THE JOURNAL FOR MEMBERS OF THE TAX INSTITUTE

Taxation in Australia

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KEY INSIGHTS FROM NSW 13TH ANNUAL TAX FORUM

The dark corners of Div 7A

Andrew Noolan, CTA

Trust hot topics

Ken Schurgott, CTA (Life)

Don’t lose your losses

Sarah Saville and Roop Sangha

Share sale and purchase agreements

Victoria Lanyon

THE TAX INSTITUTE

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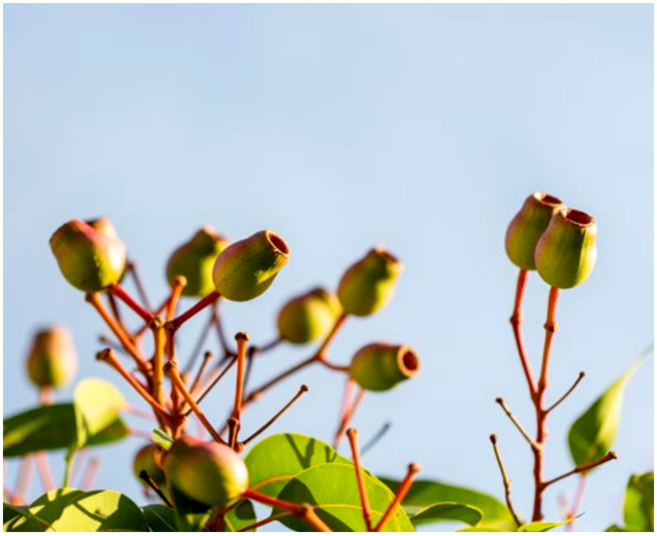

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Invitation to write

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

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

Tax News – at a glance

by TaxCounsel Pty Ltd

June – what happened in tax?

The following points highlight important federal tax developments that occurred during June 2021. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 6 (at the item number indicated).

Amending legislation

An amending Bill (the Treasury Laws Amendment (2021 Measures No. 4) Bill 2021) that was introduced into parliament by the Assistant Treasurer on 26 May 2021 contains amendments to give effect to a number of previously announced measures. **See item 1.**

Receiver's retention obligation

The Commissioner has issued a final determination that explains his views in relation to a receiver's obligation to retain money under s 254 of the *Income Tax Assessment Act 1936* where the receiver is appointed as an agent of the entity in receivership and the entity has an assessed post-appointment tax liability (TD 2021/5). **See item 2.**

GST: supply of burial right

The Commissioner has issued a draft determination that considers the GST consequences where an Australian government agency supplies a burial right in respect of a public cemetery (GSTD 2021/D2). **See item 3.**

Cars and tax

The Commissioner has released details of the car threshold amounts that apply from 1 July 2021. **See item 4.**

COVID-19 and permanent establishments

The ATO has updated its guidance on whether the presence of employees in Australia, due to the impacts of COVID-19, may create a permanent establishment. **See item 5.**

FBT: car parking benefits

The Federal Court (Griffiths J) has upheld appeals by two airlines (collectively, Virgin) against FBT assessments in relation to car parking facilities provided by Virgin to flight and cabin crew employees located near airport terminals in Sydney, Brisbane and Perth (*Virgin Australia Airlines Pty Ltd v FCT* [2021] FCA 523). **See item 6.**

Allowable deductions: "prepaid rent"

The Full Federal Court (McKerracher, Thawley and Stewart JJ) has unanimously dismissed an appeal from a decision of Jagot J in which her Honour held that payments identified as "prepaid rent", and which were paid when entering into lease and licence arrangements in relation to the operation of a number of McDonald's restaurants, were outgoings of capital or of a capital nature and, so, were not deductible as general deductions (*Mussalli v FCT* [2021] FCAFC 71).

The taxpayers are applying to the High Court for special leave to appeal against this decision of the Full Federal Court in this case. **See item 7.**

Subdivision and sale of land

The AAT has rejected a taxpayer's contention that she was not assessable on her share of a profit made from the subdivision and sale of certain land (*McCarthy and FCT* [2021] AATA 1511). **See item 8.**

CGT and non-resident beneficiaries

The Full Federal Court has affirmed two first instance decisions which had upheld assessments made on distributions by resident discretionary trusts to non-resident beneficiaries out of capital gains. The decision of the Full Federal Court in *Peter Greensill Family Co Pty Ltd (trustee) v FCT* [2021] FCAFC 99 is discussed in the Tax Tips column of this issue of the journal (see page 11).

President's Report

by Peter Godber, CTA

Things to fix in the tax system

President Peter Godber talks about a range of things that we hope to improve in our tax system over the short and long term.

Time has passed now since the Federal Budget was handed down and we completed our analysis of what was announced and what was left for another day. Significant tax reform has been left for another day, but the debate about reform has to continue.

We will soon welcome the release of The Tax Institute's comprehensive work entitled the *Case for Change*. This is a holistic and sweeping contemporary analysis of tax reform opportunities for Australia, and I'd guess it is currently one of the most significant of its nature.

It represents the culmination of a year's work involving hundreds of people and my thanks go to the many volunteers and participants who gave their time to contribute to the work.

We need a tax system that is equitable, efficient and simple. This underpins long-term economic growth and our future. Change for a better system for all is a worthy purpose and one for which we can advocate on behalf of a very wide and interested audience.

The *Case for Change* is a basis for further discussion, identifying some of the more important areas of reform of the tax system that should be considered. We have been through a process of debating and filtering many ideas that lead to options for change.

We look forward to the next stage of the ongoing debate that we hope will ultimately lead to significant tax reform to power our economy on to support a greater society.

Even more immediate for me are the matters up for consultation at present in forums in which The Tax Institute is represented.

I recently participated in the second National Tax Liaison Group meeting for 2021. Key messages from these meetings are ultimately made available on the ATO website. It is fair to say that forums such as these continue to give us and the larger professional bodies an opportunity to voice concerns and engage with the ATO and Treasury on high-level matters.

On the international stage, you will have heard of the resolutions of the G7 and the continuing noise about fair corporate tax rates. The ongoing work relating to OECD Pillar One and Two reforms and multi-jurisdiction negotiations is rightly a high tax policy priority for Australia at present.

Closer to home and the practices of many members is the ATO approaches to compliance enforcement and reviews. The larger private taxpayer groups are now in, or about to be in, the process of review under the Top 500 and Next 5,000 campaigns. There will be periods of learning about the understanding and expectation of taxpayers involved in these programs. Ultimately, these programs are intended to build trust in the administration of the system and enforce good taxpayer behaviours. We are interested in any feedback from members on their experiences with these reviews, so please reach out to our Tax Policy and Advocacy team if you have any observations.

We are also conscious of the continuing uncertainties that arise with the list of announced but not yet enacted tax measures under the wing of Treasury. Treasury has plenty of priorities, but we continue to raise the delays as a matter of concern.

We all want more certainty, and that also extends to improving all administrative and interpretative guidance. Through the work of other consultation we have with the ATO, we know that the timing and effect of all ATO guidance products is being positively addressed on an ongoing basis for the benefit of taxpayers and advisers. We really need that.

Finally, thanks again to all of our volunteer members in each state. At the moment, the state councils and national technical committees of The Tax Institute are actively working with our internal management on ensuring that the activities of our councils and the various committees are always invigorated and kept valuable.

We are more and more aligned in our operations across the country, but the local engagement and input from our volunteers is most important. That engagement is what continues to keep The Tax Institute vibrant. The many local CPD events of late have been testament to the value our members place on local interaction. We look forward to more of that in the remainder of 2021.

I hope by now that you have had a happy financial new year and all the best for 2021-22.

CEO's Report

by Giles Hurst

Growing together through change

The Institute is propelling tax reform discussions forward with you and for you.

As we begin a new financial year, I have been reflecting on change. In many cases, change is an experience dramatically defined by your attitude towards it. Is it something unnerving and scary? Or is it something bursting with potential? And perhaps, more importantly, is it something that happens *to* you, while you hang on for the ride, or do you *make* it happen?

We're not always in control of when or how or why things begin to change. But we are in control of how we react. And when we react to a catalyst with positivity and vision, we make the choice to lean into change and grow through it.

The Tax Institute and its members make change happen. We are actively taking positive steps forward for our profession through the strength of our advocacy efforts and the Tax Policy and Advocacy team behind them.

We are able to do that thanks to the support and contributions of our members. Our recent renewals period has been a rousing success and I am thrilled to have you all on board for the next year of learning, shared challenges and successes. There is much to look forward to.

Putting tax reform on the agenda

This month, we will launch our ground-breaking paper, the *Case for Change*. Look for it in your inbox and take the time to consider the arguments presented. You may not agree with all of them — that's fine. We welcome feedback, debate and differing opinions.

The *Case for Change* is just what it says it is — a case for why and how true reform to the tax system should happen. It is a monumental step forward for our profession in that this is tax policy designed in wide consultation with our membership, who, as you know, run the gamut of tax and tax-adjacent professionals. It presents options for reform that we believe represent significant forward progress for our tax system, and which would make a clear impact on your daily life and on the wider economy.

I can't stress enough how proud we are to bring this report to life. Beyond that achievement, this is just the beginning of the conversation, and we are committed to seeing it through to the end, advocating for conversation to become action.

That kind of meaningful reform doesn't happen overnight, and it doesn't happen by accident. My congratulations to Andrew Mills, our Director, Tax Policy and Technical, who has been the driving force behind this initiative since day one. I think I speak for The Tax Institute when I say my congratulations and sincere thanks also go out to the many talented and dedicated contributors who came together to make this report possible. This is a success that we all share in.

Tax Adviser of the Year Awards and The Tax Summit 2021

Not all change is so overwhelmingly positive. The upheaval of 2020 brought about many shifts that the world was unprepared for. Our profession buckled down, got on with it, and accepted its integral role in helping Australian businesses to navigate a new and emerging world of tax measures.

After all that, The Tax Institute is looking forward to recognising outstanding contributions from tax practitioners who showed resilience and determination in the face of these huge challenges at our 2021 Tax Adviser of the Year Awards. We plan to celebrate those who not only dealt with unexpected change, but who also overcame and thrived during it.

Nominations are currently open for the awards. Please give some thought to who among your peers deserves recognition for their efforts in the last 12 months. Recognising and celebrating each other is one of the very best parts of being a member of a community like ours. I'd also heartily encourage you to self-nominate. After all, who knows your contributions and efforts better than you?

I'm sure you will all be excited to hear that The Tax Adviser of the Year Awards will be announced during an event with a scope and energy like no other: The Tax Summit 2021. More information on that is to come, but suffice to say, the program this year is very exciting, and I think we will all be looking forward to connecting for another event of this significance. I know I am.

These are just a few of the exciting things on The Tax Institute's 2021 calendar. If you haven't renewed your membership, I urge you to get in touch with our team today, so you can join us for an exciting year ahead and be part of making change happen.

THE TAX INSTITUTE

Tax Adviser of the Year Awards 2021

Australia's most prestigious tax awards return!

Chartered Tax Adviser

Tax leaders with outstanding expertise, vision and innovation

Emerging Tax Star

Emerging tax leaders building a successful career in tax

Introducing the RESPECT Awards for 2021:

RESPECT SME

SME tax advisers who have gone above and beyond during COVID-19

RESPECT Corporate

Corporate tax advisers who have gone above and beyond during COVID-19

21 October 2021
MCEC, Melbourne

Nominate Now
taxsummit.com.au/awards

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Tax Counsel's Report

by Angie Ananda, FTI

ATO client verification requirements

Client verification requirements need to be balanced with the compliance burden that the requirements will impose on tax professionals.

The Tax Institute recently prepared a submission to the ATO in relation to the *Consultation paper — Transition to strengthening client verification* (consultation paper). The consultation paper sets out the ATO's proposed guidelines for client verification within tax and superannuation practices.

We understand the importance of client verification and the need to apply a minimum standard across the tax profession. However, this needs to be balanced with the compliance burden that the verification requirements outlined in the consultation paper will impose on tax professionals.

In our submission, we made the point that, prior to any measures outlined in the consultation paper becoming compulsory, proper consideration should be given to the type of instrument that would be appropriate to implement the requirements. Further, consultation should be undertaken in relation to the implications associated with not satisfying the verification requirements.

TPB requirements

The consultation paper was released concurrently with the Tax Practitioners Board exposure draft practice note TPB(PN) D45/2021 (practice note). The practice note provides practical guidance to registered tax practitioners (ie registered tax agents, BAS agents and tax financial advisers) in relation to proof of identity requirements for client verification. The approach outlined in the consultation paper is intended to apply to a broader sector of tax practitioners, beyond those who are regulated under the *Tax Agent Services Act 2009* (Cth).

The requirements in the practice note have been set out in a clear and concise manner and are easier to follow than the requirements set out in the consultation paper. The Tax Institute's position, as outlined in our submission, is that the ATO should adopt a similar and consistent approach to that set out in the practice note, both in terms of content and style.

Impact of client verification requirements

The Tax Institute has a broad membership base, with tax professionals working across a variety of firms and practices which differ in structure, size and location. Based on feedback and information gathered from our members, we understand that some tax professionals already conduct verification procedures similar to the verification procedures required under the consultation paper. However, for other tax professionals, who do not have such verification policies and procedures in place, the verification requirements in the consultation paper will place a new burden on their practices and firms. Therefore, the impact of the client verification procedures in the consultation paper will vary greatly.

As outlined in our submission, at a minimum, all tax professionals will need to review and update their practices' compliance policies, procedures and professional engagement documentation to ensure that their policies and procedures satisfy the ATO client verification requirements. Although these requirements are voluntary for now, the consultation paper notes that the requirements will become compulsory in the future.

For many tax professionals, this will require extra time and expenses to establish policies and procedures to satisfy the verification requirements. Further, there are likely to be ongoing expenses incurred to satisfy the requirements for each new client. Tax professionals will need to explain the requirements to clients, follow up new clients for the relevant verification documents, and record the sighting of documents. It is likely that tax professionals will be required to address privacy concerns raised by new clients and deal with information inconsistencies in client documentation (eg change of address). All of this will place a significant burden on tax professionals.

Further, the verification procedures may impact tax professionals' ability to conduct business remotely, unless further clarification is provided in the consultation paper. Physical meetings may not be practical or allowed. The consultation paper should expressly state whether a client showing a tax professional their driver's licence or passport through electronic video conferencing technology (eg Zoom, Microsoft Teams etc) would be sufficient.

As outlined in our submission, tax professionals may be adversely impacted as a result of the types of documents that the ATO is requiring for verification purposes in the consultation paper. In this regard, we again note that the approach taken in the practice note is clear and easily understood. In our submission, we recommended that the ATO outline the types of documentation that may be accepted for verification purposes in a manner consistent with the practice note.

What next?

The Tax Institute will closely follow the outcome of the ATO consultation process. Hopefully, the ATO will amend the consultation paper as suggested so that it is consistent with the practice note.

Tax News – the details

by TaxCounsel Pty Ltd

June – what happened in tax?

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

Government initiatives

1. Amending legislation

An amending Bill (the Treasury Laws Amendment (2021 Measures No. 4) Bill 2021) that was introduced into parliament by the Assistant Treasurer on 26 May 2021 and passed by the House on 17 June 2021 contains amendments to give effect to a number of previously announced measures which were the subject of exposure draft legislation noted in last month's Tax News column.

The measures that are of particular interest are noted below.

FBT: retraining and reskilling

Amendments that are being made to the *Fringe Benefits Tax Assessment Act 1986* (Cth) will mean that employers will be exempt from FBT if they provide training or education to a redundant, or soon to be redundant, employee for the purpose of assisting that employee to gain new employment.

These amendments are to apply to benefits provided on or after 2 October 2020.

CGT: granny flat arrangements

The CGT provisions in the *Income Tax Assessment Act 1997* (Cth) (ITAA97) are being amended to provide a targeted CGT exemption for CGT events that occur on entering into, varying or terminating formal written arrangements under which an older person or person with a disability acquires, varies or disposes of a granny flat interest.

The amendments will ensure that CGT consequences are not an impediment to formalising granny flat arrangements and seek to reduce the risk of financial abuse and exploitation of older Australians and other vulnerable people.

These amendments are to commence on the first 1 July after the Bill receives royal assent and will apply in relation to events that happen on or after the amendments commence that would, apart from the provisions contained in the amendments, be CGT events.

Low and Middle Income tax offset

The *Treasury Laws Amendment (A Tax Plan for the COVID-19 Economic Recovery) Act 2020* is being amended to make the Low and Middle Income tax offset available in the 2021-22 income year, with the offset now ceasing to be available in the 2022-23 and later income years.

The Commissioner's perspective

2. Receiver's retention obligation

The Commissioner has issued a final determination that explains his views in relation to a receiver's obligation to retain money under s 254 of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) where the receiver is appointed as an agent of the entity in receivership and the entity has an assessed post-appointment tax liability (TD 2021/5).

The determination explains that, at times, income, profits or gains of a capital nature are derived by an entity through the actions of a receiver acting as the entity's agent. When this happens, the receiver must retain enough money to pay the tax that has been assessed on the income, profits or gains. This obligation to retain only applies to money that has come to the receiver in their capacity as agent for the entity.

Once an assessment has been made, the obligation to retain remains ongoing. The money does not have to come to the receiver in a lump sum. The amount that the receiver must retain does not exceed the amount of the liability that the Commissioner can legally recover from the entity.

The following is an example given in TD 2021/5.

Example

Kathleen's Kites Pty Ltd (Kathleen's Kites) purchased a capital asset in 2008. In 2017, Big Bank Co (a secured creditor of Kathleen's Kites) appoints Dipika as receiver under a deed of appointment. The deed specifies Dipika as agent for Kathleen's Kites.

During the receivership, Dipika disposes of the capital asset and discharges Big Bank Co's secured debt from the sale proceeds. As a result of the disposal, Kathleen's Kites, not Dipika, makes a capital gain. Kathleen's Kites' income tax liability relates to the whole of the capital gain. Kathleen's Kites has, through Dipika's agency, derived a gain of a capital nature. This gain satisfies the requirements in s 254(1)(a) ITAA36. Therefore, any tax assessed on that gain enlivens the retention obligation (in s 254(1)(d) ITAA36).

Kathleen's Kites includes the capital gain in its income tax return and the tax payable on the gain is assessed to Kathleen's Kites. As agent, Dipika must retain from any moneys that come to her as receiver, including the sale proceeds that remain after having repaid Big Bank Co's secured debts, enough money to pay the tax assessed. The amount that Dipika must retain is limited to the amount of the assessed tax that the Commissioner can legally recover from Kathleen's Kites. The Commissioner does not have a legally enforceable right to be paid the tax amount ahead of Big Bank Co and can only recover the assessed tax from any funds left after paying the secured creditor.

Although Dipika is personally liable for the tax assessed on the capital gain, that liability is limited to the amount that she has retained, or should have retained, under s 254(1)(d). She is not otherwise personally liable for the assessed tax. If the tax remains unpaid, the Commissioner may recover the debt from Dipika, to the extent of her personal liability.

Example (cont)

Dipika pays the amount of tax that the Commissioner is legally entitled to using the retained funds because s 254(1)(a) makes her answerable as taxpayer for all things required to be done by the ITAA36 in respect of the capital gain, including the payment of tax.

TD 2021/5 is not relevant to court-appointed receivers.

3. GST: supply of burial right

The Commissioner has issued a draft determination that considers the GST consequences where an Australian government agency supplies a burial right in respect of a public cemetery (GSTD 2021/D2).

The draft determination states that the supply of a burial right in respect of a public cemetery is not subject to GST. To be subject to GST, a supply must be made for consideration. Division 81 of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GSTA99) and the Regulations exclude certain fees and charges from being consideration. One such exclusion is a fee or charge that relates to (or relates to an application for) the provision, retention, or amendment, under an Australian law, of a permission, exemption, authority or licence (however described). Another exclusion is a fee or charge for a supply of a regulatory nature made by an Australian government agency.

The operators of public cemeteries are Australian government agencies and the supply of a burial right in a public cemetery is regulatory in nature. The fee charged also relates to the provision, under an Australian law, of a permission, exemption, authority or licence. Accordingly, a fee paid for the supply of a burial right in a public cemetery is not consideration and the supply is therefore not subject to GST.

A fee paid for the renewal of a burial right in respect of a public cemetery is also excluded from consideration for the same reasons and therefore no GST applies to the renewal of the burial right.

The supply of other goods or services, such as grave digging, stonemasonry and plaques, will be subject to GST.

Apportionment may be necessary if an undissected amount is charged for a burial right and taxable goods and services.

Where a funeral director arranges for the supply of a burial right in a public cemetery, they are acting as agent for the estate of the deceased and the supply of the burial right is being made by the operator of the public cemetery to the estate. This supply is not subject to GST. It will be necessary for the funeral director to identify that part of the invoiced amount that corresponds to the fee charged by the operator of the public cemetery for the burial right and ensure that GST is not calculated on that component.

4. Cars and tax

The Commissioner has released details of the car threshold amounts that apply from 1 July 2021.

Car limit

For the purposes of working out the depreciation for the business use of a car or station wagon (including four-wheel drives), the upper limit on the cost that applies in relation to the income year that the vehicle is first used or leased is $60,733 in 2021-22.

GST

Generally, if a car is purchased and the price is more than the car limit, the maximum amount of GST input tax credit that can be claimed is one-eleventh of the car limit amount. That means that the maximum input tax credit for 2020-21 is $5,521.

A GST input tax credit cannot be claimed for any luxury car tax that is paid when a luxury car is purchased, regardless of how much the car is used in carrying on a business.

Luxury car tax

From 1 July 2021, the luxury car tax (LCT) threshold increases to $69,152.

The LCT threshold for fuel-efficient cars is to increase to $79,659 for the 2021-22 financial year.

It should be noted that the LCT value of a car generally includes the value of any parts, accessories or attachments supplied or imported at the same time as the car.

5. COVID-19 and permanent establishments

The ATO has updated its guidance on whether the presence of employees in Australia, due to the impacts of COVID-19, may create a permanent establishment.

COVID-19 has resulted in overseas travel restrictions. Foreign companies may be concerned about potential effects on their business and tax affairs because of the presence of employees in Australia.

The updated guidance states that the ATO will not apply compliance resources to determine whether a foreign company has a permanent establishment in Australia if:

- the company did not otherwise have a permanent establishment in Australia before the effects of COVID-19;
- the temporary presence of employees in Australia continues to solely be as a result of COVID-19 related travel restrictions;
- those employees temporarily in Australia will relocate overseas as soon as practicable following the relaxation of international travel restrictions; and
- the company has not recognised those employees as creating a permanent establishment or generating Australian source income in Australia for the purposes of the tax laws of another jurisdiction.

This approach is applicable until 31 December 2021. From that date, a foreign company will be required to consider whether ongoing arrangements give rise to a permanent establishment in Australia.

Recent case decisions

6. FBT: car parking benefits

The Federal Court (Griffiths J) has upheld appeals by two airlines (collectively, Virgin) against FBT assessments in relation to car parking facilities provided by Virgin to flight and cabin crew employees located near airport terminals in Sydney, Brisbane and Perth (*Virgin Australia Airlines Pty Ltd v FCT*[1]).

During the relevant years, Virgin operated passenger airline services in Australia. In order to operate commercial flights, flight and cabin crew were required on board each aircraft.

During the relevant years, Virgin carried on its business at multiple premises, including the airport terminals at Sydney, Brisbane and Perth from which the aircraft on which it transported its passengers arrived and departed. At the airport terminals, Virgin's ground operations included passenger check-in and other guest services, operation of the Virgin lounges, baggage handling, and aircraft re-fuelling. On the aircraft, flight crew operated the aircraft and cabin crew provided food and beverage service, other general customer service, safety and emergency procedural checks, and first aid as required on board the aircraft.

Virgin entered into contracts with the commercial car park operators of the car parks at Sydney, Brisbane and Perth airports to provide Virgin with car parking spaces. Virgin provided those car parking facilities to its flight and cabin crew by giving them access cards to the car park at the airport nearest to the location where the crew members lived.

During their rostered shifts, the flight and cabin crew performed their duties at both airport terminals and on the aircraft. In the Commissioner's reasons for disallowing the objections to each of the relevant assessments, the Commissioner stated that it was understood that "the crew members spend most of their time on the aircraft and are rostered for various routes and differing time schedules".

As Virgin contracted directly with the operators of the relevant car parking facilities where their employees (that is, the flight and cabin crew) parked their cars, it was not an "expense payment benefit" pursuant to s 20 of the *Fringe Benefits Tax Assessment Act 1986* (Cth) (FBTAA86) and thus not an "eligible car parking expense payment benefit". Virgin's provision of car parking facilities to its employees would therefore be exempt unless s 39A FBTAA86 (in Div 10A) applied.

In the circumstances, the issues that arose under s 39A were whether the employee had a "primary place of employment" and, if so, whether the employee's car was parked "at, or in the vicinity of, that primary place of employment". The statutory definition of "primary place of employment" turned on the concept of "business premises" which was defined to include "a ship, vessel, floating structure, aircraft or train".

Griffiths J accepted Virgin's contention that the duties performed by flight and cabin crew at terminals were appropriately described as ancillary to the principal duties which were performed on board the aircraft. In a quantitative sense, the duties were of a short duration and did not exceed one hour in the case of a single sector shift of 13 hours. The duties performed by both flight and cabin crew at terminals, such as attending pre-flight briefings, were, of course, important in a qualitative sense, but the evidence established that they were necessarily ancillary to the duties performed on board the aircraft. Where more than one aircraft was involved on a particular day, there was no primary place of employment.

7. Allowable deductions: "prepaid rent"

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

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

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

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

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

The trustee of the MFT claimed deductions in respect of the upfront amounts under the general deduction provision (s 8-1 ITAA97), but with the deductions spread over 10 years (s 82KZMD ITAA36). The Commissioner disallowed the deductions on the basis that the amounts were capital or of a capital nature.

At first instance, Jagot J accepted the Commissioner's primary case that the upfront payments were made to secure the rights to operate the businesses on better terms as to rent for the term of the FLLs and most likely longer. Her Honour also accepted the Commissioner's contention that, in the case of each restaurant, the upfront payments secured the acquisition of a more profitable business structure by securing an enduring reduction in ongoing costs.

On appeal, the taxpayers' case was, in effect, that an upfront payment was a payment which had some effect on a future outgoing, or at least a potential future outgoing. Those future outgoings, if paid on a recurrent basis, would have been revenue; hence the payment that substituted for them was also revenue.

In a joint judgment, McKerracher and Stewart JJ said that there was no principle that a payment that substitutes for future revenue outgoings or which compensates for them, or which more accurately in this case obviates or removes the need for them, must itself be revenue.

