirements are that the IFL does not have a fixed term, is made by a connected entity, and is repayable on demand. If the borrower's GST turnover is less than $20m, such a loan would not give rise to an equity interest but instead gives rise to a debt interest.

The application of the "at call loan" provision does require that the relevant "scheme" is the IFL itself. Section 974-75(6) appears to be drafted such that the at call loan could be identified as a particular scheme rather than inviting a broader examination as to how the scheme should be formulated. That may provide some argument against an at call loan being grouped with other interests under Div 974 (eg under the related-party provisions) and allow the at call loan (regardless of the surrounding circumstances) to be treated as a debt interest.

Another consideration is whether an IFL that is drafted as an at call loan could be treated as such a loan for the purposes of Div 974 if it remains on foot for many years. Section 974-75(6) focuses on the legal rights and obligations of the IFL rather than its economic substance. The only aspect that would unwind the debt/equity of such a loan appears to be whether the $20m GST turnover threshold is met in the relevant year.

Limited recourse debt

If the IFL is drafted as limited recourse debt, this may have a bearing on whether there is an "effectively non-contingent obligation" to repay the debt for the purposes of Div 974. The tax treatment of limited recourse debt was highlighted in March 2015 by the Board of Taxation in its report to government, *Review of the debt and equity tax rules* (see paras 3.77 to 3.85). The Board of Taxation noted that the "ability or willingness" carve-out should not be relied on to support the conclusion that there would be an effectively non-contingent obligation in respect of limited recourse debt, because that would give "the ability or willingness carve-out an operation that would allow other financing arrangements which have all the hallmarks of equity to be treated as debt for tax purposes contrary to the objects of Division 974" (see para 3.81). The Board of Taxation took the view that the ability or willingness carve-out should be read down, as the purpose of that phrase was simply to acknowledge that whether that financial benefit is provided by performance of the obligation always depends on whether the relevant entity is able or willing to perform its obligations (see para 3.19).

If a limited recourse IFL is fully secured by a particular property etc that is financed by the IFL, the application of Div 243 ITAA97 would need to be considered. If the IFL is not secured, then Div 243 should not apply.

Recharacterisation as equity under the transfer pricing rules

Another consideration is whether an alternative path to concluding that an IFL is an "equity interest" is to reconstruct the IFL under the transfer pricing provisions in Subdiv 815-B ITAA97. In order to reconstruct an IFL (where the lender is a non-resident), a party to the IFL must get a "transfer pricing benefit" as defined in s 815-120 ITAA97.

The lender

Withholding tax. From the lender's perspective, there would be a "transfer pricing benefit" if the IFL were reconstructed to having an interest rate (or having been issued at a discount to face value). This is because, under this type of reconstruction of the IFL, the amount of interest withholding tax payable would be higher (s 815-120(1)(c)(iv)).

Reconstruction to include an interest rate may be appropriate if it could be expected that arm's length parties would require the borrower to pay compensation (ie interest) to the lender for the use of the funds advanced.

Withholding tax is only a transfer pricing benefit in respect of "interest or royalties". Notably, arm's length conditions which result in the amount of withholding tax payable in respect of "dividends" is not a transfer pricing benefit. Therefore, reconstruction of the IFL (to impose interest withholding tax) would still result in the IFL being treated as a debt interest.[9]

If such an adjustment is made to the IFL, a consequence is that the company would be required to withhold and remit tax.

Consequential adjustments for the borrower. The company may be entitled to a deduction for the interest expense or discount under the consequential adjustment provisions in s 815-145 ITAA97. However, a consequential adjustment would only be made if, had the arm's length conditions applied, the disadvantaged entity would have had a lower taxable income, greater loss, greater tax offset or a lower amount of withholding tax payable. A compensating adjustment may not be available if a deduction would not have been available to the company due to its thin capitalisation position or due to the application of the anti-hybrid rules to the deemed interest expense.

If the IFL should be recharacterised as interest-bearing debt under the transfer pricing rules, this may have an impact on other related-party debt issued by the taxpayer. If the IFL is recharacterised as interest-bearing debt (ie with the result that interest withholding tax applies):

- it would be inconsistent with this conclusion for it also to be concluded that existing interest-bearing debt should be reconstructed to be equity; and
- accepting that there is a large amount of related-party debt on foot may then affect the pricing of the existing shareholder debt.

The company

No transfer pricing benefit. The company would generally not receive a "transfer pricing benefit" as defined in s 815-120 ITAA97 in relation to the IFL, even if the IFL were reconstructed to impose an interest rate or be issued at a discount. Therefore, s 815-115 ITAA97 would not permit an adjustment to the character of the IFL from the company's perspective. In this regard:

- treating the IFL as interest-bearing or having been issued at a discount would not result in the company having higher taxable income, reduced losses or reduced tax offsets — such a recharacterisation would reduce taxable income; and
- treating the IFL as interest-bearing or having been issued at a discount would not result in the company's "withholding tax" payable being greater. "Withholding tax" as defined refers to the liability to pay withholding tax in Div 11A ITAA36 (which is the lender's liability), rather than the borrower's requirement to withhold and remit amounts under the *Taxation Administration Act 1953* (Cth).

If debt deductions have been claimed in respect of the IFL. Arguably, the transfer pricing reconstruction provisions can be applied to an IFL which is otherwise a "debt interest" for tax purposes if amounts that are treated as debt deductions in respect of the IFL (debt deductions and TD 2019/12 are discussed in part 2 of this article) have been paid to a related party. A reduction in the company's taxable income (ie through debt deductions) would be a transfer pricing benefit under s 815-120(1)(c)(i). As a result, the overall conditions of the IFL might be substituted with arm's length conditions.

If arm's length conditions are substituted under s 815-115(1), this would apply for the purposes set out in s 815-115(2), including working out the taxable income of the company.

The arm's length conditions rather than the actual conditions would apply when considering the thin capitalisation rules (see TR 2010/7). The operation of s 815-140 ITAA97 (relating to modifications for thin capitalisation) would need to be considered. If the Commissioner's view is that an interest-bearing debt would arise instead of an IFL, s 815-140 would apply to modify how s 815-115 operates by not altering the arm's length conditions of the IFL but rather adjusting the taxable income of the taxpayer. The thin capitalisation rules would apply to the principal amount of the IFL, with the deemed rate being imposed on that amount. This would not result in the IFL becoming an equity interest for tax purposes.

Before an IFL is reconstructed to equity, it must be shown that the company would have issued no debt at all. Otherwise, the machinery of s 815-140 ITAA97 would operate to ensure that the debt interest characterisation is preserved. Only in a scenario where it can be demonstrated that, at arm's length, no debt interest would exist, would s 815-140 not be enlivened such that reconstruction to equity under s 815-115 could occur.

Conclusion – part one

Part one of this two-part article has focused on the debt/equity treatment of an IFL. Despite an IFL being a simple loan instrument, there is a significant amount of complexity regarding its characterisation for tax purposes when the debt/equity rules are closely examined.

Part two of this article will explore the application of s 45B ITAA36, thin capitalisation, cost base issues, and commercial debt forgiveness to an IFL.

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Disclaimer

The views expressed in this article are the views of the author, not PwC. This article provides general information, does not constitute advice, and should not be relied on as such. Professional advice should be sought prior to any action being taken in reliance on any of the information.

References

1 Such as considering directors' duties to prevent insolvent trading, the lodgment of documents with ASIC, the calling of a shareholders' meeting and, in some cases, mandating certain minimum timeframes between events/actions.

2 This would not involve the payment of money by way of a loan. The indebtedness arises due to payment in respect of goods or services being deferred (such as the taxpayer in *FCT v Armco (Australia) Pty Ltd* [1954] HCA 49, which owed its parent an amount for trading stock supplied by its parent).

3 See, for example, PBR 1051726288196.

4 In *Gebo Investments (Labuan) Ltd v Signatory Investments Pty Ltd; Application of Campbell* [2005] NSWSC 544 at [37], Barrett J observed of the words "merely because" in s 21(3) of the *Corporations Act 2001* (Cth): "The words 'merely because' are, it seems, a modern version of the words 'for the reason only that' in earlier corresponding provisions (see Companies Act 1961, s.344(3); Companies (New South Wales) Code, s.510(3))."

5 I Stanley, "Debt interests", (2002) 5(3) *The Tax Specialist* 117.

6 Noting that two interests of the same type cannot be combined under the statutory aggregation test discussed below, even if the two schemes are related.

7 This was the exposure draft instrument which accompanied the Tax and Superannuation Laws Amendment (debt and equity scheme integrity rules) Bill exposure draft.

8 [2020] HCA 5.

9 If the IFL is already an equity interest, reconstruction may result in the IFL being a debt interest (see example 2 in TD 2019/10).

Obtuse s 99B and offshore trusts

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Offshore trusts are subject to uncertain income tax rules, which means that they attract interpretations that depart from the policy intent of trust taxation. This is problematic and the issue should not be sidestepped because offshore trusts are seen as a murky area. This article argues that there are many legitimate situations where a person will interact with an offshore trust and the taxation should be clear. Section 99B of the *Income Tax Assessment Act 1936* (Cth) is one of the more problematic aspects of offshore trust taxation. This article considers what the section is trying to achieve and challenges the view on its operation taken by the Commissioner in TD 2017/24.

Introduction

Section 99B of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) introduces rules of major importance to those connected with an offshore trust. Worryingly, the operation of these rules is highly uncertain, even in the face of some simple core issues. The purpose of this article is to examine and assess selected critical problems that s 99B faces in common international trust situations.[1] It will show how these arise at the basic operational level and how they are not easily resolved. The article will examine possible answers to the questions. Section 99B has recently attracted some professional interest in relation to capital gains.[2] This capital gains debate is a core theme in this article but, as its implications are wide, it will also be examined in a follow-up article. What will ultimately be demonstrated is how difficult the problems that s 99B raises are for beneficiaries, trustees and general objects of international trusts.

The obscurity of offshore trusts

The first issue with s 99 is that it is obscure due to its limited application in many areas of taxation. However, its obscurity does not go hand in hand with a low tax impact. Offshore trusts are generally treated as an unusual area in Australian taxation. It would be fair to say that their image is tarnished in the public eye, and they are associated with tax avoidance or even evasion. This is likely to form a substantial part of the reason why the offshore tax rules remain uncertain and opaque. Uncertainty is, however, fundamentally unfair and can allow highly unjust outcomes. The injustice may be tolerated due to the idea that offshore trusts are seen in the murky light mentioned above.

It is not the case that the legislature intended the rules in relation to offshore trusts to be so unclear and therefore uncertain. Rather, they suffer from being drafted in a time of simpler taxation of trusts and of income generally, that is before CGT and before the 1990s expansion of the international tax base. The rules have never been reconciled to developments in other parts of the law and this is the source of uncertainty. The reason that they have not evolved is again likely to be attributed to their subject matter and its murkiness and secrecy. There are few reports of disputes in the area — no doubt due to unreported settlements or the fact that the issues are simply not being considered.

The above situation is changing. The attention focused on the Panama Papers and related affairs has brought offshore trusts into the spotlight and further enhanced their dark public image.[3] This has called for ATO attention and there has been the expected response. Hence, the time to consider the issues around the taxation of these trusts is now.

Policy in trust taxation and legitimate offshore trusts

Despite the uncertainty in the operation of the trust provisions, it is possible in most cases to see what the original intent of the law was. Building on the general intention in the taxation of trusts, the offshore aspects follow through and seek to follow the goals of:

– taxing income in the hands of the beneficiary or the trustee, depending on who is holding it; and
– maintaining the nature of a distribution made so that it is treated the same way in the hands of the beneficiary as it would have been had they derived it directly.

The fact that a beneficiary may receive the distribution in a (much) later year creates difficulties, but the law attempts to remedy these. Simply put, the beneficiary should ultimately be treated as if they had earned the amount directly. This means that they should not pay tax, or should not pay full tax if they would not have had to, in the case of full legal and equitable ownership of the trust property.

The above principle should be remembered by tax administrators and even tribunals when seeking to interpret the law. Unfortunately, with the current state of the tax law, it is possible to take a narrow focus and argue that the words carry a meaning that does not result in the above outcome. This is being seen more regularly and it is not desirable. In addition, the tarnished image of the offshore trust should not open the door to administration of the law in a way that departs from the core philosophy behind the taxation of trusts.

A final and critical point is to highlight that offshore trusts do not deserve the all-encompassing negative reputation that they have. The popular Australian view is very Australia-centric in a world where the Australian taxation system touches many people who are significantly connected to places outside of Australia. There may be some truth to the idea that a wealthy Australian who establishes an offshore trust in a no-tax island is trying to avoid their tax and other citizenship obligations. However, it is not necessarily true.[4]

It is almost certainly less true when the relevant Australian is not the person who established the trust but a mere object of the trust. After all, there can be a number of legitimate reasons for establishing an offshore trust.

When an offshore trust has been established by a non-Australian, the number of acceptable reasons for establishing one grows significantly. If one typifies a core role of the offshore trust as being to isolate a person's or a family's wealth from the reach of state mechanisms, it becomes easier to understand this point. From an Australian perspective, state institutions and mechanisms would generally be seen as operating in the pursuit of justice. Hence, the general Australian view on offshore trusts is understandable. However, it is a simple fact that not all states operate justly towards their populations or towards all parts of their populations. The most obvious illustration of this is Nazi Germany. Offshore trusts (or Swiss accounts) played an important protective role for persecuted people who were there in the 1930s. A view that the entire world is free of such risks in contemporary times is simply incorrect. There are corrupt, predatory or persecuting states in many parts of the world today.[5] In addition, offshore trusts necessarily have a historical dimension as they were often set up long before they paid an amount to an Australian.[6] A final point to note is that these trusts are more widely used in many other parts of the world than they are in Australia, and that it would again be incorrect to see their use as necessarily undesirable.[7]

All of the above leads to the conclusion that the Australian taxation of offshore trusts must be done fairly and bare the hallmarks of the rule of law. A large number of people who are impacted by the trust taxation rules are not in any way deserving of being tarnished with a negative brush and subject to taxation that does not comply with the basic concepts of fair laws.

The role of s 99B

In the above context, we can consider when s 99B operates. In the area of international trust taxation, it can create a significant tax liability. Thus, it is very important. The essence of its application is to make an amount received from a trust taxable when the amount is not caught by the "standard" trust rules involving present entitlement or is not an amount that has been taxed in some other way. This should not be seen as a form of anti-avoidance or a sweep-up rule. It has a clear place in the conceptual scheme around offshore trusts. The standard trust provisions tax current year income. They do this by taxing the beneficiary when they are presently entitled to current year trust income and taxing the trustee when the opposite applies.

The rationale for the above approach is clear: either the beneficiary or the trustee pays tax on the income every year. From this, it would follow that accumulated amounts would either represent taxed amounts or the original capital. The original capital should not be taxed when distributed as it amounts to a gift from the settlor to the beneficiary and would not be taxed if it had happened directly. Of course, there will always be some exceptions to these outcomes due to the fact that the amounts accumulated represent trust or accounting income, while the amounts taxed along the way represent taxable income (two very different concepts). That said, the general principle remains substantially accurate.

When the trust is a non-resident of Australia, accumulating amounts of trust income will not be taxed unless they have an Australian source. If the trust is caught by the transferor trust regime,[8] these amounts will be attributed to an Australian taxpayer and taxed in that way, but not in other cases. Non-taxation of current year income is therefore not rare and not inappropriate. If the offshore trust holds the property and no Australian has any entitlement to it, it should not be taxed in Australia. The transferor trust regime does not seek to defeat this outcome unless the trust represents a transfer of wealth by an Australian. This will often not be the case.

As discussed above, offshore trusts are established for many reasons internationally. It is by no means uncommon that such a trust will be accumulating trust income that is not from Australian sources and would not have been settled by an Australian. Rather, it is common for these trusts to accumulate income for many years as a result of the investment of the original wealth by a non-Australian.

Australia comes into the above picture when offshore trusts provide a sum of money or an asset to an Australian resident. This is not rare. Essentially, offshore trusts have been established for the long-term benefit of the extended families of the original foreign person. Given Australia's history of immigration, and the fact that many of these people came from troubled regions, it is not exceptional that one of these family members resides in Australia. Thus, the trustees may do their job and decide to provide money or an asset to the Australian. Perhaps they wish to assist the relevant family member in a time of need or at an important stage of life.

It is when this money is paid that the taxation issues become complicated and section 99B is enlivened. Considering the policy above, the beneficiary should pay tax when they have the benefit of the income. If they are presently entitled to current year income, then the standard provisions will apply to them. However, when they are paid money by the trust that represents prior year income, the standard provisions cannot apply. In essence the beneficiary is being paid out of past year income. This income would have never been taxed to the trustee or the beneficiary. Thus, the policy is to ensure that it is taxed to the beneficiary now.