Also, significantly, if the term of the lease was irrelevant to the method of calculation of the payment, any argument that the payment was in truth (as distinct from its description) a computation of prepayment of rent was extremely difficult to mount.

Both experts who gave evidence at the first instance hearing confirmed that MAL valued stores at about five to five-and-a-half times yearly earnings, such that, for example, the value of one of the stores was approximately $940,000 as a going concern. $465,000 was attributed to the value of the equipment and it followed that $475,000, simply being the difference between the business value and its equipment, was the figure described as prepaid rent. Having calculated in this way the figure of $475,000, MAL then converted it by assessing that the equivalent of $475,000 would, if described as a rent prepayment, be in effect an increase in rent to 13.93%, and then, in this instance, offered to reduce the rent back to 9.4% if the $475,000 was paid. The Commissioner contended that this payment was to obtain a more profitable business structure.

In their Honours' view, this contention was correct for the reason that the trustee, to take the example referred to, was offered an existing profitable business which the trustee could take over, and the trustee could either take it over at the 13.93% rent level or the 9.4 % rent level, but by paying $475,000 as a "once and for all" payment, they received the benefit of what was in reality a better version of the lease or a more profitable lease. Clearly, the FLL was a capital asset of the business. In fact, it was by far the most important capital asset. By the time the FLL was executed, there was no consideration of the higher rent. The taxpayer had, in effect, purchased the right to have the better lease with the lower rent.

Thawley J, in a separate judgment, held that the upfront payments in the present case were made to acquire a business and its associated structure and were therefore not allowable as general deductions.

8. Subdivision and sale of land

The AAT has rejected a taxpayer's contention that she was not assessable on her share of a profit made from the subdivision and sale of certain land (*McCarthy and FCT*[3]).

On 27 August 2016, the taxpayer and her husband purchased a residential property in Mullaloo, Western Australia (the property), at auction for $675,000 plus stamp duty and associated costs. Settlement of the purchase of the property occurred on 31 October 2016.

On or about 10 November 2016, the taxpayer and her husband lodged an application for approval of a plan for the subdivision of the property into two lots. The plan of the subdivision submitted for approval was dated 21 October 2016.

At the time that the taxpayer and her husband purchased the property, there was a long-term tenant in residence. The tenant vacated the property in May 2017 and the house was demolished in July 2017.

The two lots resulting from the subdivision of the property were sold under contracts of sale dated 3 August 2017 (lot 11), for a sale price of $480,000, and 2 January 2018 (lot 10), for a sale price of $490,000.

On 27 March 2019, in response to an application by the taxpayer for a private ruling, the Commissioner issued a ruling to the effect that the profit she had made from the sale of the lots resulting from the subdivision of the property was assessable income under s 6-5 ITAA97 on the basis that there was an isolated transaction carried out for profit and commercial in nature.

On 13 May 2019, the taxpayer filed an income tax return for the financial year ended 30 June 2018 which included, among other income, $57,109 in profit derived from the transaction. On 20 May 2020, the Commissioner issued an assessment to the taxpayer on the basis of the information contained in the 2018 return and the taxpayer objected.

In dismissing the taxpayer's application for the review of the Commissioner's objection decision, the AAT said that the circumstances in the present case were similar to those considered by Davies J in *McCurry v FCT*.[4] The only potentially material difference was the finding in the *McCurry* case that the predominant objective of the transaction was the making of a profit through the purchase, development and sale of the units over the possible generation of income through renting the units. The AAT said that, while in that case Davies J stated that he was not satisfied that profit by development and sale of the units was not "the predominating objective", that comment could not be taken to be a rule that there had to be a singular or clear, overriding intention at the time of purchase of the property. Other cases had made it clear that that is not the case.

Curiously, no details were given in the AAT's decision as to what the length of the existing tenancy of the property was when the taxpayer and her husband purchased it, nor of the circumstances in which the tenancy ceased. Also, the taxpayer's husband was not called to give evidence and the reason for this does not appear to have been explained.

Subject to any appeal from the decision of the AAT in this case, the findings of the AAT would also mean that the taxpayer and her husband would be carrying on an enterprise (an adventure in the nature of trade) for the purposes of GST and, so, GST issues would potentially arise.

TaxCounsel Pty Ltd
ACN 117 651 420

References

1 [2021] FCA 523.

2 [2021] FCAFC 71.

3 [2021] AATA 1511.

4 [1998] FCA 512.

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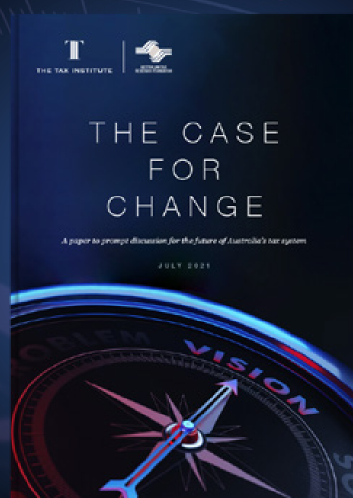

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Tax Tips

by TaxCounsel Pty Ltd

Discretionary trusts: CGT and non-resident beneficiaries

The Full Federal Court has affirmed two decisions which had upheld assessments made on distributions by resident discretionary trusts to non-resident beneficiaries out of capital gains.

Background

In a joint judgment handed down on 10 June 2021, the Full Federal Court (Davies, Moshinsky and Colvin JJ) has affirmed the view that the fact that a presently entitled beneficiary of a resident discretionary trust was a foreign resident immediately before a CGT event happened in relation to CGT assets of the trust that were not taxable Australian property, meant that the foreign resident capital gain disregarding provision in s 855-10(1) of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) was not called into play. The decision of the Full Court upheld two decisions of the Federal Court at first instance.

The decision of the Full Court is *Peter Greensill Family Co Pty Ltd (trustee) v FCT*,[1] and the first instance decisions are the decision of Thawley J in *Peter Greensill Family Co Pty Ltd (trustee) v FCT*[2] and of Steward J in *N & M Martin Holdings Pty Ltd v FCT*.[3]

The facts in essence

The basic factual scenario giving rise to the issues for determination were common to both appeals. Briefly stated, they were as follows:

- the discretionary trusts were the Peter Greensill Family Trust (the PGFT) and the Martin Family Trust (Martin Trust);
- the trustee of each trust was resident in Australia and, so, the trusts were resident;
- both trustees, in that capacity, sold shares that were not "taxable Australian property" for the purposes of Div 855 ITAA97;
- in each case, the trustee distributed the capital gain from the disposal of the non-taxable Australian property to a foreign resident beneficiary of the trust;
- in each case, the Commissioner assessed the trustee under s 98 of the *Income Tax Assessment Act 1936* (Cth) (ITAA36), on the basis that s 855-10(1) ITAA97 Act did not apply to disregard the capital gain when calculating the amount assessable to the trustee in relation to the beneficiary pursuant to s 115-220 ITAA97; and
- in the case of the Martin Trust, the Commissioner also assessed the foreign resident beneficiary on the basis that s 855-10(1) ITAA97 did not apply to disregard the capital gain when calculating the amount treated as the beneficiary's capital gain under s 115-215(3) ITAA97.

The Greensill facts in detail

In more detail, the facts in the *Greensill* case were as follows. The PGFT was a discretionary trust that was established by deed dated 21 January 2010 (the trust deed). The trustee was Peter Greensill Family Co Pty Ltd (PGFC), a company that was incorporated in Queensland on 7 January 2010.

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

From what is stated in the judgment at first instance, the relevant terms of the trust deed followed what would be expected in a typical discretionary trust deed.

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

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

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

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

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

- the net income of the trust for the year ended 30 June 2015 was to be the net income as determined under s 95

ITAA36, excluding franking credits and any capital gains; and

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

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

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

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

The Commissioner's assessments

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

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

The N & M Holdings case

The facts of the *N & M Holdings* case were for present purposes similar to those of the *Greensill* case and raised the same issues. Steward J said, however, that the taxpayers had a problem because their legal argument had already been considered and rejected by Thawley J in the *Greensill* case. His Honour said that he was not satisfied that the *Greensill* case was wrongly decided and that it was his duty to follow it.

The legislation

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

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

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

It is also relevant to refer to s 855-40(1) ITAA97 which provides:

> "(1) The purpose of this section is to provide comparable taxation treatment as between direct ownership, and indirect ownership through a fixed trust, by foreign residents of CGT assets that are not taxable Australian property."

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

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

> "**115–215 Assessing presently entitled beneficiaries**
>
> Purpose
>
> (1) The purpose of this section is to ensure that appropriate amounts of the trust estate's net income attributable to the trust estate's capital gains are treated as a beneficiary's capital gains when assessing the beneficiary, so:
>
> (a) the beneficiary can apply capital losses against gains; and
>
> (b) the beneficiary can apply the appropriate discount percentage (if any) to gains.
>
> Extra capital gains
>
> (3) If you are a beneficiary of the trust estate, for each capital gain of the trust estate, Division 102 applies to you as if you had:
>
> (a) if the capital gain was not reduced under either step 3 of the method statement in subsection 102-5(1) (discount capital gains) or Subdivision 152-C (small business 50% reduction) — a capital gain equal to the amount mentioned in subsection 115-225(1); and
>
> (b) if the capital gain was reduced under either step 3 of the method statement or Subdivision 152-C but not both (even if it was further reduced by the other small business concessions) — a capital gain equal to twice the amount mentioned in subsection 115-225(1); and
>
> (c) if the capital gain was reduced under both step 3 of the method statement and Subdivision 152-C (even if it was further reduced by the other small business concessions) — a capital gain equal to 4 times the amount mentioned in subsection 115-225(1).
>
> Note: This subsection does not affect the amount (if any) included in your assessable income under Division 6 of Part III of the *Income Tax Assessment Act 1936* because of the capital gain of the trust estate. However, Division 6E of that Part may have the effect of reducing the amount included in your assessable income under Division 6 of that

Part by an amount related to the capital gain you have under this subsection.

(4) For each capital gain of yours mentioned in paragraph (3)(b) or (c):

(a) if the relevant trust gain was reduced under step 3 of the method statement in subsection 102-5(1) — Division 102 also applies to you as if your capital gain were a discount capital gain, if you are the kind of entity that can have a discount capital gain; and

(b) if the relevant trust gain was reduced under Subdivision 152-C — the capital gain remaining after you apply step 3 of the method statement is reduced by 50%.

Note: This ensures that your share of the trust estate's net capital gain is taxed as if it were a capital gain you made (assuming you made the same choices about cost bases including indexation as the trustee).

(4A) To avoid doubt, subsection (3) treats you as having a capital gain for the purposes of Division 102, despite section 102-20.

Section 118–20 does not reduce extra capital gains

(5) To avoid doubt, section 118-20 does not reduce a capital gain that subsection (3) treats you as having for the purpose of applying Division 102."

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

(1) This section applies if:

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

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

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

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

(b) …

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

"**115–225 Attributable gain**

(1) The amount is the product of:

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

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

"**115–227 Share of a capital gain**

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

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

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

The first instance decisions

In very brief terms, the appellants, in each of the proceedings at first instance, had contended that the assessments were excessive because s 855-10(1) ITAA97 required the gains of the trust estates, from the disposal of non-taxable Australian property which the trustees distributed to the foreign beneficiaries, to be disregarded. In each case, this contention was rejected, both as a matter of construction of s 855-10(1) ITAA97 and also of Subdiv 115-C ITAA97.

The Full Court decision

On the appeals, the Full Federal Court held that Thawley and Steward JJ at first instance were correct to hold that s 855-10(1) ITAA97 had no application to the facts of either case. The provision did not apply to the trustees of the respective trusts because both trusts were resident trusts. Further, s 855-10(1) did not apply to the foreign beneficiaries to disregard any capital gain in the calculation of the amount under s 115-215(3) ITAA97 treated as the beneficiary's capital gain for the purposes of the application of Div 102 ITAA97 to the beneficiary. This was because "the amount mentioned in s 115-225 in relation to the beneficiary" for the purposes of ss 115-215(3) and 115-220 ITAA97 was not a "capital gain … from a CGT event" within the meaning of s 855-10 ITAA97.

The Full Court considered a number of submissions in some detail and the Full Court's reasons included the following in relation to s 855-10 ITAA97:[4]

> "… s 855-10 identifies the capital gain to be disregarded as one that is 'from a CGT event'. The appellants argued that Thawley J wrongly held that the use of the word 'from' requires a direct connection between the capital gain and the relevant CGT event and that s 855-10 merely requires that the CGT event 'happens' in relation to a CGT asset that is not taxable Australian property. That submission, however, ignores that the expression 'CGT event' is defined in s 995-1 to mean any of the CGT events described in div 104. Hence, the threshold question for s 855-10 to operate is whether the relevant capital gain is from a CGT event described in div 104, which is the criterion that founds the application of the section in relation to a foreign beneficiary or the trustee of a foreign trust. The capital gain treated as the beneficiary's capital gain by s 115-215(3) is not, however, a capital gain from a CGT event described in div 104, but a capital gain that the beneficiary is deemed to have made by operation of s 115-215(3). Hence, s 855-10 does not apply on its terms either in the context of sub-div 115-C or in relation to a beneficiary after the capital gain of the trust estate has been attributed to the foreign beneficiary by the application of sub-div 115-C."

A statutory construction point

One contention of the appellants was that the construction of s 855-10 ITAA97 accepted in the judgments appealed from (that is, that that section only applies to capital gains from CGT events happening to assets of the foreign beneficiary or foreign trustee) had anomalous and capricious results.

The Full Court stated that, although anomalous or capricious consequences may be an indication that parliament did not intend the provision to be read in that way, the identification of possible anomalies or capricious consequences does not mean that the provision should be construed differently. Their Honours referred to the following passage from the judgment of Black CJ and Sundberg J in *Esso Australia Resources Ltd v FCT*:[5]

> "Especially when different views can be held about whether the consequence is anomalous on the one hand or acceptable or understandable on the other, the Court should be particularly careful that arguments based on anomaly or incongruity are not allowed to obscure the real intention, and choice, of the Parliament."

The Full Federal Court went on to say that, as Campbell J cautioned in *Ganter v Whalland*,[6] a court is not justified in using an anomaly as a reason for rejecting what otherwise seems the correct construction where, on all other tests of construction, it is the correct construction as "[w]ere courts to act otherwise, they would risk taking over the function of making policy choices which properly belongs to the legislature".

The Full Court then said that underpinning the appellants' arguments about the proper construction of Div 855 was the a priori assumption that parliament did not intend that foreign residents be taxable on gains from non-taxable Australian property. As the High Court cautioned in *Certain Lloyd's Underwriters Subscribing to Contract No. IH00AAQS v Cross*,[7] when construing legislation, the purpose of legislation must be derived from what the legislation says, not from any assumption about the desired or desirable reach or operation of the provisions. Nothing in the express statement of objects of Div 855 in s 855-5 or in the extrinsic material warranted a construction by reference to that a priori assumption, to the disregard of the text of ss 855-10 and 855-40 ITAA97. To the contrary, the contrast between ss 855-10 and 855-40 ITAA97 demonstrated that parliament specifically directed its attention to when, and in what circumstances, a foreign beneficiary is entitled to an exemption under Div 855 ITAA97. Section 855-40(1) ITAA97 made this clear in the identification of the legislative purpose or the exemption in relation to interests through fixed trusts.

Observations

It should be noted that the fact that the Commissioner took the position he did in the *Greensill* and *Martin* cases is not surprising as it reflects views that he had expressed as far back as 2007 (see ATO ID 2007/60). The Commissioner's views in ATO ID 2007/60 are repeated in TD 2019/D6.

It is not known whether the taxpayers intend to seek special leave to appeal to the High Court.

TaxCounsel Pty Ltd

References

1 [2021] FCAFC 99.
2 [2020] FCA 559.
3 [2020] FCA 1186.
4 [2021] FCAFC 99 at [50].
5 [1998] FCA 1655.
6 [2001] NSWSC 1101 at [36].
7 [2012] HCA 56 at [26] and [41].

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Mid Market Focus

by Daryl Jones, CTA, HLB Mann Judd

Company tax rates and base rate entities

With global corporate tax rates in the headlines and the G7 finance ministers' announcement on taxation of tech giants, we must consider our clients' structures.

Introduction

For those like me who started in the tax profession in the 1980s, we can remember that the corporate tax rate in Australia was 49% and the dividend imputation system had started. Over many years, the various governments started the process of reducing that rate (with the complementary conversion of franking accounts) until we had the single rate of 30% in the 2015 income year.

High global corporate tax rates were accompanied by significant attempts by companies, particularly multinationals, to reduce their tax burden. As an International Monetary Fund working paper noted:[1]

> "The empirical literature (mostly using data on United States multinationals) is generally unambiguous in finding multinational firms use transfer pricing as a means to minimise their tax burden …"

Since that time, there have been other significant reforms to complement the changing global corporate tax rates. In particular, the Organisation for Economic Co-operation and Development (OECD) 2015 report, *Measuring and monitoring BEPS, action 11*, highlighted the lack of quality data on corporate taxation to the measurement and monitoring of the scale of base erosion and profit shifting. It noted that corporate tax systems are important more generally in terms of the revenue that they raise and the incentives for investment.

Interestingly, OECD statistics[2] (covering 109 jurisdictions) show the following in relation to statutory income tax rates (not the effective rate that would account for various incentives) since the year 2000:

- 13 jurisdictions had tax rates greater than or equal to 40%, while only India exceeded 40% in 2020;
- 68 jurisdictions had corporate tax rates greater than or equal to 30% in 2000 compared to 21 jurisdictions in 2020;
- most of the downward movement between 2000 and 2020 was to corporate tax rates equal to or greater than 10% and less than 30%;
- jurisdictions with tax rates equal to or greater than 20% and less than 0% jumped from 24 to 48;
- jurisdictions with tax rates equal to or greater than 10% and less than 20% more than tripled from seven to 28; and
- the average tax rate across regions has fallen, with significant differences in 2020 between Africa (27.5%), the OECD (23.2%), Asia (17.0%) and Latin America (19.4%).

Australia's corporate tax rate and base rate entity (BRE) tax rate is at the higher end for the Asia region (see Table 1).

The enterprise tax plan

The federal government's enterprise tax plan reduces the corporate income tax rate for BREs over the course of 10 years. The enterprise tax plan's stages are as follows:

- the *Treasury Laws Amendment (Enterprise Tax Plan Base Rate Entities) Act 2018* was enacted to limit access to the lower corporate tax rate of 27.5% from the 2017-18 income year to BREs in accordance with s 23(2) of the *Income Tax Rates Act 1986* (Cth) (ITR86);[3]
- the key change for a BRE to qualify for the lower corporate rate was to replace the carrying on a business test with a passive income test (and also meeting the aggregated turnover test, being $50m in the 2020 income year);
- under the passive income test, companies that are generating predominantly passive income will not be eligible for the lower corporate tax rate;
- LCR 2019/5 lists the circumstances where income will or will not be considered BRE passive income in s 23AB(2) ITR86, for example, where interest income will not qualify as passive income; and
- the key change for a BRE to qualify for the lower corporate rate was to replace the carrying on a business test with a passive income test (and also meeting the aggregated turnover test, being $50 million in the 2020 and 2021 income years).

Table 1. Australia in comparison to G7 nations and New Zealand[4]

Corporate income tax rate	Combined corporate income tax rate
Australia	30.00%
Canada	26.15%
France	28.41%
Germany	29.94%
Italy	27.81%
Japan	29.74%
New Zealand	28.00%
United Kingdom	19.00%
United States	25.75%

Base rate entity

Section 23AA ITR86 states:

"An entity is a ***base rate entity*** for a year of income if:

(a) no more than 80% of its assessable income for the year of income is base rate entity passive income; and

(b) its aggregated turnover (within the meaning of the *Income Tax Assessment Act 1997*) for the year of income, worked out as at the end of that year, is less than $50 million."

Section 23AB(1) ITR86 defines "base rate entity passive income" (BREPI):

"(1) ***Base rate entity passive income*** is assessable income that is any of the following:

(a) a distribution (within the meaning of the *Income Tax Assessment Act 1997)* by a corporate tax entity (within the meaning of that Act), other than a non-portfolio dividend (within the meaning of section 317 of the [*Income Tax Assessment Act 1936*];

(b) an amount of a franking credit (within the meaning of the *Income Tax Assessment Act 1997)* on such a distribution;

(c) a non-share dividend (within the meaning of the *Income Tax Assessment Act 1997)* by a company;

(d) interest (or a payment in the nature of interest), royalties and rent;

(e) a gain on a qualifying security (within the meaning of Division 16E of Part III of the [*Income Tax Assessment Act 1936*]);

(f) a net capital gain (within the meaning of the *Income Tax Assessment Act 1997*);

(g) an amount included in the assessable income of a partner in a partnership or of a beneficiary of a trust estate under Division 5 or 6 of Part III of the [*Income Tax Assessment Act 1936*], to the extent that the amount is referable (either directly or indirectly through one or more interposed partnerships or trust estates) to another amount that is base rate entity passive income under a preceding paragraph of this subsection."

The importance of the term "aggregated turnover"

The meaning of "aggregated turnover" is an important element in many areas of the income tax law. Its meaning is contained in s 328-115 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97). In broad terms, aggregated turnover is the sum of the following turnovers:

- your annual turnover for the income year;
- the annual turnover for the income year of any entity connected with you at any time during the income year; and
- the annual turnover for the income year of any entity that is an affiliate of yours at any time during the income year.

On 11 June 2021, the Commissioner of Taxation released for comment TD 2021/D1. It provides the Commissioner's view on the inclusion of turnovers of connected entities and affiliates (in circumstances where they may have a substituted accounting period) in the calculation of aggregated turnover, by reference to the term "an income year" in s 328-115(1).

It concludes that "your income year" is the relevant reference point to ensure that your aggregated turnover:

"– includes your annual turnover for the corresponding period

– only includes the annual turnover of entities that are connected with you, or that are your affiliates, for the period that matches your income year, and

– does not include amounts derived during that period

  – from dealings between you and entities while they are connected with you or are your affiliates;

  – from dealings between entities while they are connected with you or are your affiliates; or

  – by entities while they were not connected with you and were not an affiliate of yours."

Small business entities and BREs

While there has been a degree of uncertainty around the definitions of "small business entities" (SBEs) and BREs since the introduction of the lower company tax rate from 1 July 2015, the change from 1 July 2017 so that only BREs could qualify for the lower company tax rate alleviates the need to consider the SBE rules when determining the applicable corporate tax rate.

Section 328-110 ITAA97 broadly provides that an SBE must:

- carry on a business in the current year; and
- have an aggregated turnover that is below the $10m threshold.

The concept of when a company is carrying on a business created confusion and was finally clarified by the release TR 2019/1.

The definition of an SBE is therefore relevant for a range of tax concessions (for example, accessing the instant asset write-off) but an entity not meeting the BRE tests will be taxed at the 30% company tax rate. The definition of a BRE is only relevant as to whether the company can access the lower company tax rate. As such, there will be certain situations where a company will have 100% BREPI and still be carrying on a business. Of course, care must be taken when completing the relevant labels on the company income tax return.

Take, for example, a company within a family group which acts as the financing entity for the rest of the group entities (that is, trusts and other companies that may be owned by individuals or other family trusts), and is not eligible to consolidate. It may borrow externally and lend at a margin to group entities and, as such, derive only interest income.

When interest income is not BREPI

LCR 2019/5 and s 23AB(2) ITR86 provide that interest income will not be BREPI:

- where the entity is a financial institution (s 202A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36), ie a bank or a cooperative housing society;
- where the entity is a "registered entity" that carries on a general business of providing finance on a commercial basis;
- where the entity holds an "Australian credit licence" or is a "credit representative" of another entity that holds such an Australian credit licence;

– where the entity is a "financial services licensee" whose licence covers dealings in securities, or is an "authorised representative" of such a financial services licensee; or
– where the interest is a return on an equity interest in a company.

Section 23AB(2)(ii) ITR86 states:

> "the entity is a registered entity (within the meaning of the *Financial Sector (Collection of Data) Act 2001*) that carries on a general business of providing finance (within the meaning of that Act) on a commercial basis;"

Section 5(3) of the *Financial Sector (Collection of Data) Act 2001* (Cth) states:

> "a ***registered entity*** is a corporation whose name is entered in the Register of Entities kept by APRA …"

As noted above, LCR 2019/5 lists the circumstances in s 23AB(2) ITR86 under which interest income will not qualify as passive income.

Company tax rate and franking distributions

For the year ended 30 June 2021, the lower company tax rate of 26% will apply only to a BRE (for all other companies, the rate is 30%).

As noted above, a company will be a BRE if it satisfies both of the following:

– it has a turnover of less than $50m; and
– 80% or less of its assessable income is BREPI (such as dividends, interest, rent and net capital gains).

For the year ended 30 June 2021, the 26% company tax rate for franking distributions will apply where the company's aggregated turnover, assessable income and BREPI in the 2020 income year is less than $50m, and 80% or less of the company's assessable income is BREPI.

The lower company tax rate applying to BREs reduces to 25% from 1 July 2021 and future income years.

As highlighted by The Tax Institute's Senior Advocate, Robyn Jacobson, in *TaxVine* on 11 June 2021, the lowering of the company tax rate for BREs has created an issue of franking credits for tax paid at the 30% rate being trapped. As provided in the example, the extent of the trapped franking credits where tax was paid at the 30% rate on $100 of taxable income in 2013-14, and a $70 dividend is paid out in the 2021 and 2022 income years, is set out in Table 2.

Legislated tax cuts for individuals and all companies

In the 2021-22 Federal Budget, the government made no changes to the already legislated[5] "stage 3" tax cuts for individuals which reduce the 32.5% current marginal rate from 32.5% to 30%. With this change, it is estimated that 94% of Australian individual taxpayers will face a marginal tax rate of 30% or less. See Table 3 for the 2024-25 income year.

The proposed reduction in the tax rate for all companies in the Treasury Laws Amendment (Enterprise Tax Plan No.2) Bill 2017 was never legislated. This would have seen the corporate tax rate for all companies being reduced to 25% for the 2026-27 and future income years. As such, for now we are left with a two-tiered corporate tax system.

New patent box scheme

As yet, we have not learned the detail behind the government's 2021-22 Federal Budget announcement to tax corporate income derived by Australian-owned biotech and medical patents at a rate of 17% (income derived directly from a patent). The measure is to take effect from 1 July 2022. The impact of this concessional tax rate on a company's franking account is still unknown.