The challenge is to tax the beneficiaries in the same way that they would have been taxed had they originally earned the income that the current cash or asset represents. It must be remembered that not all trust income is taxable. Some amounts are exempt or partly taxable. In addition, if the cash received does not represent trust income but the original settled sum or a gift, it would not have been taxed at all. Finally, it is possible that the cash received represents an amount that has been taxed. This could be because the transferor trust regime had applied to the trust in a prior year, or the income had been Australian-sourced, to name two of the more obvious reasons. Thus, the law seeks to tax the beneficiary as if they had received the original amount, but not if it has been taxed already. The way it does this is to make amounts taxable unless they can be linked to an amount that should not be taxed. Thus, if a person simply receives $100,000 from an offshore trust, it will be taxable under s 99B if it is not otherwise taxable and does not fall into one of the exclusions in the section.

Section 99B reads as follows:

> "**Receipt of trust income not previously subject to tax**
>
> (1) Where, at any time during a year of income, an amount, being property of a trust estate, is paid to, or applied for the benefit of, a beneficiary of the trust estate who was a resident at any time during the year of income, the assessable income of the beneficiary of the year of income shall, subject to subsection (2), include that amount.
>
> (2) The amount that, but for this subsection, would be included in the assessable income of a beneficiary of a trust estate under subsection (1) by reason that an amount, being property of the trust estate, was paid to, or applied for the benefit of, the beneficiary shall be reduced by so much (if any) of the amount, as represents:
>
> (a) *corpus of the trust estate* (except to the extent to which it is attributable to amounts derived by the trust estate that, if they had been derived by a taxpayer being a resident, would have been included in the assessable income of that taxpayer of a year of income);
>
> (b) an amount that, *if it had been derived by a taxpayer being a resident, would not have been included in the assessable income of that taxpayer of a year of income*;
>
> (ba) an amount that is non-assessable non-exempt income of the beneficiary because of section 802-17 of the *Income Tax Assessment Act 1997*;
>
> (c) an amount:
>
> (i) that is or has been included in the assessable income of the beneficiary in pursuance of section 97; or
>
> (ii) in respect of which the trustee of the trust estate is or has been assessed and liable to pay tax in pursuance of section 98, 99 or 99A; or
>
> (iii) that is reasonably attributable to a part of the net income of another trust estate in respect of which the trustee of the other trust estate is assessed and is liable to pay tax under subsection 98(4);
>
> (d) an amount that is or has been included in the assessable income of any taxpayer (other than a company) under section 102AAZD; or
>
> (e) if the beneficiary is a company — an amount that is or has been included in the assessable income of the beneficiary under section 102AAZD.
>
> (2A) An amount that is not included in a beneficiary's assessable income because of paragraph (2)(d) or (e) is not assessable income and is not exempt income.
>
> (3) In paragraphs (2)(d) and (e):
>
> ***'company'*** *means a company other than a company in the capacity of a trustee.*"

Reviewing s 99B, it can be seen how it tries to meet the policy objectives noted above. For this analysis, it is clear that the section first makes amounts received assessable income and then excludes them if they represent:

1. the original corpus;
2. an amount that would have been excluded from assessable income;
3. an amount that is assessed to a trustee or beneficiary under the standard trust provisions; and
4. an amount that is assessable under the transferor trust provisions.

The first two listed items focus on amounts that should not be taxed as they do not represent income. The second two items, on the other hand, should not be taxed as they have already been taxed. Item two more particularly refers to an amount that, "if it had been derived by a taxpayer being a resident, would not have been included in the assessable income of that taxpayer of a year of income". The policy behind this is that, if an Australian is receiving cash that represents something that would never have been taxed, then they should not be taxed on it. For example, if the trustee had won a competition and received a cash prize, the amount would not be income if the same thing had happened to a person living in Australia. This is because prizes are not income (assuming that they are not the product of an income-earning activity or business).[9] Therefore, if the trustee passes the cash win on to the beneficiary, the beneficiary should not be taxed.

The hypothetical taxpayer

The wording of this exclusion, however, raises some significant difficulties. It excludes amounts that would not have been assessable if "derived by *a taxpayer* being a resident". Thus, its scope asks you to consider a hypothetical taxpayer, not the actual taxpayer. This causes a problem as not all taxpayers are taxable on the same amounts. Notably, resident companies and individuals are given different exemptions under the tax law. For example, companies are exempt on non-portfolio dividends[10] and foreign branch profit income. Individuals are not. Individuals, on the other hand, are not taxable on half of most of their capital gains, while companies are.

Thus, the issue is determining the taxpayer-type to consider when you conduct your s 99B analysis. Two possibilities that arise are that you either let the hypothetical taxpayer take on the nature of the recipient of the amount being considered under s 99B, or you let them take on the nature of the trustee. Given the overall policy around the taxation of trust income, the stronger argument is that the hypothetical taxpayer should be of the same sort as the recipient. After all, the general policy is to treat the beneficiary as having earned the income in their own right when they are entitled to trust income. This is how ss 95 to 100 ITAA36 work, and how s 99B itself can be rationalised. On this basis, an individual recipient of an amount that represents a capital gain should be entitled to the discount when they otherwise would have been so entitled, while a company beneficiary should not. Thus, the better view is that s 99B should be interpreted as giving the hypothetical taxpayer the core characteristics of the recipient taxpayer. On the other hand, there are possible arguments in favour of the trustee if you look at more specific facts and circumstances. See below for more on this.

The view expressed in TD 2017/24

This approach is challenged by the Commissioner in TD 2017/24. When discussing s 99B and amounts representing capital gains received by resident individuals, the Commissioner argues that the discount is not available.

The rationale given for this position refers to the above discussion of the nature of a hypothetical taxpayer. However, rather than saying that such a taxpayer should be the same as the beneficiary or the trustee, the Commissioner takes the view that the hypothetical taxpayer must be like neither. As a result, they do not receive any treatment that is not available to all taxpayers.[11]

In TD 2017/24, the Commissioner grounds this argument on statutory interpretation. However, there is not a solid basis for the form of statutory interpretation used. Looking at the approach of the interpretation, it appears that it is the result of a narrowness of vision when considering s 99B in context. Essentially, TD 2017/24 identifies that the use of the indefinite article in "a taxpayer" means that the legislature deliberately distinguished the application of the analysis from applying to "the taxpayer". Having established this, it concludes that this must have been intended to remove features of the law that would not be available to all forms of taxpayer, that is, companies and individuals. On this basis, it concludes that the 50% CGT exemption is not available to *anyone*, as it is not available to companies. By the same logic, it would presumably disallow the non-portfolio dividend exemption to company beneficiaries, as individuals are not entitled to it.

The problem with TD 2017/24

The problem with the Commissioner's approach is that this interpretation goes against the core policy behind the trust taxation rules. That is, treating the beneficiary as if they had earned the income themselves when it passes through a trust to them. An interpretation of s 99B that fulfils this objective has to be superior to one that does not. The structure of s 99B shows that it is intended to fulfil this objective. The issue therefore becomes whether there is a rationale for the use of the indefinite article ("a taxpayer") that does not work against the policy intent of the regime. It is clear that the indefinite article is intentional. The Commissioner's interpretation rests on explaining this in a situation where it can only be explained by disregarding the type of taxpayer. This rather outlandish suggestion can be set aside if a good rationale for the use of the indefinite article can be identified.

It is submitted that there is a very good rationale for the use of the indefinite article in s 99B. It is not intended to strip away features of the law that are fundamental to the core type of taxpayer, for example, the 50% CGT discount for individuals and the non-portfolio dividend exemption for companies. Rather, it is intended to remove factors that are specific to the taxpayer in issue that could give a different outcome to the one that would be expected by "a taxpayer" of the same type. In this context, it must be remembered that the time when the trust earned the amount is separated from the year when the beneficiary received the amount — quite possibly by decades. It is possible that the beneficiary was not alive (or incorporated) when the trust earned the original amount. How would that be understood if s 99B referred to *the* taxpayer?

The actual taxpayer may have been a non-resident with particular circumstances at the time. It is better to separate these circumstances from the assessment by referring to *a taxpayer* rather than trying to assume that the taxpayer was a resident. Finally, we should consider the example of the windfall prize above. It is fundamental to the concept of income that an amount may be income of one person but not of another due to their particular context. A prize can be a windfall for one person but income to another. A member of the public winning a cash prize for an essay on the environment is different to a professional environmental scientist winning the same prize. The gain on the sale of shares will be income to one taxpayer, while being a capital gain to another. It is for these clear reasons that s 99B refers to a hypothetical taxpayer and not the actual taxpayer. The rationale is not to strip it of the core features of the taxpayer as an individual or a company. This is like assuming that a hypothetical person is not specifically male or female and must therefore have none of the physical features of either. You end up with a very atypical person.

It is submitted that the view taken by the Commissioner in TD 2017/24 is not correct, as the rationale for the use of the indefinite "a taxpayer" at the core of that view is not correct. However, tax professionals need to consider TD 2017/24 when dealing with an offshore trust. It should also be noted that the Commissioner's view on s 99B has implications that stretch far beyond the issue of the CGT discount that TD 2017/24 seeks to comment on. There are many differences in the taxation of individuals and companies. An interpretation of s 99B(2)(b) is an uncertain matter. The specific issue that has attracted the Commissioner's attention is arguably the tip of the iceberg. Identifying how an amount would be treated in the hands of a hypothetical taxpayer as distinct from the taxpayer is fraught with difficulties. It is submitted that an interpretation that works to achieve the policy objectives of s 99B would need to consider a range of features for the hypothetical taxpayer. The core nature for the actual recipient is essential, but other features might need to be taken from the trustee. It should be recalled that the nature of the amount and what it represents can be different in the hands of the trustee and the recipient. This is particularly the case when the trustee is involved in complex international structures.

The operation of s 99B(2)(b) raises numerous questions which will be considered in more detail in the next article in this series. In addition, s 99(2)(b) is not the only difficult part of s 99B. The operation of the law continues to raise complicated questions that need to be addressed for the certain and equitable taxation of offshore trusts. These will also be explored in the follow-up article.

Conclusion

This article has argued for the need for certainty in the taxation of offshore trusts in order that the law can work as intended without undue cost and unfairness. Uncertainty cannot be justified on the basis that offshore trusts are somehow "undesirable". Executive responses such as TD 2017/24 are not adequate. TD 2017/24 does not engage with the core meaning of the law and is too focused on a specific outcome being the denial of the CGT exemption to those who receive amounts from offshore trusts. The core provisions need to be interpreted to achieve their objectives in the taxation of offshore trusts and those who benefit from them.

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References

1 This article is part of a series examining multiple issues in the Australian taxation of offshore trusts. For the first article in the series, see N Sharkey, "When international tax meets the family trust", (2020) 55(6) *Taxation in Australia* 293.

2 See TD 2017/24 and related professional commentary.

3 Reid K Weisbord, "A catharsis for US trust law: American reflections on the Panama Papers", (2016) 116 *Columbia Law Review Online* 93.

4 STEP, *Social and Economic Benefits of Trusts,* (2021) STEP, London. Available at www.step.org/thought-leadership-and-research.

5 Consider the Chinese in Indonesia; see the recent publication by S Lie and T Sandel, "Unwelcomed guests: cultural discourse analysis of comments on ethnic Chinese in Indonesian social media", (2020) 16(1) *Journal of Chinese Overseas* 31.

6 Atrocities, unjust taking of property, genocide and discrimination are to be found in all continents other than possibly Australia, Antarctica and North America in the past half century.

7 N Sharkey, "In depth cross-border tax and asset protection perspectives on Chinese private investment in Australia", (2017) 23(10) *Trusts and Trustees* 1089.

8 N Sharkey, "When international tax meets the family trust", (2020) 55(6) *Taxation in Australia* 293.

9 See *FCT v Stone* [2005] HCA 21.

10 See Subdiv 768-A of the *Income Tax Assessment Act 1997* (Cth).

11 Para 13 of TD 2017/24.

A Matter of Trusts

by Edward Morcombe, Sladen Legal

When a declaration of trust is dutiable: part 1

In this two-part article, we explore two recent cases that provide guidance on when a declaration of trust will be a dutiable transaction.

Circumstances can arise where a trustee decides to execute a document that merely confirms or acknowledges an existing trust relationship. This could occur where such documentation was not prepared contemporaneously to the creation of the trust and documentary evidence of the trust relationship is required for commercial or litigious reasons, or for the purpose of confirming the existence of the trust for tax or duty laws or to other parties (like banks or revenue authorities).

However, a confirmation, declaration or acknowledgment of trust can potentially trigger tax or duty consequences. Therefore, any such confirmation, declaration or acknowledgment must be made with care to ensure that tax or duty consequences are not triggered. In this two-part article, we will consider two recent land transfer (stamp) duty cases involving the potential duty consequences of executing confirmatory declarations of trust.

Recent cases on duty consequences

The cases of *Chief Commissioner of State Revenue v Benidorm Pty Ltd*[1] (*Benidorm* decision) and *Commissioner of State Revenue (WA) v Rojoda Pty Ltd*[2] (*Rojoda* decision) demonstrate the potential complexity of determining whether a declaration of trust, whose ostensible purpose is merely to confirm or acknowledge an existing trust relationship, is dutiable.

The *Benidorm* decision, in particular, demonstrates that the legacy of transitioning from state stamp duty legislation that imposed a tax on instruments[3] to duty legislation that imposes a tax on transactions[4] is the potential for confusion to be caused, first, by attempts to interpret the current legislation by reference to case law decided under the former regime and, second, by lingering elements of the former regime's provisions that were transplanted into the current statute.[5]

Though the difficulties associated with the resultant complexity may be "more chimerical than real",[6] the *Benidorm* and the *Rojoda* decisions show that declarations of trust merit close inspection from a duties perspective and provide some guidance on what to look for.

Benidorm decision

The *Benidorm* decision was based on s 8 of the *Duties Act 1997* (NSW), which provides:

> "(1) This Chapter charges duty on —
>
> …
>
> (b) the following transactions —
>
> …
>
> (ii) a declaration of trust over dutiable property,
>
> …
>
> (3) In this Chapter —
>
> **'declaration of trust'** means any declaration (other than by a will or testamentary instrument) that any identified property vested or to be vested in the person making the declaration is or is to be held in trust for the person or persons, or the purpose or purposes, mentioned in the declaration although the beneficial owner of the property, or the person entitled to appoint the property, may not have joined in or assented to the declaration."

Facts

In 2007, Mr Robinson, a resident of Guernsey, instructed his solicitor in Sydney, Mr Dawson, to incorporate Benidorm Pty Ltd (Benidorm). Benidorm was incorporated on 1 May 2007, with Mr Dawson as sole director and shareholder. Mr Robinson subsequently provided $12,050,000 for Benidorm to purchase a Macquarie Street apartment in Sydney (the property). Benidorm entered into a contract for the purchase of the property on 16 May 2007.

As Mr Robinson had provided all of the funds for the purchase of the property to Benidorm, the general law would recognise an implied trust, whereby Benidorm held the property on resulting trust for Mr Robinson. This resulting trust was formally recognised in a declaration of trust dated 31 May 2007 (the first declaration of trust), whereby Benidorm declared that it held the property on trust for Mr Robinson. On 27 June 2007, the sale of the property was completed and ad valorum duty was paid on the transfer to Benidorm. The first declaration of trust was subject to nominal duty only.[7]

Mr Robinson died on 13 September 2013. His will appointed Mr Stubbs as his sole executor and sole beneficiary. On 29 January 2015, Benidorm and Mr Stubbs executed the declaration titled "Declaration of Trust by Nominee" that became the subject of the litigation (the second declaration of trust).

The second declaration of trust recited the circumstances of the property's acquisition by Benidorm, referred to the first declaration of trust, and stated that Benidorm now held the property on trust for Mr Stubbs as a result of the operation of Mr Robinson's will. It did not, however, explicitly or directly state whether the property vested in Mr Stubbs in his capacity as sole executor or sole beneficiary of Mr Robinson's estate.

The Chief Commissioner assessed duty on the second declaration of trust. At the core of the Chief Commissioner's position was the view that an instrument, being a declaration of trust as defined in s 8 of the *Duties Act 1997* (NSW), had been executed and therefore there was a dutiable transaction.[8] On the other hand, Benidorm argued that, as the second declaration of trust had no legal effect, there was no transaction and therefore duty did not apply.[8]

Did the second declaration of trust have any legal effect?

The court found that the second declaration of trust did not have any legal effect. The correct construction of the second declaration of trust was that it merely acknowledged what had already occurred, that is, the vesting of Mr Robinson's equitable interest in the property in Mr Stubbs in his capacity as executor on the grant of probate of the will of Mr Robinson (see Figure 1).[9] The second declaration of trust did not operate to vest the property in Mr Stubbs in his capacity as beneficiary immediately, nor was it a vesting to come into effect in the future once the estate had been fully administered.[10] This construction was significant, as the latter two constructions would likely have resulted in the document being construed as effecting a transaction.