Conclusion

The article highlights a few key issues with the company tax rate. These issues include the determination of Australia's corporate tax rate and its competitiveness compared to other countries, trapped franking credits for BREs, and confusion about the applicable company tax rate when a company is both an SBE and a BRE. With individual marginal rates falling, the structuring of passive investments (taking into consideration Pt IVA ITAA36) with the lesser differential between the lower company tax rate and the application of the CGT discount, give rise to potential opportunities to access the lower company tax rate (eg by restructuring, tax consolidating etc) and delaying the payment of dividends on income previously taxed at the higher rate.

Daryl Jones, CTA
Director – Tax Consulting
HLB Mann Judd

Table 3. 2025 individual resident income tax rates

Taxable income	Tax rate on this income
$18,200 to $45,000	19%
$45,001 to $200,000	30%
$200,001 and over	45%

Table 2. Corporate tax rate reduction's impact on franking account

Income year	Dividend paid	Franking rate	Franking credit	Trapped franking credit	% of company tax paid
2020–21	$70	26%	$24.59	$5.41	18.03%
2021–22	$70	25%	$23.33	$6.67	22.23%

Source: Tax Policy and Advocacy, The Tax Institute, *TaxVine 21* on 11 June 2021

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2 Organisation for Economic Co-operation and Development, *Corporate tax statistics,* 2nd ed, 2020, pp 11-12.

3 See para 1.19 of the explanatory memorandum to the Treasury Laws Amendment (Enterprise Tax Plan Base Rate Entities) Bill 2017.

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5 Treasury Laws Amendment (Tax Relief So Working Australians Keep More Of Their Money) Bill 2019.

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Higher Education

Having the right mindset for study

This month, we meet Graduate Diploma of Applied Tax Law candidate Deanne Whelan, dux of both CommLaw1 and CommLaw2 in study period 3, 2020.

Deanne Whelan, Lecturer in Accounting, Marcus Oldham College, Victoria

Please provide a brief background of your career

I was at PwC, Melbourne, as a graduate then senior auditor for four years. I established and managed a successful retail business for 10 years, with involvement in all aspects of the business including tax returns and BAS. I consulted for Alan Blackburn & Associates for five years, training farmers in recording transactions and preparing a BAS. I'm now a lecturer at Marcus Oldham College in accounting on tax law fundamentals, BAS and business structures.

What skill or knowledge areas have you gained by undertaking these two subjects?

I studied commercial law at university as part of my commerce degree, but that was a long time ago. It has been good to expand my knowledge on contract law, have a better understanding of the tort of negligence, and the remedies for breach of duty of care and breach of contract. I gained an understanding of the non-tax legal aspects of business structures, directors' duties, and the options available in terms of bankruptcy and insolvency.

How have you applied this new knowledge in your role?

Having a more comprehensive understanding of the non-tax legal aspects of business structures, directors' duties, and the options in terms of bankruptcy and insolvency will help when answering the left-field questions that you often get from mature-aged inquisitive students.

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

Completing two units in one study period while working full-time and juggling my family commitments (two teenagers and a supportive husband) was challenging. I often questioned my decision to complete two units at the same time! I felt rather overwhelmed the night before the exams, so I am very surprised and very honoured to achieve the dux award for both units.

Do you have any study tips?

I studied around my workload. When I was busy at work, I didn't try and do much study. When my workload was easier, I forced myself to do extra study and catch up. I wrote down a study plan that fitted around my work and family commitments and stuck to it.

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

I'm taking the final unit in the Graduate Diploma of Applied Tax Law ATL006 CommLaw3.

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

Attempt one unit at a time. Make a study plan that fits your work and personal commitments. Make sure you are in the right mindset to study and enjoy learning. I think that's the key: I want to learn, not just go through the process to get a Graduate Diploma.

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The dark corners of Div 7A

by Andrew Noolan, CTA, Partner, Brown Wright Stein Lawyers

Division 7A of the *Income Tax Assessment Act 1936* is scheduled to undergo major reforms. The last announcement by government scheduled those reforms to begin from 1 July following royal assent to the necessary amending legislation. At the time of submitting this article, it appeared that the reforms are unlikely to begin, for most taxpayers, until financial years beginning on or after 1 July 2022. This article highlights issues with the current Div 7A rules, and discusses the proposed reforms and their impact.

Introduction

Division 7A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) was introduced in 1998, with effect from 4 December 1997, and has caused many issues for tax practitioners and their clients since that time.

While some aspects of Div 7A are well understood and managed, such as the need to put in place written loan agreements and to ensure that minimum annual repayments are made, there are many parts of Div 7A that can operate in unexpected ways, the "dark corners" of Div 7A. This article highlights some of the problem areas in the current Div 7A.

In October 2018, Treasury released a consultation paper[1] which was based on changes recommended by the Board of Taxation in a post-implementation review paper[2] given to the government in November 2014.

That consultation paper proposed changes to the law that were to apply from 1 July 2019. The implementation date has currently been pushed back to 1 July, following royal assent to the enabling legislation.[3] At the time of writing it appeared unlikely that the enabling legislation would be passed before 30 June 2021.

Despite consultation closing on 21 November 2018, no draft legislation has been publicly released, and none of the submissions made during the consultation process had been published by Treasury at the time of writing this article.

This article also highlights areas where Treasury has proposed changes to the operation of Div 7A and suggests how tax practitioners might prepare for those changes.

Issues related to the current Div 7A

Some of the issues that can be identified in relation to day-to-day interactions with the operation of Div 7A are discussed below. Some of these issues are modified by Treasury's proposed changes.

Commissioner's discretion to disregard or frank: s 109RB

Since 1 July 2006, with a retrospective implementation date of 1 July 2002, the Commissioner has had the ability to disregard a Div 7A deemed dividend, or to allow such a deemed dividend to be franked. Section 109RB ITAA36 should be the first "port of call" for a tax practitioner who discovers that a client has failed to comply with their Div 7A obligations, where the assessment impacted by any deemed dividend is still within time for amendment.

There is no prescribed form when applying for the Commissioner's discretion to be exercised and, in practice, the process often begins with a letter setting out the facts and circumstances that result in there being a deemed dividend, and the reasons that support the Commissioner exercising his discretion.

The Commissioner appears to only allow deemed dividends to be franked when the deemed dividend flows to a shareholder in a company.

To enliven the Commissioner's discretion, there needs to have been an honest mistake or inadvertent omission that resulted in the deemed dividend not being disclosed.

The Commissioner's view on what constitutes an honest mistake or inadvertent omission, and how the process works from the ATO side to determine whether the Commissioner should exercise his discretion, are set out in TR 2010/8 and PS LA 2011/29. TR 2010/8 sets out what is meant by "honest mistake" and "inadvertent omission", while PS LA 2011/29 provides guidance for tax officers in the two-step process required by s 109RB, that is, to first consider whether there has been an honest mistake or inadvertent omission and then to consider the following factors set out in s 109RB(3):

"(a) the circumstances that led to the mistake or omission mentioned in paragraph (1)(b);

(b) the extent to which any of the entities mentioned in paragraph (1)(b) have taken action to try to correct the mistake or omission and if so, how quickly that action was taken;

(c) whether this Division has operated previously in relation to any of the entities mentioned in paragraph (1)(b), and if so, the circumstances in which this occurred;

(d) any other matters that the Commissioner considers relevant."

PS LA 2011/29 notes that the above matters can be the same factors as those taken into account when determining whether there has been an honest mistake or inadvertent omission.

Repayment and s 109R

Where a loan has been repaid by the "lodgment day", there is no need to put in place a complying Div 7A loan agreement to prevent a loan from resulting in a deemed dividend in the year the loan is made. Where the loan has not been repaid by the lodgment day, a deemed dividend can be avoided by putting in place a complying loan agreement.

Where a complying loan agreement has been put in place for a loan that would otherwise be a Div 7A deemed dividend, if minimum annual repayments are not made, the shortfall in the repayment calculated under s 109E ITAA36 is a deemed dividend, subject to the amount of the distributable surplus.

When working out how much of a loan has been repaid, one needs to consider the operation of s 109R ITAA36. This section is effectively an anti-avoidance provision, the need for which can be best understood by considering the following simple example.

Example

A loan is made to a person on 1 July 2019. The loan is repaid on 30 June 2020. Division 7A deems there to be a dividend on 30 June 2020 if the loan is not repaid by the lodgment day, unless one of the exceptions (such as having a written loan agreement) applies. The amount repaid is re-borrowed on 1 July 2020.

Without an anti-avoidance provision, the operation of Div 7A could be thwarted by repaying and re-borrowing the amount of a loan each year.

Section 109R(2) provides:

> "A payment [repayment] must not be taken into account if:
>
> (a) a reasonable person would conclude (having regard to all the circumstances) that, when the payment was made, the entity intended to obtain a loan or loans from the private company of a total amount similar to, or larger than, the payment; or
>
> (b) both of the following subparagraphs apply:
>
> (i) the entity obtained, before the payment was made, a loan or loans from the private company of a total amount similar to, or larger than, the amount of the payment;
>
> (ii) a reasonable person would conclude (having regard to all the circumstances) that the entity obtained the loan or loans in order to make the payment."

Thus, if there is an intention to borrow a similar or greater amount when a repayment is made, the repayment is disregarded.

If a loan is obtained when there is the intention to borrow the amount to repay the company, the repayment is disregarded.

While, on its face, this anti-avoidance provision is reasonable as it prevents repaying to borrow and borrowing to repay, it has potentially dire consequences for private companies and people who borrow from them (discussed below).

Section 109R allows for seven- or 25-year loans to be refinanced to have longer or shorter terms, and also allows for certain refinancing to occur to give effect to a loan being subordinated.

Repaying from salaries or dividends

In a large number of private companies, shareholders borrow money from their companies each year. They meet with their tax advisers and then plan how the loans will be repaid. The loans are often repaid out of salaries or out of dividends. The shareholders, after making their repayments, then continue the practice of borrowing in later years — a habit which, it could be argued, would make a reasonable person believe that they intend to obtain a similar or greater amount as a loan.

Fortunately, there is an exception that prevents s 109R(2) from applying where the amount is repaid by setting off an amount that is a dividend, an amount that is subject to PAYGW (eg salary), or where the repayment occurs by way of setting off the difference between what might be paid by a party at arm's length for property against the amount paid by the private company for the transfer of the property.

Another exception that prevents s 109R(2) from applying is where another entity (other than the borrower) pays the private company an amount that has been included in the assessable income of the borrower in the year the payment is made or in an earlier year.

What repayments can clearly get disregarded?

In some accounting firms, there is a process of quarantining the credit entries in a loan account from the debit entries in a loan account and using the credits to either repay the prior year loan or to meet the minimum annual repayment obligations. If someone is both repaying and re-borrowing in the same year, this could clearly fall foul of s 109R.

How s 109R operates for current year loan accounts

Section 109R could operate in a perverse fashion where a person borrows from a company during a year and also makes repayments, so that the repayments are disregarded while the amounts borrowed are not.

While it is sensible to treat the net movement in the loan account for a year as the "loan", and indeed the definition of "amalgamated loan" in s 109E(3) ITAA36 contemplates that this is the loan, this can only occur if the repayments made are taken into account when determining the amount of the loan.

Section 109R requires that you disregard repayments that fall foul of s 109R for all purposes. That is, you disregard them for the purposes of s 109D ITAA36 (current year loans) and for the purposes of s 109E (amalgamated loans).

Example

If a loan of $500 was made in year one, and in year two repayments of $200 were made and borrowings of $300 occurred, if 109R(2) applies, the repayments could not reduce the year one loan or the year two loan.

In effect, in the example above, no credit is allowed for the $200 repayment. There is no provision allowing you to ignore part of the $300 borrowed where s 109R applies to the $200. This seems unreasonable and is, in the author's opinion, unlikely to be a position adopted by the ATO or the courts.

What is suggested as a conservative practice to adopt is to treat repayments as reducing a current year loan and not prior year loans, unless such repayments are made in a way that is exempted from s 109R. Where current year repayments exceed current year borrowings, but the conditions of s 109R apply, it is not clear what should occur with the balance.

If the operation of s 109R is not reformed by the Treasury changes, it would be beneficial for the Commissioner to provide binding guidance on how he will apply the provision in practice.

Refinancing and s 109R

Section 109R also needs to be considered where refinancing occurs. Consider the following example of a refinancing transaction.

Example

Company 1 loans $100 to a shareholder. Company 2 (in which the shareholder is also a shareholder) loans money to the shareholder to allow them to repay company 1, with the overall effect being that company 2 now owes company 1, as no cash changes hands.

Section 109T ITAA36 can operate so that the loan from company 1 to company 2 to the shareholder is an interposed entity loan from company 1 to the shareholder. This can result in a deemed dividend if the amount is not repaid (subject to the Commissioner determining the amount under s 109W ITAA36). The amount that the shareholder has repaid company 1 can be disregarded under s 109R as, at the time the repayment was made, there was the intention to borrow the same amount (the interposed entity s 109T loan). This could result in double taxation. Note that s 109K ITAA36 ordinarily results in a company-to-company loan not triggering Div 7A, but this provision is switched off for the purposes of the interposed entity provisions (see s 109X ITAA36).

The refinancing does not trigger s 109R where money is borrowed from one entity, in cash, to repay another entity, with the consequence that the two entities do not have a loan between them at the end of the transaction.

Example

Company 1 is owed $100 by its shareholder. The shareholder also owns shares in company 2 which has $100 in cash. The shareholder could borrow money from company 2 in order to repay company 1 without triggering s 109R, unless a reasonable person would conclude that, when the payment was made, the entity intended to obtain a loan or loans from company 1 of a total amount similar to, or larger than, the repayment.

Theoretically, this refinancing could occur indefinitely, but the operation of Pt IVA ITAA36 would need to be considered. In addition, note that using a credit loan in one entity to offset a debit loan in another entity should not, on its own, cause s 109R to apply.

Example

Company 1 is owed $100 by its shareholder. The shareholder is in turn owed $100 by company 2. The shareholder asks company 2 to repay it the $100 by paying company 1 by direction.

Although, at the end of this transaction, company 2 may not have settled its obligation to pay company 1 in cash, so that there is a borrowing by company 1 to make a payment of $100 to its shareholder, there should be no amount of deemed dividend under ss 109T and 109V ITAA36 (the payment provision) as the payment is discharging company 2's obligation to pay its shareholder. Section 109R has no application as the shareholder has not indirectly borrowed from company 2, there is instead an indirect payment and not a loan.

Consolidating loan accounts

Another example of refinancing (slightly different to the one described above but which is more common in practice) is where, as part of year-end accounting, there is a desire to "clean up" company accounts by consolidating loan accounts into only one entity. For instance, a person with two operating companies might have debit loans in both companies but, for simplicity, only one company is to be recorded as having an amount due to it by the shareholder.

In this instance, before the end of the year, the parties could agree that the shareholder would be indebted to only one of the companies. What would then happen is that the company that will not show the shareholder's debit loan will instead show that it is owed money by the company that will show the shareholder's loan.

Example

Company 1 has loaned $100 to a shareholder. Company 2 is the one that is to show the debit loan. A journal will be done in company 1 debiting company 2 with $100 and crediting the shareholder loan with $100. In company 2, a journal will be done debiting the shareholder's loan and crediting company 1.

In this example, company 1 has loaned money to company 2 in order for it to make a loan to the shareholder. The shareholder has used this money to repay company 1.

The effect of the interposed entity provisions in ss 109T and 109W will be that company 1 will be taken to have loaned an amount of $100 to the shareholder. As this loan is the loan that has been used to repay company 1, s 109R(2) will operate to disregard the repayment.

If the transaction had been structured differently so that company 2 agreed to loan money to the shareholder but company 1 had advanced it the money for this purpose, while the interposed entity provisions would still have potential operation, a complying loan agreement between company 2 and the shareholder would prevent there being a deemed dividend.

Interposed entity rules

The interposed entity rules, which are proposed to be amended so that they might more easily be applied by the ATO (although not at present by taxpayers), can cause unintended issues.

Interposed entity example: mum, and dad

Consider the following transaction. All of the shares in a private company are owned by Mum. Mum takes a dividend from the private company. Mum gifts the funds to Dad who uses the amount to pay his credit card bill.

Technically, when Mum has taken a dividend from the company, the company has made a payment to her. Division 7A does not deem this to be a dividend as it is an *actual* dividend. Actual dividends cannot be deemed dividends under s 109C ITAA36 (the payment provision) because of s 109L ITAA36.

When Mum chooses to give the dividend to Dad, she is making a payment. A payment in s 109C(3) is "a payment to the extent that it is to the entity"; Dad is an entity.

A payment made by a private company to an entity (Mum) where the funds are then on-paid to a target entity (Dad) can result in there being a deemed dividend under s 109T if "a reasonable person would conclude (having regard to all the circumstances) that the private company made the payment or loan solely or mainly as part of an arrangement involving a payment or loan to the target entity". Under the new "but for" test, discussed later in this article, s 109T would still apply.

In the circumstances, if Mum caused the company to pay the dividend in order to pay Dad, these requirements would then be satisfied.

The amount of the deemed dividend in the case of an interposed entity payment situation is the amount determined by the Commissioner under s 109V. When determining the amount of the deemed dividend, the Commissioner must have regard to:

– the amount that the interposed entity paid the target entity; and
– how much (if any) of that amount the Commissioner believes represented consideration payable to the target entity by the private company or any of the interposed entities for anything (assuming that the consideration payable equals that for similar transactions at arm's length).

It is not clear how much the Commissioner would believe represented consideration payable by Mum to Dad for anything, although it is hoped that the Commissioner would not seek to deem there to be an amount of dividend.

Usually, the fact that the dividend received by Mum is assessable would be enough to prevent Div 7A from applying because of s 109L. Section 109X states that, for the purposes of determining whether there is a deemed dividend in Subdiv E of Div 7A (which is where s 109T is located), you ignore the operation of s 109L.

It is not clear how to handle a situation involving Div 7A where the Commissioner must exercise a discretion, as the legislation is silent on whether the Commissioner must be approached and asked to form a view in what is otherwise a self-assessment system.

That the Commissioner considers that a deemed dividend can arise in the above circumstances follows from a position outlined in ATO ID 2011/104.

The facts in ATO ID 2011/104 differ from those described above in that, because of the arrangement in place, there is no tax paid by the recipient of the actual dividend. The facts in the interpretative decision are:

– Jack Jones is a shareholder of Private Company A, holding 100 A class shares;
– Jack Jones needs $100,000 to enable him to purchase a new residence;
– Private Company A has significant cash reserves and a distributable surplus;
– Private Company B is also a shareholder of Private Company A, holding 100 B class shares;
– Private Company A paid a fully franked dividend of $100,000 to Private Company B, and on the same day, Private Company B made an interest-free loan of $100,000 to Jack Jones;
– no repayments of the loan were made by Jack Jones before the private company's (presumably, Private Company B's) lodgment day for the relevant year of income; and
– Private Company B has no distributable surplus.

The ATO states that s 109T can operate to deem a dividend to Jack Jones. In relation to why it would consider that there is a deemed dividend of $100,000, the ATO says:

> "Under section 109W [as is the case for s 109V] of the ITAA 1936, the amount of the notional loan is the amount (if any) determined by the Commissioner. Given the facts and circumstances relating to the loan made to Jack Jones, the Commissioner would determine that the amount of the notional loan was $100,000. There has been an informal or disguised distribution of Private Company A profits to Jack Jones."

The difference between this example and the Mum and Dad example is clearly that Mum pays tax on the dividend received and Private Company B in ATO ID 2011/104 does not. However, if Mum was on a low tax rate (or had losses) and Dad was on a high tax rate, the ATO could use ss 109T and 109W to assess Dad.

In TD 2011/16, the ATO considers that, in forming its view on the amount of an interposed entity loan or payment, it is not restricted to taking into account the factors set out in s 109V or s 109W. While the analysis in TD 2018/13 (concerning interposed entity arrangements) suggests that the ATO would not seek to treat there as being a deemed dividend in the "mum and dad" example, the "mum and dad" example above is not part of the determination.

Forgiveness of debts: s 109G(3)

Section 109G(3) ITAA36 is an exception to the forgiveness of a debt triggering a deemed dividend under s 109F ITAA36. Section 109G(3) currently states:

> "(3) A private company is not taken under section 109F to pay a dividend at the end of a year of income because of the forgiveness of an amount of a debt resulting from a loan if, because of the loan, the private company is taken:
>
> (a) under section 109D to pay a dividend at the end of that year or an earlier one; or
>
> (b) under former subsection 108(1) to pay a dividend on the last day of that year or an earlier one."

The provision was likely intended to prevent double taxation, that is, preventing a forgiven amount from resulting in a deemed dividend where an earlier loan has also resulted in a deemed dividend. However, if the earlier loan was not properly recognised as a deemed dividend, the later forgiveness could still result in there being no deemed dividend. This is particularly problematic for someone wanting to collect tax on a transaction when the omitted amount is out-of-time to be included in an assessment, as the assessment is out-of-time to be amended.

Pre-4 December 1997 loans

Loans made prior to 4 December 1997 were made subject to Div 7A when it began unless, under s 109D(5), the terms of such a loan were varied on or after 4 December 1997 by extending the term or increasing the amount. As such, a practice developed of "freezing" pre-4 December 1997 loans on balance sheets.

Loans that are not recoverable because the period in which a creditor can sue for recovery of a debt has ended are taken to be forgiven under Div 7A (s 109F(3)). In New South Wales, a debt that has not been created under a deed will be "statute barred" if action is not taken to recover the debt after six years have elapsed from the time a cause of action in respect of the debt arises. A cause of action arises in respect of a loan made "on demand" at the time a loan is made. This means that most loans made on demand, and prior to 4 December 1997, would be statute barred by at least some time in 2003. However, the statutory period for recovery is extended if, within the six-year period, the borrower confirms in writing that they owe the debt. Confirmation can also occur if a payment is made towards the debt by the borrower. Confirmation must be in writing and "signed" by the borrower.

It should be noted that the law around whether a borrower that signs accounts of the lender is confirming a debt is, arguably, unsettled.

In 2006, PS LA 2006/2 (GA) was released, stating in part:

> "… as a matter of practical compliance and sensible administration, the Commissioner has decided to take no active compliance action on private company and trustee loans made prior to the enactment of Division 7A of the ITAA 1936 deemed to be forgiven in consequence of the operation of subsection 109F(3) of the ITAA 1936, merely because the period within which the creditor is entitled to sue for recovery of the debt ends by the operation of a statute of limitations."

PS LA 2006/2 (GA) also said:

> "The fact that a loan has become statute barred may be evidenced by the writing down of the loan in the financial statements or accounts of an entity."

Despite the issuing of the law administration practice statement, it is still common to see pre-4 December 1997 loans on company balance sheets.

PS LA 2006/2 (GA) provides protection against penalties and interest, but not against the Commissioner seeking to recover primary tax.

When determining whether a debt has been forgiven because of the statute of limitations relevant to the particular loan, the following points should be considered:

– what the governing law of the loan is: this is important as the states and territories have their own versions of statutes limiting causes of action, and it is necessary to determine which statute applies. While this should be straightforward if there is a written agreement nominating the governing law, or where all parties are in one jurisdiction, it could be complex. In NSW, s 63 of the *Limitation Act 1969* (NSW) provides that a debt that has become statute barred is one on which a cause of action cannot be maintained. In other states and territories, the limitation period may operate only as a defence (meaning that the debt has not come to an end) or the period in which action might be taken might be refreshed by the courts;

– whether the time for the limitation period to run has begun: where a loan has been made "at call", the limitation period runs from the time the loan is made (*Ogilvie v Adams*[4]). However, where the loan has been made for a term, the limitation period would begin to run from the end of the term; and

– whether the loan has been confirmed so that the limitation period has been refreshed: for instance, in NSW, under s 54 of the *Limitation Act 1969*, part-payment or confirmation extends the limitation period. It has been held that a director who signed an annual return where the assets listed on the return included their loan did not amount to confirmation, on the basis that the return was prepared for the purposes of the company and not the director (*VL Finance Pty Ltd v Legudi*[5]). A company showing an amount owed to a creditor can amount to confirmation of the debt (*Lonsdale Sand & Metal Pty Ltd v FCT*[6]).

As a practical matter, when preparing tax returns for 2020 or 2021, whether pre-4 December 1997 loans have become statute barred in an earlier income year should be considered. If they have, consideration should also be given to writing them out of the accounts. It is noted that, despite the Commissioner's non-binding position in PS LA 2006/2 (GA) (that he will not tax an amount of a pre-4 December 1997 loan that has been forgiven as a result of the statute after that date), if an amount was in fact forgiven for s 109F purposes and had been a deemed dividend prior to this time, s 109G(3) (as it currently applies) would prevent the Commissioner from levying tax as a result of the forgiveness. It can be expected that most amendments to reflect the forgiveness would be outside of the periods for amendment of assessment.

Caution should be exercised, however, as the forgiveness of a pre-4 December 1997 loan in an earlier year or a current year could have other tax consequences if there are not Div 7A consequences, that is, forgiveness could result in:

– ordinary income being derived;

– a fringe benefit being provided;

– a capital gain arising;

– commercial debt forgiveness applying; or

– the value shifting rules applying.

It may also be that the retained earnings that match the amount of a pre-4 December 1997 loan are needed to allow franked dividends to be paid in future.

Later dividends: s 109ZC

Section 109ZC ITAA36 deals with a later dividend that is set off against an amount of a loan that was an earlier deemed dividend and allows that later dividend to be disregarded.

Paragraph 3.52 of the explanatory memorandum to the Taxation Laws Amendment Bill (No. 4) 2003 confirms that the purpose of s 109ZC is to prevent double taxation.

A dividend taken to be paid under Div 7A is unfranked (s 202-45 of the *Income Tax Assessment Act 1997* (Cth)

(ITAA97)). Since 1 July 2006, there has been no debit to the franking account because of the deemed dividend.

Section 109ZC(2) only allows a later dividend to be set off to the extent that it is unfranked. The provision provides:

> "The amount of the later dividend set off or applied is taken not to be a dividend for the purposes of this Act, except Part 3-6 of the *Income Tax Assessment Act 1997* (which deals with franking of distributions). However, if the amount set off or applied exceeds the amount of the later dividend that is not either the franked part of that dividend, or the part of that dividend that has been franked with an exempting credit, the excess is still a dividend."

The franked part of a dividend (distribution) is defined in s 976-1 ITAA97 which, when combined with the current definition of "corporate tax gross-up rate", is:

$$\frac{\text{Franking credit on the distribution} \times (100\% - \text{Corporate tax rate for imputation purposes})}{\text{Corporate tax rate for imputation purposes}}$$

Thus, where \$30 of franking credits are attached to a distribution, \$70 (ie \$30 × (100% – 30%)/30%) will be the franked part of the dividend.