Was a mere acknowledgment of existing trust a "declaration of trust" as defined by the statute?

The court found that a mere acknowledgment of the existing trust was not a "declaration of trust" as defined by the statute. Taking into account the shift to a "transactional" basis of imposing duties, the court favoured a construction whereby the requirement that there be a transaction was "central".[11] Therefore, a declaration of trust would not be dutiable unless it met the overriding condition of being a transaction, whereby a transaction was defined as "something which alters the legal or equitable rights or obligations concerning property".[11]

The court therefore found that the second declaration of trust was not dutiable. The Chief Commissioner has advised that it will be seeking special leave to appeal the *Benidorm* decision to the High Court.

In the second part of this article, we look at the *Rojoda* decision, where a declaration of trust by the taxpayer was found to be dutiable, as well as comparisons between the *Benidorm* decision and the *Rojoda* decision and key takeaways.

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References

1 [2020] NSWCA 285.

2 [2020] HCA 7.

3 *Stamp Duties Act 1920* (NSW).

4 *Duties Act 1997* (NSW).

5 [2020] NSWCA 285 at [4].

6 *Benidorm Pty Ltd v Chief Commissioner of State Revenue* [2020] NSWSC 471 at [344].

7 Pursuant to the apparent purchaser provision in s 55(1)(a)(ii) of the *Duties Act 1997* (NSW).

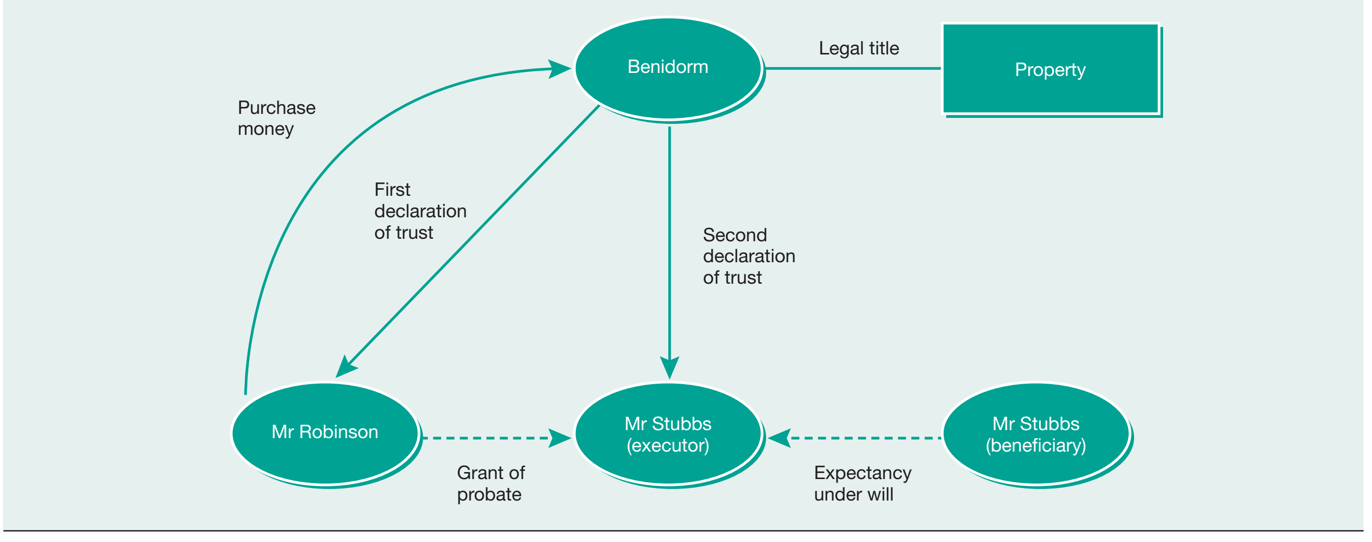
8 [2020] NSWCA 285 at [57].

9 By operation of s 44 of the *Probate and Administration Act 1898* (NSW). This vesting in the executor was subject only to nominal duty under s 65(12) of the *Duties Act 1997* (NSW).

10 [2020] NSWCA 285 at [30], [43]-[44].

11 [2020] NSWCA 285 at [82].

Figure 1. Declarations of trust structure in the Benidorm decision



Superannuation

by Daniel Butler, CTA, DBA Lawyers

SMSFs and 50-50 unit trusts

This month's column discusses a number of important considerations to determine whether a related trust relationship exists in s 70E(2) SISA93.

Overview

There is an increasing number of SMSFs that invest in fifty-fifty (ie 50-50) unit trusts. That is, an SMSF has a 50% interest in a unit trust, with another unitholder holding the remaining 50% interest, which invariably is an unrelated SMSF.

Our experience over the years has uncovered weaknesses in how many of these have been implemented, operated or documented.

Some key risks that should be considered and strategies for successfully navigating this type of structure are examined below.

Is the trust a related trust?

Where there are two unrelated SMSFs each holding 50% of the units in a unit trust, this "arrangement" has generally been considered not to give rise to a related trust for in-house asset purposes under s 70E(2)(a) of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA93). However, there are several other tests that can easily give rise to a related trust relationship and related follow-on consequences, as discussed below.

The primary consequence of the related trust relationship is that, once this relationship arises, the in-house asset rules limit each fund's investment to no more than 5% of the market value of each fund.

ATO materials regarding 50-50 unit trusts

On 5 March 2013, in its National Tax Liaison Group Superannuation Technical Sub-group minutes (2013 NTLG minutes), the ATO confirmed that an SMSF holding a 50% interest does not, by itself, amount to control of a unit trust. These non-binding ATO comments have been relied on by many without realising that the ATO did not rule out the other tests in s 70E(2), such as s 70E(2)(b) and (c).

Section 70E(2) provides three limbs to test whether a unit trust is a related trust:

> "(2) For the purposes of sections 70B, 70C and 70D, an entity ***controls*** a trust if:
>
> (a) a group in relation to the entity has a fixed entitlement to more than 50% of the capital or income of the trust; or
>
> (b) the trustee of the trust, or a majority of the trustees of the trust, is accustomed or under an obligation (whether formal or informal), or might reasonably be expected, to act in accordance with the directions, instructions or wishes of a group in relation to the entity (whether those directions, instructions or wishes are, or might reasonably be expected to be, communicated directly or through interposed companies, partnerships or trusts); or
>
> (c) a group in relation to the entity is able to remove or appoint the trustee, or a majority of the trustees, of the trust."

More than 50% of units

The test in s 70E(2)(a) relies on whether a group (eg the member and the member's related parties) has a fixed entitlement to more than 50% of the capital or income of the trust. This requires more than a 50% holding of units. Therefore, a 50% or lesser holding does not give rise to a related trust relationship under s 70E(2)(a). This test is generally relatively easy to establish from the unit trust documentation and related records if all units are of the same class of units.

When reviewing a trust deed, however, you need to carefully review the provisions of each deed in detail and should not make any assumptions on what, for instance, you might expect to find in the document. As noted by the High Court in *CPT Custodian Pty Ltd v Commissioner of State Revenue*:[1]

> "In taking those steps, *a priori* assumptions as to the nature of unit trusts under the general law and principles of equity would not assist and would be apt to mislead. All depends, as Tamberlin and Hely JJ put it in *Kent v SS 'Maria Luisa' (No 2)*,[2] upon the terms of the particular trust. The term 'unit trust' is the subject of much exegesis by commentators. However, 'unit trust', like 'discretionary trust', in the absence of an applicable statutory definition, does not have a constant, fixed normative meaning which can dictate the application to particular facts of the definition in s 3(a) of the Act."

If there are different classes of units, for instance, a detailed analysis would need to be undertaken to see which unitholder may exert more influence or control.

Sufficient influence

The second test in s 70E(2)(b) that can result in a related trust relationship is what is broadly known as the "sufficient influence" test. In the 2013 NTLG minutes, the ATO comments on the 50-50 unit trust question was qualified by being subject to s 70E(2)(b) (and s 70E(2)(c) discussed below), stating that:

> "… the trustee of the trust … might reasonably be expected, to act in accordance with the directions, instructions or wishes of a group in relation to the entity …"

Until recently, there has been little guidance on the sufficient influence test in s 70E(2)(b). As such, SMSF trustees involved in 50-50 unit trusts have generally tried to minimise any "related trust" risk. Instances that may indicate some influence might include:

- the unit trust deed provides one unitholder a discretion, power or advantage over the other unitholder;
- the constitution of the corporate trustee to the unit trust provides one director/shareholder with power or an advantage over the other director/shareholder, eg the chair of a directors or shareholders meeting has a casting vote; and
- one unitholder and/or a related entity, for example:
  - is actively involved in managing and controlling the unit trust's affairs and the other is relatively passive; or
  - provides loans to the unit trust and has influence via the loan agreements or mortgage or security arrangements in relation to the unit trust.

Recent developments in case law and ATO materials now provide better guidance on what is meant by "sufficient influence".

The *BHP Billiton Ltd v FCT*[3] decision considered "sufficient influence" for the purposes of identifying "associates" of a company under s 318 of the *Income Tax Assessment Act 1936* (Cth) (ITAA36). The High Court held that BHP Billiton Ltd sufficiently influenced BHP Billiton Plc (and vice versa). Further, BHP Marketing AG (the group's Swiss marketing entity, owned 58% by BHP Billiton Ltd and 42% by BHP Billiton Plc) was sufficiently influenced by BHP Billiton Plc and BHP Billiton Ltd.

Similar wording is used in s 318(6)(b) ITAA36 to that in s 70E(2)(b) that relevantly provides:

> "(6) For the purposes of this section:
>
> (a) …
>
> (b) a company is sufficiently influenced by an entity or entities if the company, or its directors, are accustomed or under an obligation (whether formal or informal), or might reasonably be expected, to act in accordance with the directions, instructions or wishes of the entity or entities (whether those directions, instructions or wishes are, or might reasonably be expected to be, communicated directly or through interposed companies, partnerships or trusts);"

The *BHP* decision held that, for a company to be "sufficiently influenced" by another entity under s 318(6)(b), it was not necessary to show "effective control" or a causal link between the entity's "directions, instructions or wishes" and the company's actions (as BHP had contended). The court held that the test could be satisfied if the facts provided a basis on which to conclude a "requisite degree of contribution" between such directions and actions. The *BHP* facts broadly involved, among other things, a dual-listed UK–Australian company arrangement where directors had to generally vote in a consistent manner.

While the *BHP* decision related to a different legislative test in relation to a company and its associates for tax purposes to the test in s 70E(2)(b) SISA93 that relates to a unit trust, the decision is relevant as it provides meaning to the similar legislative text/test. As you will glean from the above legislative extracts, both tests (ie s 318(6)(b) ITAA36 and s 70E(2)(b) SISA93) largely include similar wording including "directions, instructions or wishes … communicated directly or through interposed companies, partnerships or trusts …".

There have also been other recent developments where a company has been taken to be controlled by a person who was not formally appointed as a director. Therefore, the fact that a person is not formally appointed does not preclude that person from being in a position of control or sufficient influence.

The power to hire or fire the trustee

For completeness, the third test in s 70E(2)(c) is reliant on who can remove or appoint the trustee, or a majority of the trustees, of the trust. As with the more than 50% of units test in s 70E(2)(a), this test is generally relatively easy to determine by way of a review of the unit trust's documentation and related records.

As noted above in relation to the High Court's comments in the *CPT Custodian* decision, there is no constant, fixed normative meaning of what a unit trust is, as it depends on the terms in the deed being considered.

In this regard, there are various drafting methods used in relation to who has the power to remove or appoint the trustee, or, in the case of individual trustees, a majority of the trustees of the trust. Several popular methods that we encounter include:

- a certain majority of unitholders, eg 75%, can vote to remove or appoint a trustee;
- an appointor/guardian/founder or similar person or entity is given the power to remove or appoint a trustee; and
- the current trustee may be given the power to resign, remove or appoint a trustee.

The multi-pronged related trust test

As you will see from the above outline, there are a number of important considerations to review to determine whether a related trust relationship exists in s 70E(2) SISA93. There are also a number of less well-known provisions that might prove a trap for young players.

Does the ATO have discretion to deem an asset to be an in-house asset?

The ATO has a broad discretionary power to deem an asset (that is, not an in-house asset under the usual tests) to be one under s 71(4) SISA93.

The ATO relied on this deeming power in *Aussiegolfa Pty Ltd as trustee of the Benson Family Superannuation Fund and FCT*.[4] While the ATO lost in the Administrative Appeals Tribunal, the ATO does have a broad discretion to deem an asset to be an in-house asset.

The ATO won a separate case in the Full Federal Court, namely, *Aussiegolfa v FCT*,[5] that resulted in the units in the unit trust in question being held to be an in-house asset. The Full Federal Court decision effectively removed the ability of the Administrative Appeals Tribunal to deem the asset to be an in-house asset, as the Full Federal Court had already determined the asset's status.

Understanding the risks

As will be appreciated from the above discussion, a 50-50 unit trust faces a number of possible risks. If there is any doubt, timely expert legal advice should be obtained, especially as a contravention of the in-house asset provisions can result in serious adverse consequences. For example, a contravention can potentially result in, among other things:

- significant administrative penalties being imposed;
- an SMSF being rendered non-complying, with a significant tax liability; or
- the SMSF directors/trustees being disqualified from ever being SMSF directors/trustees again.

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References

1 [2005] HCA 53 at [15].
2 [2003] FCAFC 93.
3 [2020] HCA 5.
4 [2017] AATA 3013.
5 [2018] FCAFC 122.

Alternative Assets Insights

by Sarah Saville, ATI, and
Patricia Muscat, CTA, PwC

Temporary full expensing of depreciating assets

Temporary full expensing of depreciating assets will supercharge previous capital allowance concessions.

As part of the response to the widespread economic impact of COVID-19, the federal government announced in the 2020-21 Budget that it will allow a deduction for the full cost of certain depreciating assets acquired and used by eligible businesses. This measure, known as "temporary full expensing", broadly applies to eligible assets acquired from 7.30 pm AEDT on 6 October 2020 (2020 Budget time) and first used or installed by 30 June 2022.

Temporary full expensing of the cost of depreciating assets is intended to "supercharge" previous capital allowance concessions by extending access to larger businesses and eliminating the cap on the cost of eligible assets. Businesses that were not eligible for the previous concessions may now be entitled to write off the cost of eligible assets under the new concession.

There are some limitations on entities that can access the concession and the types of assets that are eligible, and this will depend on the size of the business seeking to claim the concession. For example, businesses with an annual aggregated turnover of less than A$50m will be able to claim the cost of second-hand assets, while larger businesses will generally not be able to.

Following amendments passed by parliament on 10 December 2020, businesses also now have the option to opt out of this measure on an asset-by-asset basis. Businesses which opt out or are ineligible to claim the temporary full expensing concession for certain assets may still be eligible for other concessions, including the original "instant-asset write-off" concession and the backing business investment accelerated depreciation measure.

When is an entity eligible for temporary full expensing?

There are a number of conditions that must be met before a taxpayer can access the temporary full expensing concession. In simple terms, the entity's eligibility threshold is whether:

- the entity meets an aggregated turnover threshold of less than A$5b (aggregated turnover test); or
- if the entity is a company, it meets an alternative threshold test based on the company's ordinary and statutory income and historical capital expenditure (alternative test).

Aggregated turnover test

Under the aggregated turnover test, the entity must be carrying on a business in the current year and satisfy one of the following tests:

- the entity carried on a business in the previous income year and the aggregated turnover for the previous income year was less than A$5b;
- as at the beginning of the current year, the entity is likely to have less than A$5b in aggregated turnover for the current year, provided that it did not have more than A$5b in aggregated turnover for both of the previous two income years; or
- the entity's aggregated turnover for the current year is less than A$5b (determined at the end of the current year).

A taxpayer's aggregated turnover is the sum of the "annual turnovers" of the taxpayer and also those of any entity connected with or affiliated with the taxpayer (excluding amounts derived from dealings between those entities). An entity's "annual turnover" is the total "ordinary income" that it derives in the income year in the "ordinary course of carrying on a business". "Ordinary income" is "income according to ordinary concepts" and bears no relationship to whether the income might be assessable or made exempt under provisions in the Australian tax law or whether the income is included as revenue in an entity's financial report.[1]

Alternative test

An alternative test is available for corporate tax entities seeking to access the temporary full expensing concession. Interestingly, this alternative test does not extend to trusts, superannuation funds or partnerships, other than those that are treated for tax purposes as though they were a company. Specifically, this means that a company with an annual aggregated turnover of A$5b or more will be able to access the measure if:

- the company has less than A$5b in total statutory and ordinary income (excluding non-assessable non-exempt income) in either the 2018-19 or 2019-20 income year; and
- the company has invested more than A$100m in certain tangible depreciating assets in the period covering the 2016-17 to 2018-19 income years.