Where there is an initial deemed dividend because of a loan of, say \$100, and there is a later dividend set off against that amount of \$100 and that later dividend is unfranked, the later dividend can be disregarded as s 109ZC(3) treats the amount as non-assessable non-exempt income.

However, where the later dividend is a franked dividend of \$100 (which would carry approximately \$43 in franking credits at a 30% rate), the later dividend is not disregarded at all. Instead, there would be effectively double taxation.

If there is a later unfranked dividend that is disregarded because of s 109ZC, the amount of credits that relate to the funds from which the actual dividend is sourced are left in the franking account of the company. Unless the company earns untaxed profits which these excess credits could be used to frank, such credits are wasted.

The failure to be able to offset a later dividend that is franked is especially unfair where a company with multiple shareholders makes a loan to one or more, but not all, of those shareholders (or their associates). In most companies, shareholders have a preference for franked rather than unfranked dividends (because of the franking credits), and it is unlikely that shareholders who have not suffered (or benefitted) from Div 7A loans would accept unfranked dividends simply because they are more tax-effective for people offsetting their loan repayment obligations.

The protection in s 109ZC also extends to later unfranked dividends that are on-loaned by the shareholder to an associate, for set-off and repayment of a loan by the company to an associate, that was an amount previously deemed to be a Div 7A dividend.

In practice, two things should be observed about the operation of s 109ZC:

1. you would not want to inadvertently set off a later franked dividend against a loan that was previously a deemed dividend. To do so would tax the amount twice, although, if the shareholder was on a low tax rate, perhaps the benefit of a refund of franking credits would make this palatable; and
2. the loan that is to be reduced by set-off could also be forgiven without a later Div 7A consequence because of s 109G(3) or (3A), although care would need to be taken that other tax consequences do not arise.

Pre-16 December 2009 UPEs as debts

That an unpaid present entitlement (UPE) is not a debt was a point made by the Commissioner in TR 2010/3.[7] However, the position appears to have changed, at least perhaps in NSW, with the NSW Court of Appeal finding that recording a UPE as a debt due to a beneficiary rendered the amount a debt.[8]

If it is the case that UPEs are debts, three points flow from this:

1. the Commissioner's view that pre-16 December 2009 UPEs could trigger the operation of ss 109XA and 109XB ITAA36 is arguably correct, but this would lead to double taxation as the amounts would also result in deemed dividends under s 109D;
2. the Commissioner's view that post-16 December 2009 UPEs are debts would be correct; and
3. as debts, the amounts might be "statute barred" in the same way as pre-4 December 1997 loans might be statute barred.

If pre-16 December 2009 UPEs are statute barred, there should be no Div 7A consequence of them being forgiven if they were in fact deemed dividends in earlier years, as a result of the operation of s 109G(3).

> *"Treasury proposes that Div 7A loans, which will have a 10-year term, will have an amendment period of 14-years."*

Treasury consultation paper

Treasury released a consultation paper[1] on 22 October 2018, with a consultation period which closed on 21 November 2018. The paper made suggestions concerning changes to Div 7A and also posed questions as part of the consultation process.

It can be assumed that many submissions were made to Treasury as part of the process but, as at the time of submitting this article, no submissions had been published by Treasury on its website. On 30 June 2020, the government announced that any changes would take effect from income years commencing after enabling legislation is given royal assent. It appears unlikely that legislation will pass through parliament before 30 June 2021 to allow any changes to start from 1 July 2021.

The various changes and some of the questions are outlined below.

14-year amendment periods

Treasury proposes that Div 7A loans, which will have a 10-year term (see below), will have an amendment period of 14-years.

The 14-year period is to "cover" 14 years after the end of the year in which the loan, payment or forgiveness might have otherwise given rise to a deemed dividend. Presumably, this means that, for a loan made on 1 July 2021, the amendment period would end on 30 June 2036 (14 years after 30 June 2022). When drafting, to be consistent with existing law, presumably Treasury will change this to be 14 years from the time that an assessment is raised for the year in which the loan, payment or forgiveness occurred.

The justifications given for this long period are:

> "To improve integrity and ensure compliance with the new loan model, as well as the ability to self-correct …
>
> This approach is consistent with other areas of the law in which there are an extended period of review, including capital gains tax and loss recoupment rules."

Under the transfer pricing provisions (by which the ATO might attack the transfer pricing policies of multinationals, among others), there is only a seven-year period of review under s 815-150 ITAA97.

Given that, in practice, Div 7A is often either overlooked or applied incorrectly, the position for taxpayers, regardless of whether they manage their own affairs or engage tax professionals, will be years of uncertainty.

It is not clear how a comparison can be made with the extended period of review that is given to CGT transactions. For CGT purposes, for example, an open-ended period of time is available to include in an assessment a gain from CGT event A1, in order to give effect to the time of the event, being the contract date. Without this rule, a sale with a five-year settlement period might escape taxation. The rule is needed because, without it, when a real disposal occurs (on settlement), the timing rule would push any gain back into a year that might be closed for assessment. That is not the case with Div 7A, when the actual transaction clearly occurs in a particular year.

The reference to an extended period of review for loss recoupment appears to be a reference to item 170 of the table in s 170(10AA) ITAA36 (being the only item in the table that relates to losses providing for an unlimited period of review):

> "Reduction in respect of reduced cost base etc. of debt disregarded if commercial debt forgiveness provisions apply."

Presumably, this change has been called for by the ATO who might reasonably be frustrated with auditing taxpayers, detecting Div 7A issues, and then finding that it is out of time to raise assessments in relation to the issues identified. Where this is due to fraud or evasion, the ATO already has the necessary tools to deal with this. Where there is no fraud or evasion, it can be argued that the usual two- or four-year time limit should apply so that there is certainty, both for taxpayers and for someone seeking to collect tax on the transaction.

While the intention seems to be to allow the ATO to monitor whether a 10-year loan agreement has been complied with, giving a 14-year amendment period to payments and forgiven amounts is, in the author's opinion, a clear overreach. If a person receives a trust distribution but inadvertently omits it from their income, they have a four-year period of review. If a different person had a payment made for their benefit by a private company in which they are a shareholder or an associate, they would have a 14-year period of review. It is clearly inequitable for two taxpayers that have omitted income to be held to two such different standards.

Distributable surplus

One of the most remarkable proposed changes to Div 7A is in relation to the distributable surplus. While the Board of Taxation had recommended retaining the concept, Treasury intend to abolish it.

The justifications given in the consultation paper include:

> "Capping the amount of the deemed dividend is considered contrary to the efficient operation of the Division 7A integrity rule. That is, if a certain amount is 'distributed' to the shareholder, then tax should be paid on the entire amount, and it should not be arbitrarily limited.
>
> … This will also align the treatment of dividends with section 254T of the *Corporations Act 2001* (Cth) which allows dividends to be paid out of both profits and capital."

The above points can be contrasted with the policy intent of Div 7A set out in the Treasury consultation paper:

> "Division 7A of Part III the *Income Tax Assessment Act 1936* is an integrity rule that is intended to protect the operation of the progressive personal income tax system and ensure taxpayers cannot access funds that have not been taxed at their applicable marginal tax rates for the year (e.g. amounts taxed at the corporate tax rate)."

While simplifying the operation of Div 7A, the result of the change will be that money that does not represent current or future profits or gains taxed at the corporate rate can be assessable as income to a shareholder or an associate.

At its most ludicrous, the following could occur:

– step 1: incorporate a company for $1;

– step 2: the company borrows $1,000,000 from a bank and on-lends to a shareholder; and

– step 3: the shareholder is taxable on a $1,000,000 deemed dividend.

While those who understand the change would presumably do nothing so stupid, and while the above could be "fixed" through the self-corrective mechanism set out below, the self-corrective mechanism could also require that there be some tax paid to fix the deemed dividend.

Also consider the position where a family has conducted business in the past through a company and incurred losses so that it has a negative retained earning position. The family currently has a trust with profits and distributes the income to the company to utilise the losses, bringing it to a nil net asset position, but it fails to comply with Div 7A (ignoring the new self-correction option as it would subject the family to some tax). The trust would, without reference to a distributable surplus, have a deemed dividend of the amount distributed.[9]

Presumably, what is behind this change is the fact that, at present, s 109Y(2) ITAA36 does not require a taxpayer to determine to what extent a company has a real "distributable surplus" based on the difference between the assets and the liabilities of a company. Instead, the accounts of the company are to be used. Those accounts usually show assets at cost, but liabilities at their market values, leading to the potential "profits" of the company being arguably understated. While the Commissioner is given the ability to revalue assets and liabilities, a taxpayer is not. This may lead to lower deemed dividends than the ATO and Treasury would like to be taxed.

A better way to have dealt with this issue might have been to provide that there is a deemed dividend unless a taxpayer could show that there is an insufficient distributable surplus based on market values, or to deem there to be a dividend to the extent that there is a sufficient surplus of the market value of assets over liabilities.

It is not clear from the consultation paper whether the removal of the distributable surplus concept will result in deemed dividends in relation to existing seven- or 25-year loans that fail to be brought under complying loan agreements as part of the transitional measures (see below).

10-year loans

The consultation paper proposes something different than the milestone payment option put forward by the Board of Taxation in its recommendations. Having repayments made at three-, five-, eight- and 10-year milestones as suggested by the Board of Taxation, rather than annually as currently occurs, would lead to lumpy cash flows for the government, given most taxpayers anecdotally manage their Div 7A loans by setting off taxable dividends against their obligations to repay rather than repaying loans with cash or property.

The proposal from Treasury is that loans will be subject to new, simpler rules (see Table 1).

Table 1. Proposed loan terms

Treasury proposal	Comments
The principal of a loan will be repayable over 10 years in equal instalments.	It is not clear what will happen if a loan balance is reduced by more than the minimum required amount and whether this will impact on the later repayment obligations; it appears not. For example, if a $100,000 loan was repaid with $50,000 of principal plus interest at the end of the first year, would the remaining principal obligations continue to be set at $10,000 per annum?
The interest on a loan will be calculated based on a full year's opening balance, regardless of whether repayments are made during an income year.	The interest model clearly favours the government, that is, any Div 7A loan interest that is non-deductible is maximised, encouraging earlier repayment by a borrower. This early repayment usually results in someone paying tax to make the repayment. Where interest is deductible to the borrower and assessable to the lender, the change in interest model may result in a better tax outcome (tax at the corporate rate). Also, query whether the interest under this model might be seen to give rise to "excessive" deductions where borrowed money is on-lent on more commercial terms (where interest is usually calculated on a daily outstanding balance). In the author's view, it would be preferable for interest to be calculated on a daily outstanding balance, as occurs with most loans.
Any repayments made up to the lodgment day for the year in which the loan is made will reduce the opening balance of the loan.	The position in relation to loan repayments made up to the lodgment day is consistent with the current law. It is not clear whether the loan repayments will continue to be treated as part of the first year's minimum repayment obligation in line with the ATO's current interpretation of Div 7A set out in ATO ID 2010/82.
The interest rate will be set as the *Small business; Variable; Other; Overdraft – Indicator* lending rate reported by the RBA just prior to the beginning of the income year.	The 2021 Div 7A rate based on the current reference rate is 4.52%. If the new indicator rate were used, the rate would be 6.57%. An opportunity for simplification has been missed here, that is, the indicator rate could have been set for an income year, rather than using the rate just prior to the beginning of the lender's income year (which might not be 1 July).
Any shortfall in the minimum annual repayment will result in a deemed dividend.	This is consistent with the current law.
There must be written or electronic evidence in existence prior to the lodgment day of: – the parties to the loan; – the agreement that the loan has been made, including details of the date and evidence of its execution and binding nature on the parties to the agreement; and – the loan terms (the amount of the loan, the date the loan was drawn, the requirement to repay the loan amount, the term of the loan and the interest rate payable).	Apart from the fact that the law currently requires there to be an 'agreement in writing' the new requirements are quite similar, and arguably a missed opportunity for simplification. If the amounts are reported as Div 7A loans and minimum repayments are made Treasury could have suggested that they be treated as complying loans, and otherwise they would be presumed to either be payments, or non-complying loans.

Transitional rules for loans

As a result of the loan terms being simplified to one 10-year arrangement, there is a need for transitional rules for existing loans.

Seven-year loans

While the Board of Taxation's review had recommended that seven-year loans be transitioned to 10-year loans, Treasury has instead suggested that seven-year loans keep their current term but be subject to the new benchmark interest rate and, it appears principal repayment model, from 1 July 2019. This start date will presumably become 1 July 2021 or 1 July 2022 given the government's most recent announcement.

For seven-year loans that will be made before the start date for the Div 7A changes is known, it will be important to ensure that the increased interest rate and principal commitments do not cause any repayment problems for a borrower.

25-year loans

The Treasury consultation paper proposes that existing 25-year loans will be brought into the new system in two stages.

In 2018, the proposal was that, from 1 July 2019, 25-year loans would bear interest at the new Div 7A rate. It is not clear what will happen to taxpayers who will not have budgeted to pay a rate that is likely to be some 3% higher. If there is a deemed dividend, presumably they could rely on the Commissioner disregarding a deemed dividend under s 109Q ITAA36 (concerning circumstances outside the entity's control and hardship). However, it should be noted that, if the repayment is not made, the outstanding loan is not reduced.

Unlike for seven-year loans, it is not clear whether the principal repayment obligations in 2020 and 2021 will be calculated under the existing rules or under the new straight line principal reduction rules.

From 30 June 2021, it was intended that 25-year loans would need to be brought under a 10-year loan arrangement, meaning they will need to be repaid in full by 2031 and subject to the new straight line principal reduction rules. The first repayment under the new 10-year loan model would be due on 30 June 2022.

Given the delay in implementing the Div 7A changes:

- if the law changed from 1 July 2021, a 25-year loan would need to bear interest at the increased rate from 1 July 2021 and be brought under a 10-year loan agreement by 30 June 2023, with the first repayment under the new system due on 30 June 2024; or
- if the law changed from 1 July 2022, a 25-year loan would need to bear interest at the increased rate from 1 July 2022 and be brought under a 10-year loan agreement by 30 June 2024, with the first repayment under the new system due on 30 June 2025.

The delay in the Div 7A changes means that, for anyone who is considering refinancing a seven-year loan to be a 25-year loan, it is worthwhile doing so now, as it will minimise repayments to be made at least in the 2021 and 2022 financial years.

For anyone contemplating a 25-year loan, a tax practitioner should check that the loan is affordable under the new 10-year model and the proposed implementation timetable.

Pre-4 December 1997 loans

The Treasury consultation paper proposes that loans which have not already been forgiven by being statute barred, and which continue to be reported in tax returns, should be brought within Div 7A, but from 2021, making them repayable in full under the new loan model by 30 June 2031, with the first repayment being due on 30 June 2022.

Given the delayed start to the Div 7A changes:

- if the start date for the Div 7A changes is 1 July 2021, the loans would need to be brought under 10-year loan terms by 30 June 2023, with the first minimum yearly repayment being made by 30 June 2024; or
- if the start date for the Div 7A changes is 1 July 2022, the loans would need to be brought under 10-year loan terms by 30 June 2024, with the first minimum yearly repayment being made by 30 June 2025.

To avoid a pre-4 December 1997 loan being required to be repaid, it would need to not be reported in a tax return, and to have been forgiven by being statute barred. While the first point is a mere matter of reporting, the second point, the statute barring of the debt, requires detailed consideration of the circumstances surrounding the loan.

UPEs

In the 2018 Federal Budget, it was proposed that UPEs would come within the scope of Div 7A from 1 July 2019.

Since the ATO changed its views on corporate beneficiaries from 16 December 2009, the position has been that a UPE created in year one is taken to be a financial accommodation (ie a loan) in year two, so that a repayment or written loan agreement is required by the lodgment day for the corporate beneficiary's return for year two to prevent there from being a deemed dividend.

On the author's "wish list" following this reform to Div 7A is recognition from the ATO that, now that the amounts are loans rather than UPEs, the treatment of interest deductions set out in TR 2005/12 (concerning interest on loans taken out in connection with distributions to beneficiaries) will not apply to interest incurred on such Div 7A loans.

Post-1 July 2019 UPEs

From 1 July 2019, the Treasury consultation paper stated that a UPE owed to a corporate beneficiary will be treated as being a Div 7A loan in the year it is created, so that a loan agreement or repayment by the company's lodgment day for that year will be needed in order to prevent a deemed dividend.

For example, it was to be the case that a UPE created in a corporate beneficiary on 30 June 2020 would be a loan from the company to the trust on 30 June 2020, so that a written loan agreement or repayment would be needed by the company's 2020 lodgment day in order to prevent a deemed dividend.

With the deferred implementation date for the Div 7A changes, it is not clear whether there will be a 1 July 2021, 1 July 2022 or a later start date for this measure.

Post-16 December 2009 UPEs treated as loans

For post-16 December 2009 UPEs that have been dealt with through seven- or 25-year loan agreements, they will be transitioned in under the rules for seven- or 25-year private company loans.

Post-16 December 2009 UPEs treated as sub-trust arrangements

Unpaid present entitlements that have been dealt with under sub-trust arrangements were to be required under the Treasury consultation paper to be subject to complying loan agreements by 30 June 2020 in order to prevent deemed dividends from arising. The first minimum yearly repayment was scheduled to be due on 30 June 2020.

If the Div 7A changes occur from 1 July 2021, this will be a 30 June 2022 date for a loan agreement to be in place and minimum yearly repayment made, and if there is a 1 July 2022 start date, this will be a 30 June 2023 date for a loan agreement to be in place and minimum yearly repayment made.

This change will have a detrimental impact on people who have based their cash-flow planning on the ATO sub-trust arrangements set out in PS LA 2010/4. The seven- and 10-year interest-only arrangements set out there have a drastically different cash-flow implication from that which arises under Div 7A. In addition, sub-trust arrangements structured where assets have been acquired, which were effectively open-ended under PS LA 2010/4, will be difficult to rearrange into complying Div 7A loan arrangements.

There would appear to be little detriment to the government to leave existing seven- and 10-year sub-trusts as they are, and to leave the purchase of asset sub-trust arrangements in place until they come to an end. In the author's experience, such arrangements are relatively uncommon but, where they have been used, careful planning has been done to ensure that the terms of the arrangements can be appropriately funded.

Treasury stated in its consultation paper that UPEs that are not paid out or brought under complying loan terms by 30 June 2020 "will result in a deemed dividend for the outstanding amount of the UPE". It is not clear whether this will be without reference to distributable surplus.

Pre-16 December 2009 UPEs

The Treasury consultation paper did not suggest that pre-16 December 2009 UPEs should be brought under complying Div 7A terms, unlike pre-4 December 1997 loans. However, Treasury did ask whether such loans should become subject to Div 7A. If consistency and certainty are desired, then making them subject to Div 7A would be preferable.

If, however, consideration is given to the fact that such pre-16 December 2009 amounts were never considered to be subject to Div 7A by tax practitioners or the Commissioner prior to 16 December 2009, unlike pre-4 December 1997 loans which may have been captured by the now repealed s 108 ITAA36, leaving them as grandfathered would be the preferable position.

Self-correction

The Treasury consultation paper proposed a self-assessed corrective action that mirrors the Commissioner's current position on what corrective action needs to be taken in most instances for him to exercise his discretion under s 109RB.

To be able to self-correct, Treasury suggested that the following conditions must be met:

- objectively, the breach was inadvertent;
- corrective action is taken as soon as practicable, and within six months of finding the error unless the ATO allows more time; and
- the taxpayer has taken or is taking reasonable steps to identify and address other breaches of Div 7A.

The corrective action would then involve:

- making catch-up payments of principal and interest (on a compounded basis) to bring the loan up to date as if it had been made on a complying 10-year basis;
- bringing the loan under a complying loan agreement, with a remaining term based on an overall 10-year loan term; and
- bringing any interest to account in the year that the catch-up payment of interest is made.

The arrangement does not appear to mirror what the Commissioner sometimes allows, where the catch-up is done by way of a new loan with a reduced term.

The consultation paper does discuss the Commissioner, presumably by way of a ruling or other product, setting out other appropriate action considered reasonable by the ATO.

Note that Treasury has not proposed that a penalty should apply, as was recommended by the Board of Taxation, in connection with self-correction.

Modification of s 109RB

Treasury recommended that s 109RB should be removed in its current form and that it instead deal only with allowing a taxpayer to request a deemed dividend to be franked. The author understands that it is unusual for a request for a dividend to be franked to be made, given the Commissioner's view that only deemed dividends to shareholders, and not associates, can be franked.[10]

Non-resident private companies

Treasury is seeking feedback in relation to how Div 7A applies to non-resident private companies.

While s 109BC ITAA36 was introduced from 1 July 2009 to make it clear that Div 7A does apply to such companies, some clarity would be useful in this regard as it appears at present that:

- a resident shareholder or associate that benefits from a non-resident company can be subject to Div 7A; and
- a non-resident shareholder or associate that benefits from a non-resident company can be subject to the inclusion of a Div 7A deemed dividend in its assessable income because there is no source rule in Div 7A. It can

easily be argued, however, that Div 7A merely deems an amount to be a dividend, and s 44 ITAA36 only includes in the assessable income of a non-resident dividends to the extent that they are paid from profits derived by the company from sources in Australia.

While the first point appears to be what s 109BC is directed at, the second point can lead to technical non-compliance with Australian tax law by every non-resident non-corporate shareholder or associate in a foreign resident private company that benefits from a loan, payment or forgiveness involving a foreign private company.

It would also be useful for there to be some change to the law to reflect the fact that, in some instances, benefits from foreign companies result in (arguably) unreasonable outcomes, where, at present, the Commissioner could only take a "no further action" approach. Consider an Australian resident individual who receives a gift of money from a relative in China that is paid to them through a family company in Hong Kong. Such an amount could be included in their assessable income if they are an associate of a shareholder under Div 7A (and could also be included under s 47A ITAA36). Where the Australian resident individual has no control over the source of the funds, and where the amount would not otherwise be their income (as it is not ordinary concepts income), it is unclear why Australia should seek to tax such an amount.

Safe harbour for asset use

Treasury noted that determining the market value of a benefit obtained through the use of an asset can be difficult in some instances, and so a safe harbour method is being proposed for all assets other than motor vehicles. The method will be unavailable if the right to use the asset is a non-exclusive right.

The method takes into account:

- for the first five years of ownership, the cost of the asset and any improvements;
- after five years, the market value of the asset or the cost, whichever is higher;
- the Div 7A benchmark rate uplifted by 5%; and
- the days the asset is used or there is an exclusive right of use.

The formula is:

$$\frac{A \times IR}{\text{Days in year}} \times \text{Days used}$$

where:

- A is the value of the asset at 30 June for the year in which the asset is used, which will be the greater of cost or market value after five years of ownership, with a valuation required every five years; and
- IR is the benchmark rate plus a 5% uplift.

While this will be a safe harbour method, another method can be used.

It is not clear why the statutory method for FBT or the operating cost method for FBT could not be used for motor vehicles.

Debt forgiveness: ss 109G(3) and 109D

Treasury proposed to amend s 109G(3) so that a later forgiveness of an amount can only be disregarded to the extent that an earlier loan resulted in a deemed dividend being taken into account in the borrower's tax assessment for an earlier year.

Currently, s 109G(3) provides that an amount which has been taken to be paid as a dividend at the end of a year of income or an earlier one under Div 7A, or under s 108, does not give rise to a deemed dividend if forgiven.

It is not clear whether s 109G(3) will be amended to apply to the forgiveness of loans made on or after 1 July 2019 (the original start date of the Div 7A changes), or to the forgiveness of loans made after the start time in relation to a loan of an earlier year.

This change, if it occurs, will give the ATO two ways to deal with Div 7A non-compliance. If the ATO discovers non-compliance within the 14-year period, it can raise an assessment. If it discovers non-compliance outside the 14-year period while the loan is still collectible but has not been included in an assessment of an earlier year, tax can be collected if the loan is forgiven either by action or omission.

Given the 14-year amendment period, it is not clear why this provision is necessary, unless Treasury is proposing a retrospective change to the law.

Other minor issues

There are a number of proposed technical changes that Treasury has stated will improve the integrity and operation of Div 7A and increase certainty for taxpayers.

Timing for use of assets

Under s 109CA ITAA36, a payment by use of an asset is taken to occur at the time the shareholder or associate first uses the asset, or at a time when they have a right (exclusive or non-exclusive) to use the asset and the provider does not have the right to use the asset or provide it for use to another entity.

This would mean that a right to use, that is not enjoyed, has no timing rule where the provider continues to have the right to use the asset or provide it to another for use.

Treasury proposes to make the timing of payment the time of use, or the time the right to use is granted, if earlier.

Ordinary course of business and s 109M

Section 109M ITAA36 is to be amended so that, rather than excluding an amount from being a deemed dividend where a loan is made merely in the ordinary course of business on the usual terms on which the private company makes similar loans to parties at arm's length, the provision will require that the loan be made as part of a business of making loans to third parties.

This change is said to be needed because the ATO has since issued TR 2019/1, effectively consider any company undertaking activities for a profit to be in business.

Arguably, the change is unnecessary as the loan to a related party still needs to be made as part of the ordinary course of business and, under the current law, that business does not need to be a money-lending business.

Interposed entities and s 109T

Section 109T, as it operates in conjunction with ss 109V (payments) and 109W (loans), is intended to ensure that a payment or loan made through an interposed entity is not prevented from giving rise to a deemed dividend.

Without s 109T, Div 7A could be circumvented in relation to a loan, for instance, by having a private company make a loan to an interposed entity with no distributable surplus, and then having the interposed entity make a loan or payment to a shareholder or an associate of a shareholder in the private company.

Section 109T, however, includes a "reasonable person" test that requires the view to be formed that a loan or payment was made as part of an arrangement involving a loan or payment to a target entity. This makes it difficult for the provision to apply where there is a lag in time between a payment or loan to an interposed entity and a loan or payment to a target entity, or a difference in amount.

Treasury is proposing a "but for" test whereby s 109T will be satisfied where a loan payment or other benefit would not be provided (note there is no reference to other benefit in the current s 109T) by the interposed entity, but for the loan, payment or other benefit being provided or expected to be provided by the private company to another entity (even if this is not the one providing the benefit).

Fixing s 109T in this way, as well as removing the need for distributable surplus, will also fix a defect in ss 109V and 109W which effectively require the Commissioner to take action to determine the amount of the deemed dividend. As noted above, a more targeted amendment to the definition of "distributable surplus" would be preferable, as would amendments to ss 109V and 109W to make them self-assessment provisions, consistent with most other provisions in tax law.