Asset eligibility for temporary full expensing

Temporary full expensing is available for eligible assets acquired from 7.30 pm AEDT on 6 October 2020 (2020 Budget time) and first used or installed by 30 June 2022.

Although most new depreciating assets will qualify, there are a number of important exclusions. Broadly, businesses with an aggregated turnover of less than A$50m are able to access this concession for a wider range of assets. The exclusions are summarised in general terms in Table 1.

Table 1. Summary of eligible and excluded assets

✓ = eligible asset ✗ = excluded asset

	Businesses with an aggregated turnover of less than A$50m	Businesses with an aggregated turnover of A$50m or more but less than A$5b	Companies eligible under the alternative test *only*
New depreciating assets (not otherwise excluded below)	✓	✓	✓
Certain intangible assets	✓	✓	✗
Assets previously held by associates	✓	✓	✗
Assets available for use by associates or foreign residents	✓	✓	✗
Second-hand assets	✓	✗	✗
Asset held under a commitment entered into before 2020 Budget time	✓	✗	✗
Division 43 capital works	✗	✗	✗
Low value pool assets	✗	✗	✗
Assets allocated to a software development pool	✗	✗	✗
Certain primary production depreciating assets	✗	✗	✗
Assets that are not used or located in Australia	✗	✗	✗

As well as allowing a deduction for the full cost of eligible assets acquired and first used or installed during the relevant period, this measure also provides a deduction for any improvements to existing depreciating assets (referred to as "second element costs") between the 2020 Budget time and 30 June 2022.

Key considerations

There are a number of key issues that taxpayers should consider before claiming the temporary full expensing concession or committing to purchases on the basis that this concession is available. Some of these are highlighted below.

1. Optionality. Recent amendments have introduced the ability for taxpayers to opt out of this measure on an asset-by-asset basis. There are a number of reasons why a taxpayer may choose not to claim a deduction under this measure, for example, if the entity holding the assets is likely to be sold in the future, to retain the ability to reset the cost of the asset on joining a tax consolidated group (see issue 4 below), or to avoid creating significant tax losses that may not be able to be utilised in future where loss carry-back is not available (see issue 5 below).

2. Assessing aggregated turnover. Assessing an entity's aggregated turnover can be a complex exercise as it involves identifying entities connected or affiliated with the taxpayer, and sourcing information regarding the ordinary income of those entities. Taxpayers should pay close attention to the appropriate test time, which is generally either the prior income year or the current income year. Where there has been a fall in turnover in the current income year which results in an expected aggregated turnover that is below the A$5b threshold, it may not be possible to confirm eligibility until the end of the income year. In these circumstances, businesses should do additional work to estimate turnover for the year before investing in any assets where the ability to claim the upfront deduction is critical to the decision-making process.

3. Accessing the alternative test. The alternative test was introduced to improve access to the concession for taxpayers with an aggregated turnover of A$5b or more. This, however, is limited to companies only (not trusts, partnerships or individuals) and those with a historical track record of substantial investment in tangible depreciating assets. In practice, this limits the alternative test to a small number of Australian taxpayers.

4. Interaction with tax consolidation provisions. Where a deduction is taken for the cost of an asset under the temporary full expensing measure, this has future implications where the entity holding the asset subsequently joins a tax consolidated group. This is due to a modification to the tax cost setting rules which reduces the asset's tax cost setting amount to its terminating value which will be nil where the cost of the asset was originally claimed under this measure. As such, there can be no "step-up" for the tax cost of the asset, even in cases where the asset's market value exceeds the historical full expensing tax claim. Unlike the position with a reduction in the tax cost setting amount under other provisions, the amount of the reduction is not re-allocated among other assets.

5. Interaction with loss rules. Claiming a deduction for the full cost of eligible depreciating assets may result in tax losses. Companies (and other entities taxed like companies) may be eligible to claim a loss carry-back tax offset which effectively provides a refund of tax paid in prior years. The temporary loss carry-back rules were announced in the 2020-21 federal Budget and are intended to complement the temporary full expensing measures. Taxpayers that are not eligible for loss carry-back should be mindful of rules that may limit the ability to recoup tax losses against future taxable income.

6. Who claims the benefit of the deduction? For Australian income tax purposes, the "holder" of a depreciating asset claims the tax depreciation (or capital allowances). In general, the holder of a depreciating asset is the owner of the asset. In genuine commercial lease arrangements (eg operating leases and finance leases), in most cases, the holder is the lessor. In a standard chattel mortgage or loan arrangement, the holder of the asset is the borrower. However, the holder of a depreciating asset is modified in certain asset financing arrangements, including:

a. for luxury car leases, the lessee is deemed to be the holder and claims depreciation deductions based on the luxury car limit; and

b. for hire purchase arrangements, the hiree is deemed to be the holder and claims depreciation deductions where the hiree possesses the asset and is reasonably expected to exercise a right that would make the hiree the holder of the depreciating asset.

For asset financing businesses, the choice of asset financing solution will determine who obtains the benefit of the enhanced tax concessions.

7. How is the benefit claimed? The depreciation deductions under the temporary full expensing measure will be claimed on lodgment of the relevant income tax return. Entities may also wish to consider bringing forward the cash tax benefit of the concession by:

a. varying PAYG instalment rates; or

b. lodging income tax returns as soon as possible to claim the benefit of the concession and reduce future PAYG instalment rates.

8. Governance/operational risk issues. There will be a number of system issues and other governance/operational issues to consider when implementing these rules, for example:

a. accessing the relevant information to assess asset eligibility (eg recording when an asset is installed and ready for use, or if it is second hand);

b. setting up the enterprise resource planning/fixed asset system to apply different tax depreciation rules to different assets;

c. the potential to apply retrospective adjustments to existing systems (noting that this may need to be done before year end);

d. guidance to finance/procurement teams for the treatment of capital additions; and

e. additional year-end checks and reconciliations to income tax provision and income tax return processes to confirm the correct application of the rules.

9. Claw-back for assets not used or located in Australia. The amendments enacted in early December 2020 introduced a balancing adjustment to effectively claw back some or all of the benefit of the upfront deduction in a later income year if the asset ceases to be used primarily for carrying on a business (for example, it is applied for private use), if it is relocated outside of Australia, or where the asset was intended to be relocated to Australia for business use but this does not occur. Practically, this means that use of the asset should be monitored for the remainder of its life. Where the balancing adjustment occurs, there is a deemed disposal and reacquisition of the asset for its market value at that time. This means that the market value of the asset will be included in the assessable income of the taxpayer at the time of the balancing adjustment, and the taxpayer will then claim normal depreciation on the deemed cost of the reacquired asset if it is used for a taxable purpose.

Takeaway

The temporary full expensing concession for capital investment is intended to stimulate investment in certain capital assets to maintain jobs and economic activity.

As highlighted above, there are a number of issues that businesses should consider before claiming deductions under this measure and/or making significant investments. The ability to opt out of these measures, coupled with the interactions with the tax consolidation rules and the balancing adjustment for assets not used or located in Australia, means that taxpayers need to not only consider their immediate plans for the use of the asset but also future plans for the asset when deciding whether to claim the upfront deduction.

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Reference

1 For further details on the determination of aggregated turnover, see J Malone, S Saville and J Murray, "Aggregated turnover threshold", (2020) 55(6) *Taxation in Australia* 321.

Successful Succession

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

Tax on dying of a broken heart

Capital gains tax assets passing from one estate to the estate of a beneficiary, and then to the beneficiaries of this second estate, may not be exempt from CGT.

Dying of a broken heart is known as the "widowhood effect" in scientific circles and studies have consistently shown that it is real and on the rise.

Wikipedia helpfully tells us that:[1]

> "The **widowhood effect** is the increase in the probability of a person dying a relatively short time after their long-time spouse has died. The pattern indicates a sharp increase in risk of death … in the three months closest thereafter the death of the spouse … Responses of grief and bereavement due to the loss of a spouse increases vulnerability to psychological and physical illnesses …
>
> Psychologically, losing a long-term spouse can cause symptoms such as depression, anxiety, and feelings of guilt. Physical illness may also occur as the body becomes more vulnerable to emotional and environmental stressors … Grieving spouses are more vulnerable during these few months not only health wise but socially and physically. During this early period of bereavement spouses tend to have less interest in their health as well as physical appearance caring less about continuing with medications or adapting healthy behaviours such as eating healthy or exercising. Also, they are likelier to practise risky behaviours and commit suicide."