No deduction for deemed dividends

The Treasury consultation paper suggests that s 109Z ITAA36 should be amended to ensure that a payment that is deemed to be a dividend will not be deductible.

Section 109Z provides:

> "If a private company is taken under this Division to have paid a dividend to an entity, the dividend is taken for the purposes of this Act to be paid:
>
> (a) to the entity as a shareholder in the private company; and
>
> (b) out of the private company's profits."

It is not clear, and the consultation paper does not set out, why such a payment might result in a deduction for the company.

Division 7A and FBT

There was a proposal by Treasury that the anti-overlap provision in s 109ZB be amended so that it is clear that, when working out whether FBT or Div 7A applies to a payment, para (r) in the definition of "fringe benefit" in s 136(1) of the *Fringe Benefits Tax Assessment Act 1986* (Cth) is disregarded. That paragraph prevents an amount taxable under Div 7A from being a fringe benefit. This appears to be a "chicken and egg" problem being fixed.

Section 109ZB will be expanded so that former employees or their associates are also subject to FBT in relation to employment benefits, rather than Div 7A. Treasury has also proposed, it appears, to tighten up the para (r) exception so that it is clear that Div 7A payments are excluded from FBT.

Conclusion

While getting across the detail of the proposed changes is important, at present, it is not clear what those changes will be, or when they will be implemented. Until it is known what changes to Div 7A will be made, and from what time they will take effect, it is suggested that the key issues to consider are:

1. for existing Div 7A loans, whether the cash-flow impact of an increase to the interest rate, and for 25-year loans, a reduction to their term, is something that can be managed effectively;
2. for any new loans that are subject to Div 7A, whether the cash-flow implications that will flow from an increase to the interest rate, and for 25-year loans, a reduction to their term, will mean that such loans are inappropriate; and
3. whether it is possible to write off pre-4 December 1997 loan amounts, where it is appropriate in the circumstances, and where this does not give rise to detrimental tax or commercial outcomes.

Andrew Noolan, CTA
Partner
Brown Wright Stein Lawyers

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4 [1981] VicRp 92.

5 [2003] VSC 57.

6 [1998] FCA 155.

7 See para 34 and *Commissioner of Inland Revenue v Ward* 69 ATC 6050 at 6071.

8 *Fischer v Nemeske Pty Ltd* [2015] NSWCA 6 at [89].

9 Usually, the loss company would have credit loans owed to related entities that could be satisfied by assigning the right to receive the amount from the trust, although query whether, in the present environment, the Commissioner might seek to apply s 100A ITAA36.

10 Para 17 of PS LA 2011/29.

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Trust hot topics

by Ken Schurgott, CTA (Life), Solicitor and Director, Schurgott & Co Lawyers

This article relates to an array of trust and tax-related issues that practitioners will come across in their day-to-day practices and which have significant technical content. The interplay of the streaming "reforms" and foreign beneficiaries enjoying distributions of capital gains is very topical and the subject of current judicial review. Trust vesting and trust splitting have each been the subject of recent binding guidance from the ATO which requires careful analysis before acting on the guidance. State/territory governments have been active in causing trust deed amendments to be made to avoid surcharges which can have significant flow-on consequences for trusts in an income tax context. Division 6D of the *Income Tax Assessment Act 1936* is a "sleeper" that can catch practitioners unaware.

Introduction

This article is about hot topics in the taxation of trusts world. Some of the matters discussed derive entirely from the application of taxation law to trust estates, or the taxation consequences for beneficiaries, and are extremely "hot". The imminent decisions in the non-resident beneficiary cases illustrate this perfectly. Other matters are of a much more oblique concern. The prevalence of state/territory revenue legislation amendments and administration impacting on trusts is an example of this indirect influence. It also should not come as a surprise that case law not specifically dealing with taxation will impact on the practitioner's understanding of taxation law as it applies to trusts. In other words, a tax practitioner needs to be aware of trust law, general law and taxation law coming at them from all directions.

Having said that, some of the hottest taxation issues concerning trusts arise in the context of Div 7A and s 100A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36). Those issues were dealt with in other papers presented at the NSW 13th Annual Tax Forum. However, those topics are really about how trusts fit in with controversial taxation legislation and not so much about the niceties of trust law and how it interfaces with taxation law. This article is replete with the interface problems.

Non-resident beneficiaries and CGT

The appeals in *Peter Greensill Family Co Pty Ltd (trustee) v FCT*[1] (*Greensill*) and *N & M Martin Holdings Pty Ltd v FCT*[2] (*Martin*) were heard together on 22 and 23 February 2021. As yet, there is no signal of an outcome. It may happen that the decision is released before this article is presented. However, the author is comforted by the thought that there is likely to be an appeal to the High Court, come what may. In the event, the decisions in the appeals were handed down before this version of the article was published. The decisions are referred to in later paragraphs.

The two at first instance decisions concerned the application of Div 855 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) to capital gains derived from an Australian source and which were appropriated to a non-resident beneficiary. *Martin,* at least at the initial appeals stage, was funded by the Commissioner. The Commissioner was seeking, and so far has succeeded in finding, support for his position set out in TD 2019/D6.

As Steward J in *Martin* put it in a very understated way (at para 8), Div 855 only applies to fixed trusts to allow a non-resident beneficiary to disregard a capital gain on the disposal of assets which are non-taxable Australian property. The capital gain made by the trustee of a non-fixed trust is not to be disregarded, notwithstanding the fact that, if the asset were held directly by the non-resident beneficiary, it would have been disregarded.

The appeals are fought out in a complexity of inter-relating provisions derived from the 2011 streaming amendments and Div 855 (which was introduced well before the 2011 amendments). Steward J, again on the issue of complexity, stated:

> "[13] … As such, absent Subdiv. 115-C, the beneficiary could not reduce the amount so included in her or his assessable income with any capital losses she or he might have. Subdiv. 115-C however, in broad terms, converts the amount assessable to the beneficiary, which is derived from the capital gains made by the trustee, into another capital gain. This permits the beneficiary to reduce the amount of the gain by any capital losses she or he might have.
>
> [14] The means adopted by Parliament to achieve this object is highly complex; perhaps unnecessarily so."

It should be noted that the process in the legislation for taxing a non-resident beneficiary involves two steps:

1. the trustee is assessed under s 98(3) ITAA36 on the amount introduced into the trustee's assessable income by s 115-220 ITAA97; and
2. the beneficiary is also assessed under s 98A(1) and allowed a credit for the tax paid by the trustee under s 98A(2).

Stepping through each and every relevant provision of the 2011 streaming amendments, as Steward J was required to do, is tedious in the extreme and intellectually harmful in a presentation like this.

Steward J's decision ultimately followed that of Thawley J in *Greensill* which came down to an interpretation of the highlighted words in s 855-10(1):

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

Following various authorities, Thawley J concluded that the phrase "from a CGT event" required a direct connection with the CGT event happening to the taxpayer, rather than to the trustee of the trust. The use of that phrase was compared to the looser connection expressed in s 855-40(2) ITAA97 in the context of the indirect connection with a capital gain:

> "A capital gain you make in respect of your interest in a fixed trust is disregarded if:
>
> (a) you are a foreign resident when you make the gain; and
>
> (b) the gain is attributable to a CGT event happening to a CGT asset of a trust …"

Thawley J also drew support for the Commissioner's position from the legislative history of Div 855 as a substitute for the former Subdiv 768-H ITAA97 where the relevant explanatory memorandum was explicit about limiting the benefit of the Division to fixed interests.

The arguments in *Martin* were like those of a de facto appeal against the decision made by Thawley J in *Greensill* and it could be expected that the Full Court would have been taken to these submissions in even greater depth. However, the fundamental submission in *Martin* was that the words "from a CGT event" require a direct connection with a CGT event beyond that happening to the trustee.

A matter of some interest to the author concerns the operation of the discount denial rules in Subdiv 115-A ITAA97 where they inter-twine with Div 855 and Subdiv 115-C ITAA97. In *Martin*, the Commissioner issued a first amended assessment which allowed the discount and then a subsequent amended assessment which appears to have denied the discount in full. Section 115-110 is directed at trust gains made by a foreign resident or temporary resident and seeks to adjust the trustee's tax liability and that of the beneficiary. It is noted that the operation of the discount denial provisions did not come under scrutiny in either *Martin* or *Greensill*. That was probably great relief for both judges. When one adds in the potential to apply the small business CGT concessions, the issues become even murkier. These are issues which require amplification in a separate and lengthy article.

Since writing and presenting this article, the Full Court has handed down its decision in the *Martin* and *Greensill* appeals.[3] Senior Counsel in the matters threw every possible argument at the court and the court batted them away. The joust is interesting to read but, ultimately, the court agreed with the construction placed on the provisions by Thawley J at first instance. The capital gain included in the beneficiary's assessable income is an arithmetic function deemed to be a capital gain by Subdiv 115-C and is not a capital gain "from a CGT event" for the purposes of s 855-10(1).

Foreign-source income

Both the *Greensill* and *Martin* decisions deal with capital gains which have a source in Australia. The Commissioner has issued TD 2019/D7 which considers the outcome where the beneficiary is a foreign resident and the capital gain has nothing to do with Australia, apart from passing through a non-fixed trust which is a resident of Australia. The Commissioner's position is that the capital gain which is included in the beneficiary's assessable income has no source attributes. It is said that the amount which s 115-215(3) ITAA97 includes in the foreign resident beneficiary's assessable income is devoid of any character and is purely an arithmetic function.

The first paragraph of TD 2019/D7 not only sets the scene, *it is* the scene:

> "The source concept in Division 6 of Part III of the *Income Tax Assessment Act 1936* … is not relevant in determining whether an amount of trust capital gain is assessable to the non-resident beneficiary or trustee."

This is to be compared to that part of the net income of a resident trustee of a resident trust which has a source outside of Australia. Where a share of that net income is appropriated to a non-resident beneficiary, s 98(2A) and (3) together operate to exclude the income with a non-Australian source. The same result applies to the trustee's otherwise tax liability.

The theory is that a capital gain derived from a non-Australian source is excluded from the operation of ss 97 and 98 ITAA36 by Div 6E of that same legislation, with the result that a capital gain is left to be dealt with entirely under Subdiv 115-C and s 98(3). In the Commissioner's view, there is no source rule for capital gains and, as a consequence, capital gains derived from anywhere in the world are subject to Australian tax where they pass through an Australian resident trust.

This can have very unexpected results (see hereunder the consideration of a deceased estate with one resident executor/trustee). Likewise, where a corporate trustee of a discretionary trust is to be treated as a resident of Australia because its Board meets occasionally in Australia following the High Court's decision in *Bywater Investments Ltd v FCT*.[4]

Depending on the outcome of the appeals in *Greensill* and *Martin*, the Commissioner is probably technically correct if those decisions are upheld. It would seem to be a strange outcome that income derived from offshore effort and income which is the fruit of investment decisions which have nothing to do with Australia are not taxable but a capital gain is. Should it be so? Is it an example of an unintended consequence foreshadowed when the then Assistant Treasurer, Mr Bill Shorten, introduced the 2011 streaming amendments (the *Tax Laws Amendment (2011 Measures No. 5) Act 2011*) and observed, in the second reading speech, that:

> "The government is aware that due to the short timeframe involved in developing these amendments, there may be scope for unintended consequences. The operation of these amendments will therefore be closely monitored and if unintended consequences are identified, the government will act to remedy these consequences retrospectively where appropriate."

The amendments were introduced in haste to ensure coverage for the 2011 income year. Nowhere in the materials supporting the legislation was it revealed that there was an intention to change the law so markedly.

It is notable that, in both TD 2019/D6 and TD 2019/D7, it is observed that the determinations do not deal with the application of double taxation agreements and the operation of their tie-breaker provisions. The priority of the appropriate taxing jurisdiction will impact on the Commissioner's position.

As mentioned above, the decision on the appeals in *Martin* and *Greensill* have been handed down and found in favour of the Commissioner. In the context of foreign-sourced capital gains, the decision, although not concerning such gains, demonstrated some support for the Commissioner's positions as expressed in TD 2019/D7. It was observed that:[5]

> "Finally, the thesis that Parliament never intended that a foreign beneficiary be brought to tax on non-Australian gains does not warrant a construction of the provisions of sub-div 115-C other than on its terms. It was submitted that it would be extraordinary that Parliament intended sub-div 115-C, as amended now, to apply to tax the foreign resident on non-Australian capital gains 'without Parliament having mentioned it specifically'. The short answer to this contention, is that Parliament introduced a new scheme for the taxation of capital gains made by a trust estate to enable streaming of capital gains and did so by taking the taxation of such capital gains out of div 6 completely. That change was significant in that sub-div 115-C now operates exclusively in respect of allocating the tax liability on capital gains of a trust estate and sub-div 115-C is to be construed and applied according to its terms, not by reference to the statutory scheme, which the 2011 amendments replaced."

Whether such an issue will come before the courts is an unknown.

Trust resident of Australia?

Section 95(2) ITAA36 provides:

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

There is a definition of "resident trust for CGT purposes" in s 995-1 ITAA97 as follows:

> "a trust is a ***resident trust for CGT purposes*** for an income year if, at any time during the income year:
>
> (a) for a trust that is not a unit trust, a trustee is an Australian resident or the central management and control of the trust is in Australia; or
>
> (b) for a unit trust, one of the requirements in column 2 and one of the requirements in column 3 of this table are satisfied.

Requirements for unit trust		
Item	**One of these requirements is satisfied**	**And also one of these**
1	Any property of the trust is situated in Australia	The central management and control of the trust is in Australia
2	The trust carries on a business in Australia	Australian residents held more than 50% of the beneficial interests in the income of property of the trust"

So far as a non-unit trust is concerned, a single Australian resident at any time acting as a trustee will bring the trust within the residency rules and cause capital gains on assets which have no connection with Australia to fall within the Australian tax system.

Consider the application of these concepts to a deceased estate of a high net wealth individual who has no connection whatsoever with Australia, with the exception that one of his children lives in Australia and is nominated as one of two executors and trustees of the estate. Because of that beneficiary's residence in Australia, based on the concepts arising in *Greensill* and *Martin,* any capital gain arising on disposal by the executors of non-Australian assets (which they all are) will be included in the s 99 assessment of the executors. If the estate is administered without disposing of any of the assets, those assets which pass to the resident beneficiary will be subject to the normal inheritance rules in Div 128 ITAA97.[6] The difference is that the *Greensill* and *Martin* approaches bring in the entirety of the capital gain on the sale by the executors, not only that proportion which relates to the Australian resident beneficiary.

What can be done about this to achieve a fair result. What if the trustee moves offshore?

The trust will become a non-resident trust and CGT event I2 will be taken to have happened (s 104-170 ITAA97). All of the CGT assets (apart from taxable Australian property and pre-CGT assets) will be taken to have been disposed of at their market value. The executors have a very significant capital gains tax liability but no cash flow to pay it. Of course, if the estate is also a resident of another jurisdiction with which Australia has a double taxation agreement, the tie-breaker rules may apply to any otherwise taxable capital gain.

Can the executor stand aside and will this cause the estate to be treated as a non-resident trust? Under Australian state/territory laws, a person nominated in the will can renounce their role before a grant of probate is granted, provided they have not intermeddled in the affairs of the estate. However, in the circumstances posited, the law relating to the administration of the estate is unlikely to be Australian law. The law which applies to a will and its administration is usually determined by reference to the domicile of the deceased. The position of an executor so far as they renounce their role as an executor of a foreign estate will be determined by the law of the domicile of the deceased.

If the foreign law operated like that in Australia, it is likely that the individual named in the will would not be regarded as an executor from the outset and the estate would not be an Australian resident trust for taxation purposes. There is no case law or guidance on this topic that the author has been able to find.

A recent personal experience of the author's was with the estate of a wealthy Indian individual where there were two Australian residents among five executors, but no Australian assets. The issue was overcome by appointing an Indian company as the executor in which the executors held shares and were the directors. Although this may have been problematic in Australia,[7] the advice from Indian lawyers was that there was not an issue in their jurisdiction. Given that there were more non-Australian resident directors than there were resident directors, it is unlikely that the central management and control of the corporate trustee and the trust was in Australia.[8]

Trust vesting and TR 2018/6

The capital gains consequences arising on the vesting of a trust have posed vexing issues for years. In many respects, the binding nature of TR 2018/6 has relieved us of most of those concerns. However, there are still outlying issues not resolved by the ruling.

First, there is a need to look at the CGT provisions which are relevant. The E events deal with trust gains, and CGT event E5 is the most relevant in the present context (s 104-75 ITAA97):

> "(1) ***CGT event E5*** happens if a beneficiary becomes absolutely entitled to a CGT asset of a trust (except a unit trust or a trust to which Division 128 applies) as against the trustee (disregarding any legal disability the beneficiary is under) …
>
> (2) The time of the event is when the beneficiary becomes absolutely entitled to the asset.
>
> Trustee makes a capital gain or loss
>
> (3) The trustee makes a ***capital gain*** if the market value of the asset (at the time of the event) is *more* than its cost base. The trustee makes a ***capital loss*** if that market value is *less* than the asset's reduced cost base.
>
> (4) A capital gain or capital loss the trustee makes is disregarded if it acquired the asset before 20 September 1985 …
>
> Beneficiary makes a capital gain or loss
>
> (5) The beneficiary makes a ***capital gain*** if the market value of the asset (at the time of the event) is *more* than the cost base of the beneficiary's interest in the trust capital to the extent it relates to the asset.
>
> The beneficiary makes a ***capital loss*** if that market value is *less* than the reduced cost base of that beneficiary's interest in the trust capital to the extent it relates to the asset.
>
> Exceptions for beneficiary
>
> (6) A capital gain or capital loss the beneficiary makes is disregarded if:
>
> (a) the beneficiary acquired the CGT asset that is the interest (except by way of assignment from another entity) for no consideration; or
>
> (b) the beneficiary acquired it before 20 September 1985; or
>
> (c) all or part of the capital gain or capital loss the trustee makes from the CGT event is disregarded under Subdivision 118-B (about main residence)."

The important aspect of CGT event E5 is that it requires the beneficiary to be absolutely entitled to a trust asset as against the trustee.

The Commissioner's description of what happens on vesting is expressed in TR 2018/6:

> "13. The vesting of beneficial interests in a trust, even if described as a 'Termination Date', does **not** ordinarily cause the trust to come to an end, nor cause a new trust to arise. Vesting does not mean trust property must be transferred to the takers on vesting on the vesting date, or that the trust must be wound up either immediately or within a reasonable period (although the deed may require these events to occur after vesting).
>
> 14. Further, where a trustee continues to hold property for takers on vesting, the property is held on the same trust as existed pre-vesting; albeit the nature of the trust relationship changes."

In an attachment to the ruling, the Commissioner set out an opinion that he had received from two senior counsel, Dominic O'Sullivan, QC, and Michael O'Meara (now SC). They summed up the situation rather pithily in this paragraph:

> "What has occurred is a change in the relationship between trustee and beneficiary that was anticipated by, and occurred in accordance with, the terms of the trust."

The Commissioner has struggled for many years with the notion of "absolute entitlement". His attempt to reach a conclusion about what was meant by the term is set out in TR 2004/D25. This is the oldest draft ruling in existence. It was issued in December 2004. The author spoke about it at the Trust Intensive in October 2005.[9] Nothing has changed about it since the original draft. TR 2018/6 ignores the draft ruling simply because the conclusion is reached that the trust continues on the vesting date so it is not possible for an absolute entitlement to its assets to arise.

The law has moved on since the Commissioner first explored the absolute entitlement issue. In particular, the trustee's right of exoneration from trust assets has become more firmly entrenched by a line of recent decisions, particularly that of the High Court in *Re Amerind*.[10] It can only be when the trustee's right to exoneration is fully satisfied or a trust asset is detached from the trust and there are no lingering claims against it that the beneficiary can be said to be absolutely entitled. The latter situation is demonstrated in *Greensill*.

Greensill is, in part, a CGT event E5 case. The last parcel of shares was distributed by the trustee in specie and CGT event E5 applied to the capital gain on that parcel. Ultimately, it made no difference to the court's reasoning.

Thawley J observed:[11]

> "[73] As noted earlier, 'CGT event E5 happens if a beneficiary becomes absolutely entitled to a CGT asset of a trust … as against the trustee': s 104-75(1). In *Kafataris v Deputy Commissioner of Taxation* [2008] FCA 1454 … at [61], Lindgren J concluded that the words 'absolutely entitled to the asset as against the trustee', when used in s 104-55(5) and s 104-60(5), were 'intended to describe a situation in which the beneficiary of a trust has a vested, indefeasible and absolute entitlement in trust property and is entitled to require the trustee to deal with the trust property as the beneficiary directs'.
>
> 74. The parties agreed that, on 5 April 2017, PGFC transferred in specie 54,444 B class shares in GCPL to Mr Greensill in satisfaction of Mr Greensill's absolute entitlement to those shares.
>
> 75. Under s 104-75(5), the Mr Greensill made a capital gain. That capital gain is 'from a CGT event' and is disregarded under s 855-10. The applicant's capital gain is the amount by which the market value of the asset is more than the cost base of the beneficiary's interest in the trust capital to the extent it relates to the asset.
>
> 76. Under s 104-75(3), the trustee also made a capital gain. The trustee's capital gain is the amount by which the market value of the asset is more than its cost base. The trustee's capital gain under s 104-75(3) is dealt with under Subdiv 115-C. Under s 115-215(3), the beneficiary is deemed to have a capital gain, or the capital gain is attributed to him, but that is not 'from a CGT event', albeit it is attributable to a CGT event. Section 855-10 does not apply to that capital gain. Under s 115-220(2), the amount by which the trustee is liable to be assessed under s 98 is increased."

Two comments can be made about these observations. The creation of an absolute entitlement was a two-step process; as suggested in para 73 above, the trustee exercised a power to appropriate capital of the trust by way of its decision to distribute the shares in specie and that was followed by the transfer of the shares in satisfaction of that entitlement to capital. This would have more properly caused CGT event E7 to happen. CGT event E7 happens if the trustee disposes of a CGT asset of the trust in satisfaction of the beneficiary's interest in trust capital. Ultimately, in the context of the decision, it makes no difference whether it is CGT event E5 or CGT event E7.

Exactly how CGT event E7 works in a two-step process is somewhat mysterious because s 106-50 ITAA97 treats the asset as belonging to the beneficiary as soon as the absolute entitlement to the asset arises. In the two-step process, that absolute entitlement arises as soon as the trustee determines to appropriate the particular assets in specie to the beneficiary.

The second point is that, in para 75, it is observed that the capital gain arising under s 104-75(5) is disregarded because of the operation of s 855-10 in Div 855. That would be correct, but there was no capital gain to disregard because s 104-75(6)(a) had already caused it to be disregarded — the capital gain of the beneficiary is disregarded if the beneficiary had acquired the CGT asset that is the interest for no expenditure. Again, this has no impact on the outcome at first instance because the capital gain which was in focus is the capital gain of the trustee attributed to the beneficiary by s 115-215(3).

An important aspect of the vesting ruling which requires consideration is that part which relates to extending the vesting date of a trust. There is often nervousness among practitioners about extending the vesting date and whether or not it will be a resettlement of the trust and trigger CGT event E1 — you create a trust over a CGT asset by declaration or settlement.

Paragraph 10 of TR 2018/6 makes the uncontroversial observation that:

> "CGT event E1 does not happen by amending the vesting date through the valid exercise of a power in a trust deed or on approval of a relevant court."

The usual case is an amendment to extend an earlier vesting date. Older trust deeds often have a date which is much earlier than the operative royal lives clause. This is an extract taken from and existing trust deed that the author caused to be amended by striking out para (i) of the definition of "distribution date":

> "Distribution Date" means the first to occur of the following three dates:
>
> (i) Fifty (50) years from the date hereof;
>
> (ii) The date twenty-one (21) years after the death of the last survivor of the lineal descendants of his late Majesty King George VI living at the date hereof;
>
> (iii) The date (if any) which the Trustee in its discretion shall by deed or in writing or by oral declaration appoint as the Distribution Date."

The amendment clause limited the power of amendment so that it could not be extended beyond the latest date provided in the deed. Immediately, there is a consideration of whether the amendment is a "valid exercise of the power in a trust deed". The author considered it was. More difficult issues arise when the amendment clause itself needs to be amended to allow the desired extension to be made or an amendment appears to be in conflict with an existing prohibition. *Balcaskie Investments Pty Ltd v Chief Commissioner of State Revenue*[12] is one case which demonstrates that an amendment apparently in conflict with the amending power will attract attention. This is a case which involved s 54(3) of the *Duties Act 1997* (NSW) where concessional duty of $50.00 is charged on the replacement of a trustee provided the new or additional trustee cannot be a beneficiary. The amendment power prohibited the exclusion of beneficiaries:

> "… nothing in this clause … or any other provision of this Deed shall prevent the Trustee from changing the persons or legal entities who are within the definition of 'Beneficiary' or 'Beneficiaries' pursuant to this Deed."

The trustee amended the deed by prohibiting the original and any new trustee from being a beneficiary. The Chief Commissioner argued that this could not be done and sought to impose ad valorem duty on the deed changing the trustee. The NSW Civil and Administrative Tribunal found for the taxpayer on the basis that the prohibition in the amending power was overridden by the amendment. It was an unexpected victory for the taxpayer.

Another aspect of the ruling is that the Commissioner takes a firm view in para 8 of TR 2018/6 that a vesting period cannot be extended once the original date has passed. It is difficult to contest that conclusion.

Where appointments of income or capital are made by the trustee that are inconsistent with the fixed interests that arise on the vesting date (for example, by continuing to exercise the trustee's apparent discretion), the Commissioner's view is that the appropriations are ineffective — they are said to be void as the capital default beneficiaries are entitled to them. The opinion scripted by senior counsel addresses in detail the case for this view. One matter that is not mentioned is the four-year time limit imposed on the Commissioner to recover income tax from the capital default beneficiaries.

Trust splitting and TD 2019/14

Trust splitting is a family succession tool allowing the controllers of a family discretionary trust to pass on control of trust assets to different members of the family group — very often used in the context of children from blended families. These situations are dynamite where members of the blended family feel that they are excluded from the control of family assets and will often trigger expensive claims under the family provision legislation in Ch 3 of the *Succession Act 2006* (NSW). The threat from an income tax perspective is that the Commissioner will treat the changes necessary to effect an asset split as causing a CGT event E1 "new" trust to happen.

In a sense, the Commissioner must be commended for demonstrating some flexibility in TD 2019/14. The determination is a little unusual as it proceeds to bind the Commissioner by simply comparing two case studies, one a bad split and the other a good split. The remaining eight pages are non-binding justification for the position taken. The real contest is to work out how far one can travel from the good split facts before becoming a bad split. The "explanation" content is not very helpful in that regard because, in summation, the explanation is that a split is axiomatically a new trust regime but, of course, the binding bit says "not always".

It is best to advance this topic on the basis of describing the good split. Example 2 is the good split. It is presented in the context of proper and appropriate succession planning but it is difficult to say how important that factor is. Dad in the good split is 71 and planning for retirement. Would it make a difference if the trust were a joint venture between two young IT entrepreneurial types and not a family trust at all? Probably, but who can say for certain.

All of the family members in example 2 are the directors of the corporate trustee of a discretionary trust (albeit Dad is the appointor) which has two different business activities, property development and the operation of retirement villages. One child (Laura) is said to be taking greater responsibility for the property development business.

The following things are done when amending the trust deed to facilitate the split:

- allow for the appointment of additional trustees in respect of some of the trust assets;
- allow for separate appointors in respect of different parts of the trust fund;
- each trustee must take into account losses incurred by other parts of the trust fund and expenses of the trust as a whole when making a determination to distribute the net income of the trust; and
- all trustees are required to act together on decisions which one trustee reasonably believes require the agreement of all trustees. These include but are not limited to:
  - selecting an accountant for preparation of the trust tax return;
  - incurring joint expenses;
  - amending the trust deed;
  - determining an earlier vesting date for the trust; and
  - giving each trustee recourse to all of the assets where the assets held by a particular trustee are insufficient to fully satisfy its right to be indemnified.

This list can be interpreted as an incomplete list of the things that the Commissioner will expect to see in a good split.

The example continues:

- a new trustee is appointed as trustee of the property development assets and the existing trustee removed from control of those assets;
- Laura and her father are the directors of the new trustee;
- Laura is appointed as the exclusive appointor of the trustee of the property development assets trustee;
- both parts of the trust continue to be governed by the original deed as amended;
- the range of beneficiaries is unaltered; and
- each trustee keeps separate accounts but these are consolidated for the entire trust fund and a single tax return prepared for the trust as a whole.

The Commissioner's conclusion about this arrangement, in para 23 of TD 2019/14, is that:

> "Considering all the elements of the arrangement, it cannot be concluded that the assets transferred to Rainbow have been subjected to new personal obligations and new rights annexed to that property. The Kingdom Family Trust continues as one trust, albeit with the two trustees, each separate trustee assuming primary responsibility in respect of a specified portion of the trust fund. The preconditions to subsection 104-55(1) are not satisfied and implementation of the arrangement does not cause CGT event E1 to happen."

What are the essential differences between the facts in example 2 and example 1?

The important differences are:

- all of the trust assets are available to satisfy claims against either trustee;
- there is a consolidated set of financial accounts;
- there is one income tax return;
- there is no exclusion of beneficiaries from potentially benefiting from the trustee's exercise of discretion; and
- trustee decisions about distribution of trust net income must take account of losses and expenses of the trust as a whole.

The extracts from the decision in *Aussiegolfa Pty Ltd (Trustee) v FCT*[13] are probably the most useful in assisting a technical analysis. The decision in *Dyda Pty Ltd v Commissioner of State Taxation (SA)*[14] less so as the courts have frequently warned us about taking decisions from other areas of the law and grafting them onto the dispute environment. *Dyda* concerned the South Australian stamp duties legislation. The Commissioner, at para 28 of TD 2019/14, accepts that there is no case law dealing directly with trust splits. The cases he refers to are only tangentially relevant as they provide some support for the notions he has put forward.

Aussiegolfa was about sub-trusts in a superannuation fund context and whether the trustee had invested in a related trust of the fund. Probably, the most precise but unhelpful observation is made by Steward J:

> "[206] … finally, the question as to whether a given sub-fund is a separate trust turns upon a close analysis of the terms governing that sub-fund. Those terms will reveal the intentions of the parties. Each case will, as Edmonds J has emphasised, need to be judged on its particular facts."

TD 2019/14 ultimately suffers from the problem of distinguishing between the relevant and irrelevant facts set out in the two examples. Really, all we can distil from the determination is that some features will be essential to remain in the Commissioner's good books. They are pretty obvious:

- the trustee must make certain decisions jointly — most importantly, the decision to distribute;
- the combined trust income, and not the net income, must be calculated by reference to the receipts and expenses and losses of the particular division of the trust;
- the separate recordings of profit and loss of the particular divisions must be consolidated;
- one tax return only is to be lodged. Nothing is said about BAS and FBT but it can be inferred that there is only one registration; and

– overall the arrangements must operate like sub-trusts of the one trust.

As an aside, the content of the compendium summary of issues raised and responses given makes for interesting reading. Clearly, the practitioners involved in the consultative process were less than satisfied with the outcome set out in the determination: see TD 2019/14EC.

It is unlikely that any sensible adviser or client would now take the risk of effecting a trust split without first obtaining a private ruling. It would be too easy to stray beyond the good split example and end up with an audit argument that it is a bad split. Surprisingly, there is no abstracted private ruling on trust splitting in the context of TD 2019/14 on the Commissioner's private ruling database. There is one only such ruling, PBR 1051421869428, which was published in August 2018 and that was before the determination was issued, However, it is clear that it was issued with the principles in TD 2019/14 in mind. There must have been collaboration between the Commissioner's officers and the draftsman of the amending deed which was the subject of the private ruling as it practically follows the later published determination.

The factual scenario replicates that in example 2 in TD 2019/14 in that the trust deed is to be amended in a way that is virtually the same as that described in example 2. The private ruling abstract provides a much better guide to putting the determination into practice than the determination itself.

It is worthwhile setting out the proposed amendments to the trust deed in full as they provide something akin to a template:

"18. It is proposed that a Deed of Amendment for the Family Trust be executed to:

a. insert clause 4A to provide that in making a determination about how to distribute the net income of the trust fund for a particular accounting period, each Trustee of any part/s of the trust fund must:
   i. take into account the losses incurred by the other part of the trust fund
   ii. ensure that the Trustee's proportion of shared expenses of the whole trust fund are paid or accounted for, and
   iii. not distribute an amount that exceeds the total net income of the relevant part less losses incurred by each other part of the trust fund.
b. make clause 9, which requires the Trustees, if more than one, to act jointly and delegate any power or discretion in writing, subject to new clause 9A
c. insert clause 9A, which will state:

While the Trust Fund will still exist as one fund, any Trustee appointed as trustee for a separate part of the Trust Fund may act severally for that part of the Trust Fund held on trust by the Trustee, provided that for:

a. any actions specified in the Second Schedule to this Trust Deed the prior written consent of all separate Trustees must be obtained; and
b. matters which one Trustee reasonably considers that the agreement of all Trustees is required, but not limited to:
   i. selecting an accountant for preparation of the tax return for the Trust;
   ii. incurring joint expenses of the Trust;
   iii. amending this Deed;
   iv. determining an earlier Vesting Date for the Trust,

all separate Trustees must act together.

d. insert clause 9B to require each Trustee to at all times act reasonably and use its best endeavours to do all things reasonably necessary to allow the other Trustee to fully act as Trustee for its relevant part of the trust fund
e. insert clause 16(1)(d) to broadly enable the Appointor to appoint additional trustees to any part of parts of the Trust Fund
f. delete and replace existing clause 16(7) with the following:

Any Appointor:

a. may, subject to any conditions of the Appointor's appointment, by writing in the form of a deed appoint one or more persons to be an additional Appointor; and
b. resigning or renouncing under clause 16(2) may be writing in the form of a deed appoint one or more persons to replace the Appointor as an appointor,

subject to any conditions not inconsistent with this Trust Deed the Appointor deems prudent.

g. insert clause 27, which states:

   If at any time Trustees are appointed to separate portions of the Trust Fund the funds to satisfy any right of indemnity the Trustee seeks to rely on must first be drawn from the portion of the Trust Fund controlled by the Trustee claiming the benefit of the right of indemnity.
h. insert a Second Schedule which requires that the matters requiring Trustees' consent are:
   i. incurring debt of over a specified, but as yet not identified, amount
   ii. granting security over any assets of the Trust, and
   iii. carrying on an active business.

19. You explain that new clause 4A is intended to allow each Trustee to deal with the net income of their respective asset pool but in doing so, must have regard to joint expenses of the trust and any losses.

Proposed Deed of Appointment of Additional Trustee

20. The proposed Deed of Appointment of Additional Trustee appoints Potato as additional trustee and removes Veggie as trustee for following assets:

a. all ordinary units currently held by Veggie in the Agriculture Investments Trust, and
b. all 7,800 ordinary units held by Veggie in the Fruit and Veggie Trust.

21. Sam and Ben Apple are the directors and shareholders of Potato.

22. Clause 6 of the proposed Deed of Appointment of Additional Trustee provides as follows:

The Additional Trustee undertakes that the Obligations will be paid:

a. firstly by the Additional Trustee with funds drawn from the portion of the Trust Fund controlled by the Additional Trustee; and
b. by the Current Trustee only to the extent that the portion of the Trust Fund controlled by the Additional Trustee is insufficient to satisfy the Obligations.

23. The Obligations are listed in the Schedule as follows:

a. Unpaid distributions owing to Pear Pty Ltd ABN XX XXX of $X that arose prior to 16 December 2009.

> Proposed Deed of Appointment of Additional Appointer
>
> 24. The proposed Deed of Appointment of Additional Appointer is executed by William Apple in his capacity of appointer of the Family trust. In this deed he appoints Sam Apple as an Additional Appointer in respect to the appointment of Potato (or any successor to Potato) and declares that he will only remain the appointer of the trust in respect of assets held by Veggie (or any successor to Veggie).
>
> Operation of the Family Trust after changes
>
> 25. You state that the proposed arrangement will only impact the administration of the Family Trust to '…facilitate orderly succession planning and future management by Sam and Paul for the continued benefit of the family as a whole.'
>
> 26. You further state that there is no desire to limit the potential beneficiaries who could benefit from the income or capital of the Trust, nor is there any intention to amend the definition of beneficiary.
>
> 27. You state that subsequent to the amendments, it is intended that each Trustee will be the sole Trustee over their respective asset pool. You state that each Trustee will be empowered to exercise their rights and discretions in respect of their asset pool under the Deed of Settlement. However, you claim that as there is only one Trust, the Trustees will need to come together for particular purposes to allow for the proper administration of the Trust. Consistent with this, you state that one set of accounts will be kept for the trust and one joint tax return will be prepared for the single trust. You also confirmed that this means that the taxation of trust income will be calculated on the basis of their being the one trust."

There are some aspects of this private ruling which give some guidance about acceptable deviations from TD 2019/14, notably:

- proposed cl 22(a) makes it clear that the trustee of each part of the trust draws first from assets under its control to satisfy that trustee's right to be indemnified against liabilities it has incurred in administering its part of the trust. This is a way of expressing the requirement in the determination that each trustee has "recourse to all of the trust assets where the assets held by that trustee are insufficient to satisfy its right to be indemnified";
- while it is a succession planning tool, the parents do not have to continue to be involved in the ongoing control of both parts of the trust fund;
- the trustees of the separate parts of the fund may act independently in relation to the assets that they control, subject to the express requirements where they must act jointly;
- in this case, the requirements of joint action include some that are spelled out in TD 2019/14 but others which are not. Those which are required by the determination are:
  - selecting an accountant;
  - incurring joint expenses;
  - amending the deed; and
  - determining an earlier vesting date.

Those which are not are:

- incurring debt over (meaning in excess of) a specified amount;
- granting security over any assets of the trust; and
- carrying on an active business.

These are probably sensible modifications but appear not to be required to satisfy TD 2019/14.

The amendments to each and every deed will require bespoke consideration. There can be no template amendment of the deed. From a succession planning perspective, there should always be a way out if the family members do not behave in a way that the initial family controllers consider appropriate. What is to happen if one of the chosen successors does not live up to expectations? What is the significance of the split in a family law or a family provision challenge? These issues arise frequently and the initial controllers will want to understand how the split process works in the face of those potential challenges. These issues are beyond the scope of this article but it must be kept in mind that the Commissioner's approach to a trust split must exist in the real legal world.

Land tax amendment wild card

As most practitioners will know, there is and has been a requirement that non-fixed trust deeds holding residential land in New South Wales must be amended to irrevocably exclude "foreign persons" otherwise there is a surcharge relating to acquisitions of property by the trustee (2%) and an ongoing land tax surcharge (7%).

A foreign person is defined in the *Duties Act 1997* (NSW) as a person who is a foreign person within the meaning of the *Foreign Acquisitions and Takeovers Act 1975* (Cth) as modified by the Duties Act. It is not necessary to dwell on this definition and the discussion can move on to the impact on discretionary trusts. The trustee of a discretionary trust is taken to be a foreign person unless no potential beneficiary of the trust is a foreign person (see s 104JA of the *Duties Act 1997*). Trust deeds have been amended to ensure that a foreign person or a foreign trustee cannot benefit under the trust with the result that the duty and land tax surcharges can be avoided.

Any trust distribution by the trustee of a trust which has excluded a foreign person and/or foreign trust must be carefully considered to ensure that the potential trust beneficiary is not a foreign trustee. If it were, the appropriation would be ineffective and the default clause in the deed may operate to send the income entitlement to the default beneficiaries. Where there are chains of trusts, each trust in the chain may have excluded foreign trustee/beneficiaries.

Where a beneficiary is a non-resident of Australia but remains a citizen, that beneficiary is not a foreign person. However, an offshore trust controlled by that beneficiary still must exclude foreign persons before a distribution can be safely made to that trust. What if the beneficiary's spouse is a foreign person? They would be excluded as a beneficiary of the offshore trust if the trustee of the recipient trust were to be excluded as a foreign trustee.

It also must be remembered that these rules apply to testamentary trusts arising out of wills or codicils executed after 31 December 2021.

The rules concerning stamp duty and land tax surcharges vary from state to state or territory. If a trust invests in property in a state/territory other than NSW, the outcome may be quite different. For example, while the impact in NSW is limited to residential property, Tasmania also imposes a surcharge on primary production land. However, this is not a topic about stamp duty or land tax as such but, rather, a reminder that the beneficiaries to whom a distribution is to be made must be carefully considered before the distribution decision is put into effect where the distributing trust has been forced to exclude a foreign person.

The foreign person amendments also need to be carefully considered in a succession planning context. It is best to provide a current day example. Mr and Mrs P control a family discretionary trust that owns an apartment in Vaucluse. Mrs P migrated to Australia in 1970 and there is only the one child of her marriage to Mr P. That child is now over 50 and not in the best of health. She has no children. Mr and Mrs P do not have any other relatives who are residents or citizens of Australia. Mrs P has a large family but they are all non-residents and non-citizens of Australia. If the daughter survives her parents, she will inherit all of their assets, including control of the trust that owns the Vaucluse apartment. If she does not survive them, the secondary beneficiaries are all non-resident non-citizens. They have been excluded as beneficiaries because the trust irrevocably excluded foreign persons and foreign trustees. What to do?

In this topic, the matter of trust deed amendments to ensure that a trust is a fixed trust for Duties Act purposes has so far not been mentioned. It raises very different issues than the foreign trustee point. In order for a unit trust to qualify as a fixed trust so that the special trust rules do not apply to eliminate the land tax threshold for the trust, the "relevant criteria" described in s 3A of the *Land Tax Management Act 1956* (NSW) must be satisfied.

The relevant criteria are that the trust deed specifically provides that the beneficiaries of the trust:

> "(i) are presently entitled to the income of the trust, subject only to payment of proper expenses by and of the trustee relating to the administration of the trust, and
>
> (ii) are presently entitled to the capital of the trust, and may require the trustee to wind up the trust and distribute the trust property or the net proceeds of the trust property."

Paragraph (b) of that provision goes on to require the amendments to be made irrevocably:

> "(b) the entitlements referred to in paragraph (a) cannot be removed, restricted or otherwise affected by the exercise of any discretion, or by a failure to exercise any discretion, conferred on a person by the trust deed."

These amendments will, at some time in the future, turn up for consideration in an income tax context and it may be that they will change the approach of the courts or the Commissioner to, for example, what is an absolute entitlement or a specific entitlement to a capital gain in the context of s 115-228 ITAA97. This is all, of course, speculation but mass changes to deeds for land tax purposes are bound to have wider income tax ramifications.

Circular trust resolutions and Div 6D

This is an aide-mémoire about Div 6D ITAA36 compliance rather than an in-depth consideration of those provisions. The legislation is near impenetrable but compliance is relatively straightforward. The best guide is the *Trust tax return instructions*[15] (see, in particular, Appendix 11).

Division 6D only applies where a closely held trust which is not an excluded trust makes a distribution to a trust (whether a discretionary or unit trust). Where there is a trust distribution made by a closely held trust to another trust, there is a requirement to make a trustee beneficiary (TB) statement. A TB statement is made if the information required under item 56 in the income tax return of the trust is accurately completed.

The blocks on the return require, in respect of each trustee beneficiary, whether a TB statement is required to be made and, for each such trustee beneficiary, their share of:

- the tax-preferred amount;
- the untaxed part of the share of net income.

A tax-preferred amount is an amount of trust income of the trust that is not included in the assessable income of the trust when working out its net income or an amount of trust capital.

An untaxed part of a share of net income is the trustee beneficiary's share of the net income of a closely held trust less any part that has been taxed under:

- s 98(4) ITAA36, where a trust is required to pay tax on a non-resident trustee beneficiary's share of trust income or capital gains;
- Subdiv 12-H in Sch 1 to the *Taxation Administration Act 1953* (Cth) (concerning managed investment trust withholding tax); and
- Div 6D itself, where the trustee of another trust estate is liable to pay the non-disclosure tax (see s 102UM ITAA36).

A trustee of a "closely held trust" must make a TB report if it is not an excluded trust and it has tax-preferred income. A discretionary trust is a closely held trust. A fixed trust or unit trust is a closely held trust if there are up to 20 individuals who between them, directly or indirectly, and for their own benefit have fixed entitlements to a 75% or more share of the income of the trust or a 75% or more share of the capital of the trust. In this discussion, we will stick to a consideration of discretionary trusts.

Excluded trusts include complying superannuation funds and deceased estates for up to five years, but otherwise the exclusions are not particularly relevant in the present context.

Section 102UK(1)(ca) ITAA36 provides that a TB statement is not necessary if the closely held trust has, for Sch 2F ITAA36 purposes:

- made a family trust election;
- made an interposed entity election; or
- is wholly owned by the family members of a family group.

This exclusion for family connected entities only applies to the requirement to make a TB statement. The closely held trust is required to pay trustee beneficiary non-disclosure tax (TBNT) where the distribution to a trustee beneficiary is circular. By circular, it is meant that the original trust distribution, after having passed through one or more other trusts, arrives back at its trust source.

Trustee beneficiary non-disclosure tax is also payable where no TB statement has been made, where there is an obligation to make one, or where an incorrect TB statement has been made. The tax rate is 47%.

Directors of a corporate trustee which is liable for trustee beneficiary non-disclosure tax are also exposed to the tax liability (see s 102UK(2) and (3)). There are exceptions in s 102UL.

The objective of Div 6D is to force the trustee of a closely held trust to disclose what the trustee knows about a recipient trustee beneficiary to the Commissioner to enable the Commissioner to check whether the taxable distributions have been subjected to tax in the hands of the beneficiaries of the recipient trust. The obligation to make a TB statement flows down the line of resident trusts.

The provisions used to be ridiculously complex and were largely ignored. Amendments in 2007 and 2019 made the provisions more user-friendly, but only slightly so.

Conclusion

This article has traversed a great deal of complicated taxation law, from the murky depths of the interplay of the streaming "reforms" with international tax rules, to simply completing a trust income tax return compliant with Div 6D. Trusts play an important part in Australian commercial and family arrangements and are very unlikely to lose favour. There has, for a long time, been a pressing need to simplify the way in which tax laws as they apply to trusts operate, even to the extent that our clients may be able to understand the explanations we, as tax practitioners, offer them.

Ken Schurgott, CTA (Life)
Solicitor and Director
Schurgott & Co Lawyers

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Don't lose your losses

by Sarah Saville, Partner, and Roop Sangha, Manager, PwC

In tough economic times, it provides some (albeit small) comfort to know that any losses incurred by businesses can be used to offset income in other periods. However, with business restructures and changes of ownership, many companies and other entities will find themselves unable to claim the losses. Care needs to be taken when planning changes to businesses in order to ensure that the losses are maintained. This article considers how a business utilises losses, and, in particular, considers: the continuity of ownership test and the business continuity test rules; the interplay with the tax consolidation rules; the new loss carry back rules; and valid strategies to maintain and utilise losses.

Introduction

With the COVID-19 pandemic creating tough economic conditions for businesses, preserving and utilising your losses has never been more relevant, particularly as:

- businesses have generated losses due to forced shutdowns or a downturn in business;
- businesses have had to make operational changes to stay afloat, impacting the application of the business continuity test (BCT);
- some shareholders have had to sell out to support their liquidity; and
- capital injections and support from existing and new investors have been required to assist with cashflow issues, impacting the continuity of ownership test (COT) and/or losses with available fractions.

Care needs to be taken when planning changes to businesses or undertaking certain transactions, as these changes can directly impact the recoupment of an entity's tax losses.

The tax legislation that governs whether a company can utilise its carried-forward tax losses and offset them against future taxable income is extremely complex and frequently misinterpreted. For corporate groups, the overlay of the tax consolidation rules can create further complexity, and occasionally anomalous outcomes.

From an opportunity perspective, there have been a number of recent developments over the past couple of years which should also be taken into account when considering the recoupment of losses. These include the similar business test (SiBT) which aims to provide more flexibility when claiming tax losses than the same business test (SBT), the changes to the application of the COT for unequal share structures, and the introduction of the temporary loss carry back rules which are designed to provide temporary cashflow support to eligible companies as a response to the COVID-19 pandemic.

Notably, the Australian Taxation Office has also been focusing its attention on the generation, carry forward, transfer and utilisation of tax losses as part of its reviews, including the recent "Top 1,000 justified trust" reviews.[1] Accordingly, it is extremely important that these rules are considered and appropriate documentation is available to support conclusions made in respect of losses.

This article will:

- briefly recap the longstanding tax loss recoupment provisions (the COT and the SBT);
- provide an overview of the new SiBT, with relevant examples of how it can be applied to changes in businesses resulting from COVID-19;
- provide guidance on the interaction between the loss recoupment tests and the tax consolidation provisions;
- provide an overview of the loss carry back rules; and
- discuss some common strategies to maintain and utilise losses.

This article will focus on the application of the tax loss recoupment rules to companies (note that separate rules apply to trusts and other entities which are not the subject of this article). Furthermore, this article focuses on the carry forward and loss carry back provisions relating to revenue losses. It does not cover other tax loss provisions such as current year losses, unrealised losses, inter-entity loss duplication rules, bad debts etc.

Basic tax loss recoupment tests

Under s 165-10 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97), tax losses can be carried forward and utilised by a company to offset its future taxable income if the company satisfies either:

- the COT — which is failed if the company has undergone a majority change in ownership or control; or
- the BCT — which is failed unless the company continues to carry on the "same" business (and has not derived income from any new kinds of business or transactions) or "similar" business (for losses incurred after 1 July 2015).

These tests are explained further in the sections below.

Continuity of ownership test

The COT in s 165-12 ITAA97 requires the same one or more persons to beneficially own more than 50% of each of the voting power, dividend rights and capital rights in the company at all times from the beginning of the year in which the loss is incurred (the loss year) to the end of the income year in which the loss is to be utilised. This is known as the "ownership test period".

Ownership is required to be traced through interposed companies back to the ultimate natural persons in whom the underlying beneficial ownership rests.

Same share, same interest rule and saving provision

For the purposes of identifying and tracing the relevant shareholders and to ultimately establish the continuity of shareholding in a company, the "same share, same interest" rule in s 165-165 ITAA97 is also required to be satisfied, except for situations in which the "saving provision" in s 165-12(7) ITAA97 applies.

"Same share, same interest" rule. The "same share, same interest" rule is contained in s 165-165 ITAA97 which states that, when testing for continuity of ownership:

> "… at all relevant times:
>
> (c) the only shares in the company that are taken into account are *exactly the same shares and are held by the same persons*; and
>
> (d) the only interests in any other entity (including shares in another company) that are taken into account *are exactly the same interests and are beneficially owned by the same persons*." [emphasis added]

This rule effectively means that the ultimate individual shareholders must not have undertaken any restructuring of their share interests (even within a group of wholly owned entities which may be owned by the same individual) throughout the entire period from the start of the loss year to the end of the income year in which the losses are to be utilised.

While there are specific exceptions to the "same share, same interest" rule in relation to share splitting and share consolidations, the test can have significant practical implications for circumstances outside these situations.

It should be noted, however, that the "same share, same interest" rule is not applicable where the "saving provision" applies.

The "saving provision". The "saving provision" in s 165-12(7) ITAA97 treats the COT as being satisfied in certain instances and disregards the "same share, same interest" rule in s 165-165 ITAA97.

The saving provision applies so that the COT is taken to have been satisfied:

- if it would have been satisfied except for the "same share, same interest rule"; and
- the company has information from which it would be reasonable to conclude that less than 50% of the tax loss has been reflected in deductions, capital losses, or reduced assessable income that occurred or could occur in future because of the happening of any CGT event in relation to any direct or indirect equity interests in the company during the ownership test period.

The "saving provision" will apply in two broad situations:

1. where CGT events have not occurred in relation to the shares or interests held by direct and indirect owners of the company that have triggered a deduction, capital loss or reduced assessable income reflecting 50% or more of the tax loss; or
2. where more than 50% of the tax loss does not reflect a real economic loss, that is, it is attributable, for example, to over-depreciation. Consequently, the tax loss has not been reflected in the tax outcome of CGT events in respect of shares or indirect interests in the company.

The following examples highlight when the "saving provision" may or may not apply.

Example 1. Issue of new shares to existing investors

In the 2020 income year, a company (Loss Co) incurs a $1,000 tax loss. At the start of the "ownership test period" on 1 July 2019, the company has 100 ordinary shares on issue (ie Alex owns 90 shares and Brian owns 10 shares) and each share has the same rights in relation to voting power, dividend entitlements and rights to capital distributions. Therefore, at the start of the ownership test period, Alex and Brian collectively hold 100% of the shares on issue in the company and collectively have 100% of the voting, dividend and capital rights.

A total of 100 new ordinary shares are issued by the company during the 2021 income year. These are all issued at the same time. Of these new shares, Alex beneficially owns 90 and Brian beneficially owns 10. Therefore, the total shares on issue at 30 June 2021 is 200 ordinary shares beneficially held in the same original percentage of 90% held by Alex and 10% held by Brian.