This phenomenon appears to be consistent across religions, ethnic groups, countries, regions etc, although women who have lost their spouse or partner tend to do better than men. This is explained by men, typically, having fewer support networks, having fewer chores and activities outside their home or work, being less able to look after themselves in terms of nutrition and health, and reporting higher rates of satisfaction with their marriage or marriage-like relationships than women. Unsurprisingly, the phenomenon is strongest in older couples in long-term relationships.[2]

Dying of a broken heart is on the increase in Australia. Life expectancy has risen substantially over the last 30 years. Female life expectancy has increased from 79.5 years in 1988 to 85.0 years in 2019, and male life expectancy has increased from 73.1 years to 80.9 years over the same period.[3] The authors have noticed a significant increase in children coming in to administer their parents' estates at the same time, with both parents having died only months apart.

This triggers an unexpected tax point.

Any capital gain or loss that arises on the death of an owner of CGT assets who was an Australian resident for tax purposes can generally be disregarded.[4,5] The gain or loss is disregarded when the CGT asset passes to the legal personal representative (executor or administrator) (LPR) of the deceased and also to a beneficiary (under a will or pursuant to intestacy (or under court order)) who was an Australian resident for tax purposes (or is a charity with deductible gift recipient status).[6] Any tax payable is deferred until the beneficiary disposes of the asset (other than on their death), or if the LPR disposes of the asset in the estate and no other exemptions apply (such as the main residence exemption).[7]

These exemptions from tax under s 128-15(3) ITAA97 are not available if the CGT asset was not owned by the deceased person before they died.[5] In other words, any CGT assets that come into the hands of the LPR after the date of death, either by the LPR acquiring new assets or receiving the deceased's entitlement from elsewhere, are not tax-exempt when passing to beneficiaries.

This rule was originally introduced to prevent the LPR from trading up the assets of the estate or to prevent additions being made to the estate to bolster what can be transferred into testamentary trusts (which can give families many tax advantages), but it can apply in other circumstances likely not considered or intended by the legislature.

Take the following example. Max's mum, Ida, died in late 2019; she was 90. Max's dad, Jonty, died 10 months later in 2020; he was 93. Jonty struggled alone in the family home after his wife of 64 years was gone. He also struggled with the restrictions imposed in Victoria as a result of COVID-19 and ended up in aged care in April 2020.

Ida owned a share portfolio that was worth about $1m. She also jointly owned the family home and the bank accounts with Jonty. Her dividends were getting paid into the joint account. Jonty owned his own share portfolio of about $500k. Having outlived his wife, Jonty received the bank accounts and the family home by survivorship immediately on Ida's death. By Ida's will, Jonty also inherited the share portfolio. Jonty was not in a state to deal with any of these legal aspects of the estate after Ida died and, practically, he did not need to as he had a roof over his head, access to dividends, and no other beneficiary was hassling him to "sort it out".

Max was overwrought with trying to assist his father in managing alone at home, being assessed for aged care, finding a suitable facility for Jonty to move into, at the same time as coping with his own pressures and constraints of COVID-19 (working from home, home schooling children etc), and therefore delayed taking any steps regarding the administration of his mother's estate.

Sadly, Max's father Jonty died only a short time later, having lost the will to go on alone. By the time Max had been able to consider the administration of his mother's estate, he also had to deal with Jonty's estate.

Jonty's will left everything to Max, and Max was the sole executor. The words in the will were simple, the intentions natural and straightforward but, as always, the tax situation was extremely complicated.

Ida's share portfolio could be transferred to Max as her executor (Jonty was the first named executor, but he had died, so Max took his place as substitute executor) and to Jonty personally without triggering any tax (even though Jonty was gone, his estate could receive these transfers). Similarly, the portfolio could pass to Max as Jonty's executor without triggering any tax. However, because Jonty did not own the portfolio before he died, Max could not inherit it (as a beneficiary under Jonty's will) without triggering CGT.

Ida's share portfolio could be:

– sold off in Ida's estate and applicable CGT paid on the increase in value between the date of acquisition and the date of sale;
– transferred to Jonty in specie tax-free, and Jonty's estate could sell it, pay the CGT and the cash could be transferred to Max in accordance with Jonty's will (CGT will not apply to a transfer of cash); or
– transferred to Jonty's estate tax-free and then to Max in accordance with Jonty's will, with any applicable CGT paid on this transfer by Jonty's estate.

The joint bank accounts were owned by Jonty on the day he died, they are not CGT assets and can therefore be dealt with by Max in any way he wishes without triggering CGT.

In addition, the jointly owned family home belonged to Jonty in its entirety before he died, so Max is able to inherit this property without triggering any tax.

Jonty's share portfolio can also be inherited by Max without triggering any tax on the transfer.

The exemption from CGT for transfers from Jonty to Max only applies to the CGT assets that Jonty owned before dying. This exemption is not available to Max in respect of Ida's share portfolio as Jonty did not own Ida's share portfolio when he died (Ida still owned it). Jonty was entitled to the due administration of Ida's estate and had an expectation that he would receive it, but he did not own it. The share portfolio can transfer to Ida's LPR and then to Jonty as beneficiary without incurring any CGT liability.[8] No CGT liability will pass to Max in capacity as executor of Jonty's estate. However, the CGT roll-over will not be available to Max as beneficiary of Jonty's will.

The actual calculation of the CGT payable if it is transferred to Max is complicated.[9] The final figure depends on the cost bases of each share and any rise in its value, the timing of the transfers etc, and discussion of the calculation is beyond the scope of this article.

Careful consideration should be given to estates which "combine" as a result of the death of both spouses or partners, with the combined estates then passing to the LPR and final beneficiaries via the will of the survivor.

There are other scenarios where CGT can be inadvertently triggered and catch a family out, for example, if a purchaser dies after signing a contract of sale but before settlement of the sale of real estate or shares; also, if an LPR takes up shares through a dividend reinvestment plan, or if property that the deceased owned is subdivided or strata titled in the estate administration phase.

One can never be too careful with estate administration. Tax must be at the forefront of the mind of every professional involved in estate administration, and consideration should be given to obtaining private binding rulings to clarify the exact position.

For will drafters, it is important to consider whether the old (and abandoned) custom in will drafting of an interest vesting in a beneficiary *only after* obtaining probate and transfer taking place should be resurrected, rather than on survival by 30 days.

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1 Available at https://en.wikipedia.org/wiki/Widowhood_effect#:~:text=The%20widowhood%20effect%20is%20the,the%20death%20of%20the%20spouse.

2 CB Kristiansen, AB Bojesen, P Munk-Jørgensen and K Andersen, "The widowhood effect — mortality and adverse health effects when losing a spouse in old age, (2017) 41(S1) *European Psychiatry* S656.

3 Australian Bureau of Statistics, *Life expectancy continues to increase in Australian*, media release, 4 November 2020. Available at www.abs.gov.au/media-centre/media-releases/life-expectancy-continues-increase-australia.

4 It is beyond the scope of this article to deal with non-residence for tax purposes of estates or beneficiaries.

5 S 128-10 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).

6 S 128-20 ITAA97.

7 S 128-15 ITAA97.

8 S 128-15(1) to (3) ITAA97.

9 S 104-10 ITAA97.

Events Calendar

April 2021

KEY EVENTS	DATE	CPD
National		
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2021 Financial Services Taxation Conference	22/4/21	11
South Australia		
2021 Barossa Convention	28/4/21	13
WOMEN IN TAX	**DATE**	**CPD**
Australian Capital Territory		
Leading from Trials to Triumph – Canberra Networking Lunch	14/4/21	1
South Australia		
Leading from Trials to Triumph – Adelaide Networking Breakfast	16/4/21	1
Western Australia		
Leading from Trials to Triumph – Perth Networking Lunch	22/4/21	1
New South Wales		
Leading from Trials to Triumph – Sydney Networking Lunch	29/4/21	1
Queensland		
Leading from Trials to Triumph – Brisbane Networking Lunch	29/4/21	1
Tasmania		
Leading from Trials to Triumph – Launceston Networking Breakfast	29/4/21	1

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

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TAXATION *in Australia*®
ISSN 0494-8343

Publishing House
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ABN 45 008 392 372

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