Under the "same share, same interest rule", the effect of increasing the shares on issue from 100 to 200 shares is that the original shares beneficially owned by Alex only carry 45% of the voting power, rights to dividends and capital in the company (90/200 = 45%), and the original shares beneficially owned by Brian only carry 5% of the voting power, rights to dividends and capital in the company (10/200 = 5%). Accordingly, the COT is not satisfied because there is only 50% (45% + 5%) continuity of ownership.

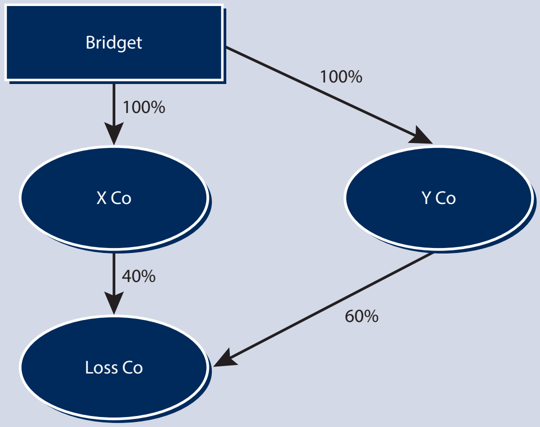
However, where the new shares are issued for market value (and therefore no CGT events relating to value shifting apply), there is no CGT event occurring in respect of the direct equity interests held in the loss company and therefore the COT would be satisfied disregarding the "same share, same interest". Accordingly, the losses generated in the 2020 year and utilised in the 2021 income year should be available due to the operation of the "saving provision".

Example 2. Transfer of existing shares from an Australian resident shareholder

In the 2020 income year, a company (Loss Co) incurs a $2,000 tax loss. At the start of the "ownership test period" on 1 July 2019, Bridget beneficially owns 100% of the shares in an interposed company (X Co) that in turn beneficially owns 100% of the shares in Loss Co.

Loss Co wishes to deduct the $2,000 tax loss in its 2021 income year. During the ownership test period, X Co disposes of 60% of its shares in Loss Co to Y Co, another interposed entity controlled and beneficially owned (100%) by Bridget. Y Co beneficially owns the 60% shareholding interest in Loss Co. X Co, Y Co and Loss Co are all Australian tax resident companies.

Example 2. (cont)



While at all times during the ownership test period, Bridget beneficially owned (as indirect equity interests through X Co and Y Co) 100% of the voting power, dividend rights and rights to capital distributions in the loss company, the "same share, same interest" rule would apply to cap Bridget's beneficial holding to the 40% that X Co holds in Loss Co at the time the loss is being recouped.

As the transfer of shares in Loss Co from X Co to Y Co would result in CGT event A1 occurring and more than 50% of the tax loss has been reflected in deductions, capital losses, or reduced assessable income that occurred or could occur in future, the "saving provision" will not apply to enable the COT to be satisfied.

For completeness, it should be noted that, where the CGT roll-over provisions apply and the capital gain or loss in relation to a CGT event is disregarded, the "saving provision" may still be able to apply.

Example 3. Non-resident company disposing of shares in an Australian resident company that is not land rich

Using the above example but assuming that X Co is a non-resident company and Loss Co is not land rich, then, where a non-resident company holds a direct or an indirect interest in an Australian resident loss company through an interposed non-resident company and disposes of that equity interest to another entity, the COT would ordinarily fail due to the operation of the "same share, same interest" rule.

However, in this scenario, the "saving provision" would apply as the non-resident company is disposing of an interest which is not taxable Australian property (TAP) and, in accordance with Div 855 ITAA97, there can be no resulting capital loss or reduced capital gain that would be recognised for Australian tax purposes.

The CGT exemption for non-residents may mean that there is some scope for internal reorganisations and restructures at the non-resident level without this causing a breach of the "same share, same interest" rule due to

Example 3. (cont)

the "saving provision". This outcome will very much depend on the nature and extent of the underlying assets in the Australian loss company and whether Div 855 applies to disregard a capital loss or capital gain from the disposal of the direct or indirect equity interests.

Division 166 concessional tracing rules

Division 166 ITAA97 contains various legislative concessions which are available to reduce the compliance burden of applying the general COT provisions. The concessions in Div 166 are available to entities which, at all times during the year of recoupment, are either:

- a "widely held company", being either:
  - a company with shares listed on an approved stock exchange (including the ASX); or
  - a company with more than 50 members (other than a company in which, during a particular income year, no more than 20 members held at least 75% of the value of the shares, 75% of the voting power, or 75% of the rights to dividends in the income year); or
- an eligible Div 166 company, being, broadly, a company that is more than 50% held by a widely held company.

Division 166 ITAA97 modifies the basic COT rules and provides the following concessions:

- the requirement to test ownership only at the end of each income year and at the end of certain corporate change events rather than continuously throughout the ownership test period; and
- removes the need to trace through to the ultimate individual shareholders and applies concessional tracing rules by attributing direct and indirect stakes to a "notional shareholder" instead.

Substantial continuity of ownership. Under s 166-5(3) ITAA97, a company is taken to meet the conditions of the COT if there is substantial continuity of ownership of the company at the following times:

- the start of the loss year;
- the end of each income year throughout the ownership test period; and
- the end of each corporate change event (broadly, any material change in the share capital of the, for example, a takeover bid for the shares, a scheme of arrangement involving more than 50% of the company's shares, or a share issue by the company that results in an increase of 20% or more in the issued share capital or number of shares in the company[2]) that occurred during the ownership test period.

This concession removes the need to demonstrate continuous ownership throughout the ownership test period and can often be of tremendous practical benefit to taxpayers seeking to apply the COT.

Notional shareholders. The second concession afforded by Div 166 ITAA97 allows the aggregation of certain shareholders into "notional shareholder(s)" for the purposes of applying the COT tracing rules. That is, where there is a notional shareholder as provided by Div 166, the application of the COT tracing rules is to be undertaken as though that particular notional entity directly controlled the voting power of that aggregated stake, had a direct right to receive any dividend or capital distributions in respect of such aggregated stake, and importantly, were a person (other than a company), meaning that there is no need to further trace. Where there is a notional shareholder, the actual ultimate shareholders are taken, for the purposes of the COT, to not hold those shares or have those rights.

In particular, Subdiv 166-E ITAA97 provides that there will be a notional shareholder for a widely held company or an eligible Div 166 company in the following circumstances:

– for entities with a direct voting, dividend or capital stake in the tested company which carry less than 10% of the voting rights, dividend rights and capital rights, those entities are aggregated into a single notional shareholder (a direct notional shareholder);
– for entities which indirectly hold less than 10% of the voting, dividend and capital rights of the tested company and hold those rights through an interest in an interposed entity (top interposed entity), that interposed entity is notionally attributed the aggregate of those indirect interests and is taken to hold those interests as a notional shareholder in the tested company (an indirect notional shareholder); and
– if a widely held company directly or indirectly holds shares in the tested company which carry between 10% and 50% of the voting rights, dividend rights or capital rights, that widely held company is taken to be a notional shareholder of those rights (a widely held notional shareholder).

Each notional shareholder as determined by the above rules is considered a separate notional shareholder for the purposes of applying the COT tracing and, as such, the shareholding of each separate notional shareholder must be monitored at each of the relevant testing times.

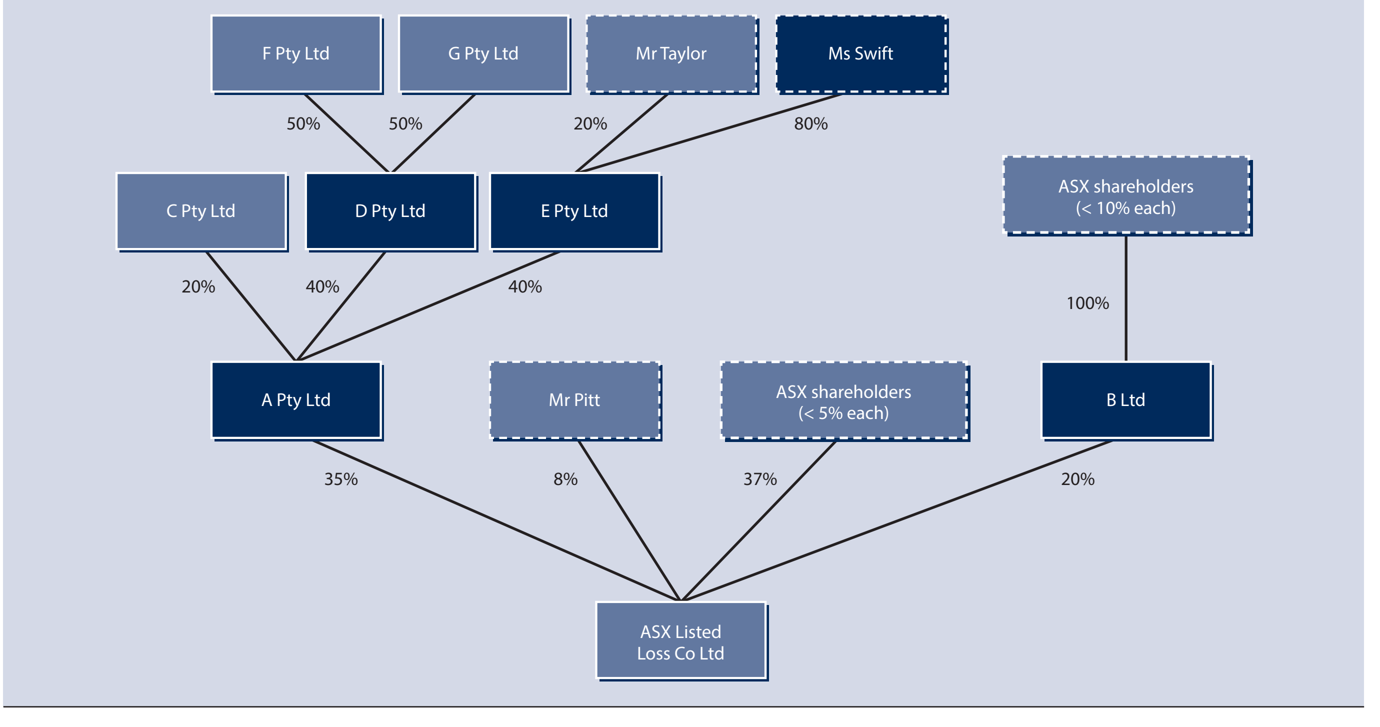
For example, the separate notional shareholders can be illustrated in Diagram 1.[3]

In the example in Diagram 1, the relevant shareholders for the testing of the COT are set out in Table 1.

Table 1. Separate notional shareholders

Shareholder	Interest
Direct notional shareholder	45% (being the less than 10% direct interest held by Mr Pitt, and the less than 10% direct interest held by ASX shareholders)
B Ltd (as a widely held notional shareholder)	20% (being the stake held by the widely held notional shareholder)
A Pty Ltd (as an indirect notional shareholder)	7% (being the indirect less than 10% stake held by the shareholders of C Pty Ltd)
D Pty Ltd (as an indirect notional shareholder)	14% (being the indirect less than 10% interests of F Pty Ltd and G Pty Ltd, of 7% each)
E Pty Ltd (as an indirect notional holder)	2.8% (being the indirect 2.8% shareholding interest of Mr Taylor)
Mrs Swift	11.2%

Diagram 1. Which entities comprise the separate notional shareholders?



The example set out in Diagram 1 and Table 1 demonstrates the significant tracing concessions afforded by these notional shareholder rules. By applying the tracing concession in Div 166, it is not necessary to trace further through to the ultimate beneficial shareholders of the direct ASX shareholders, B Ltd, C Pty Ltd, F Pty Ltd and G Pty Ltd.

Key considerations when applying the COT

Some of the key considerations and common pitfalls when applying the COT to companies include:

- when determining whether the concessional tracing rules in Div 166 ITAA97 apply to a company, s 166-5 only requires the company be a "widely held company" and/or an "eligible Div 166 company" at all times during the income year in which the loss is sought to be recouped, not at all times during the ownership test period. This means that a company which was not a widely held company or an eligible Div 166 company in an earlier year (including the loss year) but becomes such a company in the income year in which the loss is sought be recouped can still apply the concessional Div 166 rules when testing whether they have satisfied the COT.

  Conversely, where a company which was previously a widely held company or an eligible Div 166 company does not have that status at all times during the year of loss recoupment, Div 166 cannot apply and Div 165 ITAA97 will instead need to be applied when testing for continuity of ownership from the time the loss was originally incurred to the year of recoupment;
- the tracing of interests through to individual natural persons can be extremely difficult as a matter of practice, particularly where unrelated companies, trusts or superannuation funds may have invested into the tested company;
- while it might be easy to automatically assume that all listed companies will easily pass the COT, this is not always going to be the case. The Div 166 rules are complex and should be considered carefully;
- corporate change events should be identified properly as these can easily be missed;
- each indirect and widely held notional shareholder should be identified separately — they are treated as separate shareholders and should not be added to the direct notional shareholder;
- be careful to properly trace movements in/out of the direct notional shareholder characterisation. A minimum interest test applies to the direct notional shareholder which allows increases in individual direct shareholders, but the total amount attributed to the notional shareholder cannot be more than the percentage held at the start of the ownership test period (ie the start of the loss year);
- the requirement of the "same share, same interest" rule can be practically difficult in many circumstances. Carefully consider its application; and
- remember the "saving provision" when applying the "same share, same interest" rule, but take care as it does not always apply.

As the COT is an objective "black and white" test, it is relatively easy to demonstrate whether it has been passed or failed by reference to shareholder data at the relevant testing times. For this reason, the COT is often the preferred loss recoupment test that loss companies would be aiming to satisfy.

Where the COT has been failed, or a company is unable to demonstrate whether it has passed or failed the COT (due to complex holding structures, sensitivity of shareholder information etc), a taxpayer has recourse to the BCT which includes the SBT, and for losses generated in income years commencing on or after 1 July 2015, the SiBT.

Business continuity test

It should be noted that, as a result of the SiBT being introduced, the wording of the SBT in s 165-210 ITAA97 has been updated to refer to the BCT and the BCT period instead of the SBT and the SBT period, respectively. The BCT is effectively a shorthand way of referring to the SBT or the SiBT, as both tests are relevant to the same provisions within the tax law and have the same testing times.

BCT testing times

The SBT and the SiBT have the same testing times as outlined in s 165-13(2) ITAA97.

A company satisfies the SBT or the SiBT if it carries on the same or similar business, as the case may be, throughout the BCT period as it carried on immediately before the "test time".

The BCT period is the income year in which the loss is sought to be utilised (that is, the entire income year of recoupment of the tax loss).

"Test time" is defined in s 165-13(2) ITAA97 and is summarised as follows:

- where it is practicable to show that the taxpayer satisfies the COT up until a breach of the continuity of ownership — the test time is the latest time that the taxpayer can show that it has satisfied the COT;
- where it is not practicable for the taxpayer to show that it has satisfied the COT for any period since incurring the tax loss:
  - the test time is the start of the loss year if the taxpayer existed for all of the loss year; or
  - the test time is the end of the loss year if the taxpayer came into existence during that year.

Same business test

The SBT is effectively made up of three tests, the primary SBT, the new business test and the new transactions test, as well as an anti-avoidance test which is contained in s 165-210 ITAA97:

- the primary SBT is a positive test to assess whether the business of a company in the year of recoupment is actually the same business that was carried on immediately before the "test time" (ie the COT failure date or at the start of the loss year where a company is unable to demonstrate when a COT failure occurred). It is intended to ensure continuing identity between the whole of the business activities carried out at the two different times;[4]

– the new business test limits the type of expansion that the company can undertake and looks at whether the company has derived assessable income from a business of a kind that it did not carry on before the test time;
– the new transactions test is directed at preventing the injection of income into a loss company that has satisfied the other two tests and looks at whether the company has derived assessable income from a transaction of a kind that it had not entered into in the course of its business operations before the test time; and
– the anti-avoidance test applies if a company started to carry on a new business or entered into a new transaction of a kind that it did not previously carry on, and it did so for the purpose of being taken to have carried on the same business throughout the BCT period as it carried on immediately before the test time.

The SBT is a strict test where the meaning of the word "same" imports identity and not merely similarity.[5] It is highly subjective, gives rise to questions of degree, and ultimately depends on the facts of each case.

TR 1999/9. Some important principles have been established from case law on the application of the SBT and the ATO has released lengthy TR 1999/9 explaining some of these key principles. Furthermore, para 61 of TR 1999/9 sets out the Commissioner's view on the specific factors that should be considered when applying the SBT and are summarised here:

1. the nature of the business activities and products/services being sold;
2. whether there are any new activities, products or services;
3. changes in the activities of the business;
4. changes to the company's customers;
5. changes in the mix of the company's customers;
6. changes in the turnover or gross assets;
7. changes in the method of selling products or providing services;
8. changes in the company's capital and working capital;
9. changes in the goodwill of the company;
10. changes in the location(s) of where the business is carried on;
11. changes in intellectual property rights, including trade names, trademarks, patents, royalty arrangements etc;
12. reductions or increases in the number of personnel employed by the company; and
13. changes in the directors and/or senior management in the company.

The weight that is attached to each of the above factors depends on the circumstances of the case, and each factor may not be necessarily significant in and of itself.

TR 1999/9 not only provides a lot more detail on how to apply the SBT in ss 165-13 and 165-210, but it also provides 16 examples which illustrate how the SBT should be applied. Despite this detail, it is often still challenging when determining whether companies have satisfied the SBT or not, given the subjective and fact-dependent nature of the test.

Similar business test

The nature of a company's business is likely to evolve over time in order to keep up with changing economic and international markets, customer needs, and advances in technology. It is well known that the strict nature of the SBT arguably does not allow for much change in a company's business before its losses are forfeited, which may also discourage companies from entering into new kinds of transactions or businesses.

As a consequence, the government introduced the new, more flexible SiBT to allow and incentivise companies to seek out opportunities to innovate and grow without losing access to losses.

The new SiBT applies retrospectively to tax losses that were generated by a company in an income year commencing on or after 1 July 2015. It should also be noted the SiBT does not apply to tax losses (or net capital losses) transferred to the head company of a tax consolidated group where the losses were originally incurred by the joining entity in an income year beginning before 1 July 2015.[6]

The SiBT: four factors. The new SiBT is contained in s 165-211 ITAA97, which states:

> "A company also satisfies the ***business continuity test*** in relation to:
>
> (a) a tax loss for an income year starting on or after 1 July 2015 [etc]…
>
> if throughout the business continuity test period it carries on a business (its ***current business***) that is similar to the business it carried on immediately before the test time (its ***former business***)."

It requires the following four factors to be taken into account when determining whether the SiBT has been passed:

1. the extent to which the assets (including goodwill) that are used in its current business to generate assessable income throughout the business continuity test period were also used in its former business (at the test time) to generate assessable income;
2. the extent to which the activities and operations from which its current business generated assessable income throughout the business continuity test period were also the activities and operations from which its former business generated assessable income;
3. the identity of its current business and the identity of its former business; and
4. the extent to which any changes to its former business result from the development or commercialisation of assets, products, processes, services or marketing or organisational methods of the former business.

Each of the four factors outlined in the SiBT need to be considered in light of the overarching question of whether the current business is a similar business to the former business. In some circumstances, a factor may suggest that the SiBT is satisfied, while another factor may suggest that the SiBT is not satisfied. This requires the factors to be compared and an overall view to be taken, balancing out whether each of the four factors supports the SiBT or not.

As with the SBT, the SiBT is also highly subjective and the relative importance of each of the factors is dependent on the facts of each particular case.

Pursuant to the *Treasury Laws Amendment (2017 Enterprise Incentives No. 1) Act 2019* (TLAM19), the four factors allow for differences between the current and former businesses that result from attempts to grow or rehabilitate the business. However, there is no clear guidance in the Treasury and ATO materials in terms of how much the business can grow or rehabilitate without it failing the SiBT.

As with the SBT, it is critical to maintain the identity of the business to pass the SiBT. It is not sufficient for the current business to be of a similar "kind" or "type" to the former business. For example, it is not enough to say that the former business was in the hospitality industry and the current business is in the hospitality industry. It must also look at all of the commercial operations and activities of the former business and compare them with all of the commercial operations and activities of the current business to determine whether the businesses are similar.[7]

To the extent that a business changes its essential character or identity, or if there is a sudden or dramatic change in the business brought about by either the commencement, acquisition or cessation of activities, the business would fail the SiBT.[8]

Comparison between the SBT and the SiBT

Table 2 compares the features of the SiBT with the SBT.

Application of SiBT in a COVID-19 scenario

The authors have outlined below a common scenario of a business adapting due to the COVID-19 restrictions in order to draw out some of the key principles and questions regarding how the SiBT may be applied.

Example. Fine dining restaurant

A fine dining restaurant serves "chef's hat" modern Australian food.

The restaurant is forced to close as a result of COVID-19 restrictions.

The business model changes to offering the same modern Australian menu but via take-away, home delivery or the option to purchase meal kits.

Has the SiBT been passed?

Factor 1 — assets used:

- the restaurant continues to generate income from the same assets used in the former business, ie operating from the same premises and using the same equipment;
- the restaurant continues selling the same products under the same brand name;
- there are new processes and reliance on new technology/assets for delivery and meal kits; and
- there is a potential reduction in wait staff/employees due to closure of dine-in services.

Factor 2 — activities and operations:

- the restaurant continues to make the products in the same way from the same location; and
- the method of selling has changed from dine-in services to takeaway, delivery and preparation of meal kits.

Factor 3 — business identity:

- the restaurant continues to sell the same products under the same brand name but there is a shift in

Table 2. SBT and SiBT comparison

SBT	SiBT
The SBT has two negative limb tests, the new business test and the new transactions test, that must not be failed. This discourages companies from entering into new kinds of transactions or new kinds of businesses.	The SiBT does not incorporate the SBT's negative limb tests. This change allows a company to derive assessable income from new business activities and to enter into new transactions without automatically failing the SiBT.
The SBT still applies in its original form under the BCT. "Same" implies identical. As a result, companies might be stifled from the natural evolution and innovation which would allow them to turn their business around.	The SiBT looks at all of the commercial operations and activities of the former business and compares them with all of the commercial operations and activities of the current business to work out whether the businesses are "similar". If there are any significant changes to the assets, operations and processes, this needs to be as a result of development or commercialisation for the company to pass the SiBT.
The SBT contains a primary test and two negative limb tests. The Commissioner has set out in TR 1999/9 the 13 factors that should be broadly considered when applying the SBT.	The SiBT has only four factors that should be taken into account when applying the test — although there are similarities between the first three factors and the 13 factors of the SBT in TR 1999/9.
The Div 175 ITAA97 loss integrity rules do not apply to the SBT due to the negative limbs of the test.	Companies that pass the SiBT may have losses denied under the Div 175 loss integrity rules.
The SBT has an anti-avoidance test to prevent companies from anticipating a COT failure and structuring their business accordingly.	The SiBT also has an anti-avoidance test to prevent companies from anticipating a COT failure and structuring their business accordingly.

Example (cont)

identity from a dine-in restaurant to a takeaway/delivery/meal kits provider; and

- given the change in the method of selling its products, this will likely appeal both to former customers as well as new customers.

Factor 4 — development or commercialisation:

Although takeaway and meal kit offerings can be generated from the same assets and activities, there is a cessation of the former dine-in restaurant activities. It may be argued, however, that the provision of takeaway and meal kits are a natural progression of the business, or the commercialisation of the business in light of the external COVID-19 restrictions placed on the former business.

Conclusion

In this situation, it is arguable that the restaurant should satisfy the SiBT. This is on the basis that it is selling the same products to the same customers, albeit via a different sales channel. While the dine-in restaurant activities have temporarily ceased, this is purely as a result of the COVID-19 restrictions and is not related to anything within the business's control.

It is noted that the conclusion in the above example is not free from doubt due to the subjectivity of the test. While example 4 in LCR 2019/1 states that a fast-food restaurant that changes its name and menu will not satisfy the SiBT, as there is no change in brand name or identity of the business, nor the type of food being sold, the above example should be able to be distinguished from example 4 in the LCR 2019/1.

The above example seems more akin to example 3 in LCR 2019/3 where a "bricks and mortar" fashion retailer transitions to being a purely online clothing retailer in response to changing shopping trends and the greater functionality of technology. In a similar vein, the above example simply changes the channel of delivery of the same food products from a "bricks and mortar" dine-in restaurant to offering its products via takeaway, delivery or meal kits.

However, it is noted that other commentators have taken a different view and stated that "the dramatic cessation of core dine-in activities creates an issue with the retention of the business's essential nature or character",[9] and hence it is unlikely that the SiBT would be passed. One would hope that the Commissioner would also take into account the fact that external government restrictions outside the business's control have meant the business has had to reinvent itself in some way in order to remain in business and, accordingly, provided certain assets, activities and the identity of the former business are still present in some way, the SiBT should be able to be satisfied.

Key considerations when applying the SiBT

To assist taxpayers in applying the SiBT, the following key observations are taken from the legislation, the explanatory memorandum (EM) to the TLAM19, and the guidance released from the ATO so far (specifically, LCR 2019/1, PBR 1051574799355 and PBR 1051795970990). These points are not exhaustive and may evolve over time depending on the ATO's interpretation and if any SiBT cases go to court. The key observations on the application of the SiBT are:

1. taxpayers will need to continue the former business in a significant way to pass the SiBT. In example 1.1 of the EM to the TLAM19, it was noted that the furniture business passed the SiBT because the former business had largely continued despite it introducing new products/service offerings. This was also the case in example 1.2 of the EM with the algae treatments business, and in example 5 of LCR 2019/1 with the gold and copper mining business. The questions are how much change is acceptable and whether that change is "similar" to the former business, or whether it has resulted from the development or commercialisation of the assets, products, processes, services or marketing and organisational methods of the former business;
2. defining the "identity" of the business is critical to the SiBT analysis. From the examples in the EM to the TLAM19 and LCR 2019/1, however, there is conflicting guidance on what factors or aspects of the business weigh more heavily in determining the identity of the business. Example 4 of LCR 2019/1 was a fast-food restaurant supplying predominantly burgers which changed its menu to provide high-quality steaks, ribs and gourmet burgers. In this example, it was still a restaurant in the same location providing arguably "similar" food. However, it was determined that the SiBT was not satisfied as the changes to the marketing strategy, including restaurant layout, branding and logo, were enough to change the "identity" of the business. In contrast, example 1.2 of the EM to the TLAM19 satisfied the SiBT despite the business initially selling biodegradable plastic products and then commencing to sell teeth whitening products. The EM stated that "importantly … the business identity remains predominantly associated with the exploitation of algae technology. The changes in the business identity are slight and reflect the evolution of the business and the development of its core business assets and processes". The identity of the business in this example was focused on the algae technology and not the products or markets it sold to;
3. further to the above, one factor that is important in maintaining the "identity" of the business is retaining the brand name of the former business. In all examples in the EM to the TLAM19 and LCR 2019/1 where the SiBT was passed, the brand name of the former business and the associated goodwill were retained. This is supported by example 1.3 of the EM where, even though the company continued to sell iced tea to the same customers, as it was no longer selling its own brand of iced tea, the SiBT was failed;
4. the SiBT may be more advantageous for certain industries and growth cases such as technology and R&D companies and less advantageous for companies that are in more conventional industries like farming and hospitality;
5. where businesses decide to cease a particular business or process because it is no longer profitable, this

generally does not support the SiBT. This change in most cases does not result from development or commercialisation of the former business. This was the case in both example 1.3 of the EM to the TLAM19 where the iced tea company decided to stop manufacturing its own brand of iced tea products and instead became a reseller of other brands of iced tea products, and in example 1.4 of the EM in relation to ceasing a homewares business and commencing a stationery and art supplies business; and

6. further to the point above, the SiBT is unlikely to be passed in contraction/cessation of business cases and "bolt on" acquisitions. As stated in the EM to the TLAM19, "if there is a sudden or dramatic change in the business brought about by either the commencement, the acquisition or the cessation of activities, then the business would fail the similar business test".[10]

There is currently very little guidance on how the SiBT will be applied by the Commissioner. The ATO has released LCR 2019/1 as an aid to taxpayers seeking to apply the new SiBT. It contains five examples of both situations when the ATO expects that the SiBT will be passed and situations when it will be failed. However, LCR 2019/1 fails to address the interpretation of the ambiguous terms within the legislation and the complex nature of satisfying the SiBT. Accordingly, in most cases, taxpayers will need to apply for a private ruling in order to have any certainty on how the ATO will apply the SiBT to a taxpayer's particular facts and circumstances.

> *"The overlay of the tax consolidation rules can create further complexity, and occasionally anomalous outcomes."*

Interaction of the loss recoupment rules with the tax consolidation rules

With the introduction of the tax consolidation regime in 2002, integrity rules were developed to modify the interaction of the standard loss recoupment rules with the tax consolidation rules.

The broad objective of Div 707 and Subdiv 719-F ITAA97 in the tax consolidation provisions is to ensure that the use of tax losses in a consolidated environment are restricted to approximate the same rate and ability to use the losses as would have been used by the joining entity had it remained outside the group. However, there is significant complexity in their operation and application in different circumstances.

While the ordinary COT and BCT rules broadly apply to the recoupment of losses generated by the consolidated group itself (group losses) with little modification, Div 707 addresses whether losses can be transferred into a consolidated group by a joining entity (transferred losses), whether those transferred losses can be recouped by the consolidated group at a future time, and the amount of transferred losses that can be recouped in the recoupment year.

Transferring losses to a consolidated group

Subdivision 707-A ITAA97 sets out the tests that must be satisfied for a tax loss of a joining entity to be transferred to a tax consolidated group at the time the entity joins the group.

The tests are satisfied if, broadly, the joining entity could have itself recouped its tax losses for the 12-month period just prior to joining the tax consolidated group (the trial year). Thus, the joining entity must test whether it can satisfy the COT and/or the BCT in the trial year, assuming that the joining entity had not become a member of the consolidated group and had made sufficient income or gains to utilise its balance of carried forward tax losses in the trial year.[11] See Diagram 2.

The modified BCT rule (post-1999 losses)

Where a joining entity is testing whether it can transfer a loss to a consolidated group and whether the losses are subject to the BCT due to a COT failure (either before or on the date of consolidation), the consolidation rules modify the BCT to impose additional test times at which the joining entity must demonstrate that it has had the same or similar business. The modified BCT is likely to be practically applied in all joining scenarios in current times as it is applicable to losses made in an income year starting after 30 June 1999 (ie now over 20 years ago). Instead of only testing the business carried on throughout the trial year with the business carried on at the COT failure time, the "modified BCT" requires the joining entity to demonstrate that it has carried on the same or similar business:

– throughout the trial year;
– throughout the income year in which the COT failure occurred; and
– at the end of the income year for which the loss was made by the joining entity (the test time) (see Diagram 3).

If the joining entity satisfies either of the loss recoupment tests (assuming the loss recoupment year is the trial year), the tax loss will transfer to the head company of the tax consolidated group and the head company will be taken to have made the tax loss itself at the joining time.[12]

Diagram 2. COT testing times (transferring losses into tax consolidated group)

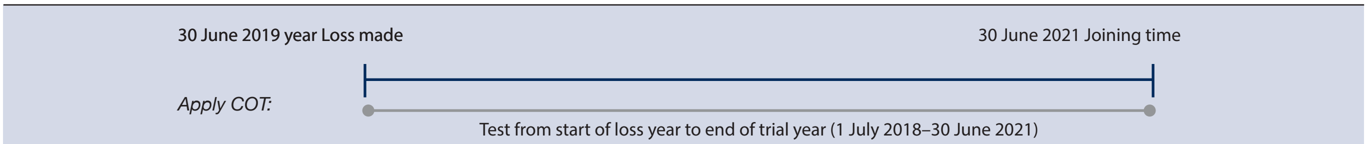
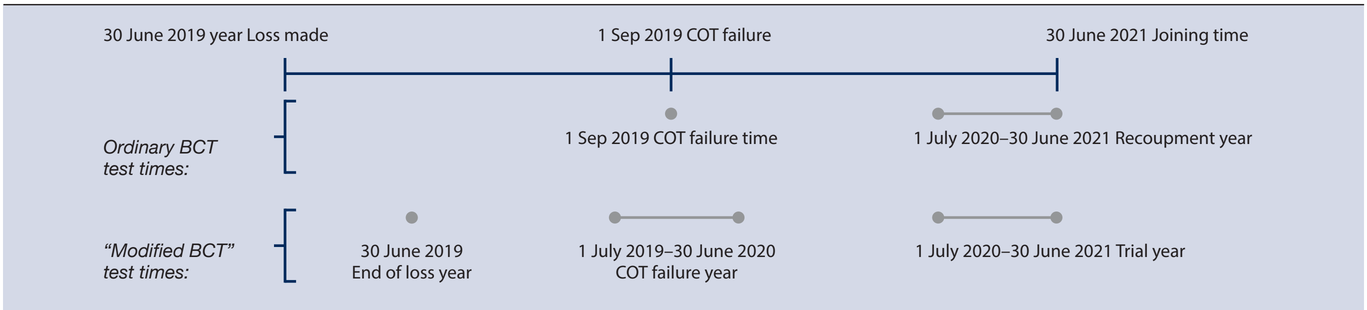


Diagram 3. BCT testing times (transferring losses into tax consolidated group)



Recouping losses that have been transferred into a consolidated group

Tax losses successfully transferred to the head company of the tax consolidated group will be taken to have been incurred by the head company at the joining time.[11]

Losses transferred to a consolidated group by satisfaction of the COT are typically referred to as "COT transfer losses". Losses transferred to a consolidated group by satisfaction of the BCT are typically referred to as "BCT transfer losses".

Recouping COT transfer losses

There are slightly different rules when it comes to recouping COT transfer losses as opposed to recouping BCT transfer losses.

Where a consolidated group is seeking to recoup a COT transfer loss (a loss that was transferred to it by a joining entity in satisfaction of the COT), the ordinary COT and BCT rules must be satisfied.

In order to preserve the ownership history prior to the joining time, the rule deeming the head company to have made the loss at the time the loss was transferred to it is deactivated and changes in ownership that occurred in the joining entity are taken into account from the start of the income year in which it originally made the loss up until the joining time. When the joining entity is acquired by the consolidated group, for the purposes of determining whether the COT is satisfied, any direct changes of ownership in the joining entity or in entities interposed between it and the head company of the consolidated group are disregarded.[13] This effectively means that only changes in ownership above the head company of the consolidated group are taken into account when applying the COT after the joining time.

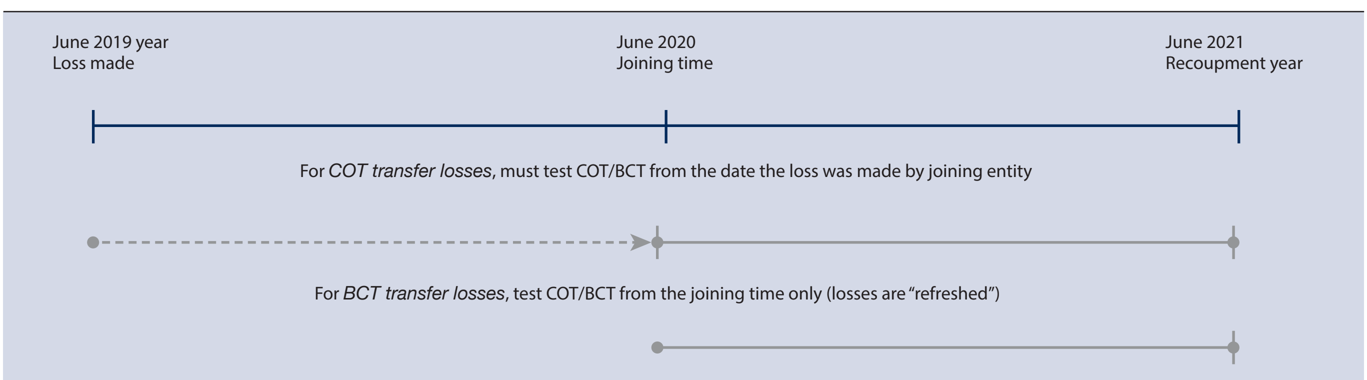
Recouping BCT transfer losses

Where a consolidated group is seeking to recoup a BCT transfer loss (a loss that was transferred to it by a joining entity in satisfaction of the BCT), no special modifications apply. As the head company of the consolidated group is taken to have made the BCT transfer loss at the transfer time, the ordinary COT and BCT rules only need to be satisfied by the head company of the consolidated group from the transfer time to the end of the recoupment year. In this way, BCT transfer losses are commonly described as being "refreshed" when they are transferred to a consolidated group, since any history prior to the transfer time is not taken into account when the losses are being recouped (see Diagram 4).

Determining the amount of a transferred loss that can be utilised: the available fraction rules

To prevent the trafficking of transferred losses by consolidated groups and the acceleration of loss utilisation, the head company of a consolidated group can only recoup transferred losses to the extent that the joining entity would have been able to utilise the loss had it not joined the tax consolidated group.[14]

Diagram 4. COT and BCT testing times (once losses transferred)



In order to achieve this objective, Subdiv 707-C ITAA97 of the consolidation rules determines the amount of the transferred loss that can be recouped by calculating the proportion of the total consolidated group's income which is referable to the joining entity's income had it remained stand-alone (the available fraction), determined by reference to applicable market values. These rules only allow the head company of the consolidated group to apply transferred losses against this proportion of its income.

When determining the amount of transferred losses that can be recouped, group losses are first applied against the income/gains of the group to determine the amount of income/gain remaining to which the transferred losses can be applied.[15] This means that transferred losses can only be utilised once group losses have been recouped.

Calculation of the available fraction

The "available fraction" is broadly calculated as the proportion of the market value of the joining entity to the market value of the entire consolidated group at the transfer time, on the assumption that the market value is a proxy for the entity's capacity to generate income and gains in the future.[16]

Section 707-320 ITAA97 outlines the methodology for calculating the available fraction for a bundle of losses as follows:

$$\frac{\text{Modified market value of the joining entity}}{\text{Adjusted market value of the consolidated group (including the joining entity)}}$$

The "modified market value" of the joining entity is its market value at the joining/transfer time, assuming that:

- the entity had no losses and its franking account balance was nil;
- the subsidiary members of the group at the joining time are separate entities and not part of the head company; and
- the market value does not include any amount that is attributable to direct or indirect membership interests in another group member (except for certain interests in fixed trusts).

The modified market value is worked out as if the joining entity had no tax attributes, on the basis that they do not enhance the joining entity's income-generating capacity.[17] In practice, it should be confirmed whether the valuation of the joining entity incorporates the value of its tax attributes, as an acquiring entity may or may not place any value on or pay for such attributes.

The "adjusted market value" of the consolidated group includes the value of the joining entity and also values the group assuming that the consolidated group had no losses and its franking account balance was nil.[18]

An available fraction will be calculated for losses, regardless of their type, transferred from each joining entity to the head company of a consolidated group for the first time (referred to as a "bundle" of losses).[19]

The following example demonstrates how the available fraction is calculated.

Example. Calculation of available fraction

Company A joins a consolidated group on 1 July 2020. It has a market value of $100m (which excludes the value attributable to its tax losses and franking credits). At that time, it transfers $50m of tax losses to the head company of the consolidated group. The consolidated group's market value immediately after the acquisition of Company A is $300m.

Assuming that Company A passes the loss transfer tests in Subdiv 707-A, the available fraction attaching to the $50m bundle of losses transferred to the consolidated group is equal to:

$$\frac{\text{Modified market value of Company A}}{\text{Adjusted market value of the consolidated group}} = \frac{\$100\text{m}}{\$300\text{m}}$$

= 0.333 (to 3 decimal places)

Rules to stop artificially inflating the available fraction.
In order to prevent the value of a joining entity from being artificially inflated before it joins a consolidated group, integrity rules also apply to reduce the modified market value of the joining entity where "capital injections" or "non-arm's length transactions" occur in the four years prior to the joining time which have increased the market value of the joining entity:[20]

The reduction is the lesser of:

- the difference between the loss entity's market value at the joining time and what would have been its market value if the capital injection or non-arm's length transaction had not occurred; and
- the total increase in the entity's market value that occurred after each capital injection or non-arm's length transaction event.

As it is not a defined term in the legislation, the ATO provides guidance in TR 2004/9 on what it considers to be an injection of capital for the purposes of the available fraction rules. Broadly, it includes any wealth introduced into an entity from outside the group which affects the equity interests in the entity and enhances its net assets.

Examples of "injections of capital" outlined in the ruling include:

- issues of shares for consideration, *but excludes* initial capitalisations;
- issues or contributions of any other types of equity for accounting purposes;
- debt/equity swaps; and
- scrip-for-scrip takeovers by the consolidated group over a target entity.

However, TR 2004/9 excludes loan/liabilities and debt forgiveness from being an injection of capital on the basis that they do not affect the equity interests in the capital of the entity.

The following example shows the impact of related party capital injections on the available fraction.

Example. Impact of capital injections on available fractions

A foreign private equity fund has established its Australian presence via a tax consolidated group and is considering the purchase of Target Co on 1 July 2020. Target Co is a business which has been making trading losses for a number of years. Its foreign parent company has made a number of injections of additional capital to enable Target Co to remain solvent. Target Co has a significant balance of carried forward losses at 1 July 2020.

Where Target Co can satisfy the modified BCT loss transfer test in Subdiv 707-A, the available fraction that will be calculated for its BCT transfer losses will need to take into account the injections of capital from its foreign parent which have taken place within the four years prior to the joining time. Reducing Target Co's "modified market value" by the increase in value resulting from these capital injections can potentially reduce Target Co's available fraction to a very low fraction.

In this example, the acquiring group would likely place minimal value (if any) on the tax losses that it will acquire from Target Co, given the low available fraction and the length of time it may take for the transferred losses to be recouped.

Available fraction adjustment rules. Once an available fraction is calculated for a bundle of losses, it remains with that bundle of losses until the losses are fully recouped or lost.

The available fraction for that bundle of losses may need to be adjusted where certain events take place involving the consolidated group. The adjusted available fraction is worked out by multiplying the existing available fraction by the factor identified at the relevant item in Table 3.[21]

Where any of these events occur, the available fraction of the loss bundles affected must be multiplied by the relevant fraction in Table 3. This is to ensure that the available fraction for each loss bundle continues to approximate the proportion of the consolidated group's income generated by the joining entity which had transferred the loss.

A loss transfer may result in more than one adjustment event. Where this occurs, the adjustments to the available fractions for the relevant item/event are made in the order of Table 3.[22]

Available fraction and transferred loss apportionment rules. Where a loss is transferred into a consolidated group part-way through an income year, the transferred loss can only be used to offset income made by the consolidated group after the joining time (and subject to the available fraction).

Similarly, where the available fraction of a loss bundle is adjusted during an income year (eg when a capital injection occurs), the head company of the consolidated group is required to calculate the applicable available fraction for each period of the income year to determine the amount of income against which the transferred loss can be applied.

In either of the above cases, the head company can apply a reasonable basis for apportionment. It is stated in the ATO's consolidation manual that the ATO would accept the following methods of apportionment:[23]

- calculate the full-year amount of the transferred loss that could be recouped for each available fraction and then apportion each on a day's basis to the periods where that available fraction was applicable; or
- calculate a weighted average available fraction for the full year.

Cancelling the transfer of a loss

Under s 707-145 ITAA97, the head company of a consolidated group can also choose to cancel the transfer of a loss from a joining entity. However, it should be noted that this choice cannot be revoked.

This may be beneficial where the available fraction of the transferred losses is low, if the calculation of a new available fraction may cause undesired reductions in the available fractions of other loss bundles, or if the group considers it more beneficial to have a higher allocable cost amount (ACA) for the joining entity to allocate to its assets given there will be no need for a step 6 ACA reduction.[24]

There is no requirement for the choice to cancel the transferred losses to be made in writing and therefore this choice needs to be reflected in the way the income tax return is completed and supported by the taxpayer's records verifying the choice to cancel the transferred losses.

The following example shows how the cancellation of losses may yield a better outcome for the taxpayer.

Table 3. Available fraction adjustment events and relevant factors

Item no.	Adjustment event	Factor
1	Previously transferred losses are transferred a subsequent time	The lesser of 1 and this fraction: $\frac{\text{Market value (MV) of the transferor at transfer time}}{\text{MV of the of the transferee at transfer time}}$
2	Group losses and transferred losses are transferred from a consolidated group to another consolidated group	$\frac{\text{The lesser of the available fraction for group losses and 1}}{\text{Total available fractions for all losses being transferred}}$
3	Existing group with transferred losses acquires new loss bundles	1 – Total available fractions for new transferred losses
4	The consolidated group has an increase in market value from a capital injection or non-arm's length transaction	$\frac{\text{MV of group before the event}}{\text{MV of group before the event + amount of increase}}$
5	The sum of all available fractions is more than one	1/Total of available fractions

Example. Choice to cancel losses to manage available fractions

A consolidated group has a market value of $100m.

On 1 July 2019, it acquired Target Co A. Target Co A has a modified market value of $1,000m and has $900m in carried forward tax losses. The losses have been transferred to the consolidated group as BCT transfer losses.

On 1 July 2020, the consolidated group acquired Target Co B. Target Co B has a modified market value of $800m and has $50m in carried forward tax losses. Assume that the losses can be transferred to the consolidated group as BCT transfer losses.

The consolidated group is expecting to make $400m of taxable income in the 30 June 2021 year.

Outlined below is the available fraction for Target Co A's BCT transfer losses at 1 July 2019, the adjusted available fraction for this bundle of losses after the acquisition of Target Co B on 1 July 2020, and the total amount of transferred tax losses that can be recouped in the 30 June 2021 year.

Available fraction for Target Co A transferred losses

The available fraction for Target Co A's transferred losses at 1 July 2019 is:

$$\frac{\text{Modified market value of Target Co A}}{\text{Adjusted market value of the consolidated group}} = \frac{\$1{,}000\text{m}}{(\$100\text{m} + \$1{,}000\text{m})} = 0.909 \text{ (to 3 decimal places)}$$

Available fraction for Target Co B transferred losses

The available fraction for Target Co B's transferred losses at 1 July 2020 is:

$$\frac{\text{Modified market value of Target Co A}}{\text{Adjusted market value of the consolidated group}} = \frac{\$800\text{m}}{(\$1{,}100\text{m} + \$800\text{m})} = 0.421 \text{ (to 3 decimal places)}$$

Adjust Target Co A's available fraction for Target Co B transferred losses

The adjusted available fraction for Target Co A's transferred losses at 1 July 2020 is:

0.909 × (1 – total of available fractions for other bundles)[25] = 0.909 × (1 – 0.421) = 0.526 (to 3 decimal places)

Total transferred losses that can be recouped in the June 2021 year

Loss bundle	Balance of losses	Available fraction	Taxable income that can be offset	Amount of transferred loss that can be recouped
Target Co A	$900m	0.526	$210.4m	$210.4m
Target Co B	$50m	0.421	$168.4m	$50m
Total				**$260.4m**

Total transferred losses that could be recouped in the June 2021 year if Target Co B's losses were cancelled

Loss bundle	Balance of losses	Available fraction	Taxable income that can be offset	Amount of transferred loss that can be recouped
Target Co A	$900m	0.909	$363.6m	**$363.6m**

The above calculations show that, if the consolidated group chose to cancel Target Co B's losses, it would be able to recoup $363.6m of tax losses in the 30 June 2021 year instead of $260.4m (an extra $103.2m of tax losses).

Assuming that the consolidated group was wanting to recoup tax losses as quickly as possible, it may be beneficial to choose to cancel Target Co B's losses to maintain Target Co A's high available fraction of 0.909.

Summary of differences between loss rules for consolidated groups and MEC groups

While a detailed analysis of the loss rules as they relate to multiple entry consolidated (MEC) groups is outside the scope of this article, Table 4 provides a high-level summary of the differences between the modifications to the ordinary COT and the BCT rules that apply to consolidated groups and MEC groups.

Key considerations in respect of interaction of the loss rules with the consolidation rules

Some of the key considerations when applying the loss recoupment rules to consolidated groups are:

– ensure that appropriate due diligence is undertaken on a target company with losses to determine whether any capital injections or significant non-arm's length transactions have been entered into within four years of joining a tax consolidated group;

Table 4. Differences between loss rules for consolidated and MEC groups

Loss rule modifications	Consolidated groups	MEC groups
Recouping group losses	No modifications — the ordinary COT/BCT rules apply to the head company of the consolidated group.	The COT applies to test the top company of the MEC group from the start of the loss year. There is a deemed MEC group COT failure if: 1. the MEC group ceases to exist; 2. there is a new top company and there is a change in membership interests between an eligible tier 1 entity (ET-1) and the old top company which does not cause the MEC group to cease to exist; or 3. there ceases to be a provisional head company for MEC group.
Bringing losses into the group	The joining entity must satisfy the ordinary COT/BCT as though recouping loss in the trial year, subject to: 1. the modified BCT (post-1999 losses) — must test at normal BCT test times (the COT failure time and trial year), as well as at the end of the original loss year and for the full income year when COT failure occurred; and 2. the additional BCT test — this only applies if transferring a loss on the basis of the COT, and that loss was previously a BCT transfer loss. Even though there is no COT failure, must test BCT during the trial year and at the end of the year the original consolidated group received the BCT transfer loss. The group can choose for transferred losses to be cancelled.	Same rules as consolidated groups for subsidiaries that are not ET-1 companies. If a new ET-1 company joins an MEC group, it can transfer a loss where it satisfies the loss transfer rules, and an available fraction will be calculated. An available fraction will also be calculated for group losses, and any available fractions for existing transferred losses will be reduced.
Recouping transferred losses	BCT transfer losses are “refreshed”, and the COT/BCT applies to test the head company of the consolidated group from the transfer time. COT transfer losses — the COT applies to the joining entity from the start of original loss year, and to the head company from the transfer time.	BCT transfer losses are “refreshed”, and the COT applies to test the top company of the MEC group from the transfer time. For COT transfer losses/losses brought in by the consolidated group converting to the MEC group, the COT applies to test the transferor entity/head company from the start of the original loss year, and to the top company of the MEC group from the transfer time. The deemed MEC group COT failure rules apply.
Available fraction rules	The available fraction is calculated for losses transferred to a consolidated group. Need to adjust for an increase in the value of the joining entity by a capital injection or non-arm’s length transaction within four years of the transfer time. Adjustments to the available fractions are required in certain circumstances: 1. losses are transferred at a subsequent time; 2. more losses are transferred to the group; 3. capital injection or non-arm’s length transaction after the transfer time; and 4. total available fractions > 1.000.	The same available fraction rules apply as for consolidated groups: 1. modification for application events: new ET-1 joins the MEC group; or 2. special conversion of the consolidated group to an MEC group. Requires the calculation of an available fraction for group losses and an adjustment to the available fraction for transferred losses. Can choose to cancel group losses or transferred losses affected by an application event.

– where the group has losses that are subject to an available fraction, be mindful that any additional capital funding that is introduced will be likely to reduce the group’s available fractions due to the capital injection rule. Where possible, consider alternative funding strategies (eg putting in place an arm’s length debt);

– if a loss entity is acquired by a consolidated group (which may include the head company of another consolidated group), consider the relative merits of transferring or cancelling the losses of the acquired entity, ie where the available fraction is low and the relative impact on the ACA is significant. Bear in mind that, once made, an election to cancel the losses cannot be revoked;

- to the extent that the group has had a COT failure, carefully manage any decisions to restructure the group's business operations in light of the fact that the BCT applies to the group on a single entity basis (see also TR 2007/2);
- transferred losses with nil available fractions can be used to offset:
  - a net forgiven amount for debt forgiveness purposes;
  - the amount of excessive capital allowance deductions calculated under the limited recourse debt rules;
  - a CGT event L5 capital gain on exit of a subsidiary from a consolidated group (where the liabilities of the leaving entity exceed the tax cost of its assets); and
- be aware that the loss transfer and recoupment rules are modified for MEC groups and that the group losses of MEC groups may become subject to an available fraction in the event of certain application events.

Loss carry back measures

As a response to the COVID-19 pandemic, the government introduced the temporary loss carry back rules which are designed to provide temporary cashflow support to companies that were previously in a tax-paying position but who found themselves in a tax-loss position.

The new measures aim to monetise the value of revenue losses generated by companies, rather than deferring this until when a company returns to profitability and a tax-paying position. As part of the 2021-22 Federal Budget, the government announced that the temporary loss carry back rules would be extended for an additional year, allowing eligible companies to carry back tax losses from the 2022-23 income year.

How do the rules operate?

In accordance with the loss carry back rules in Div 160 ITAA97, to claim the loss carry back offset, an entity must meet all of the following criteria:

- it is a corporate tax entity (ie the loss carry back measures do not apply to any other types of entities, eg trusts, partnerships and individuals);
- it has an aggregated turnover of less than A$5b for the year;
- it made a tax loss for the 2019-20, 2020-21, 2021-22 and/or 2022-23 income year(s);
- it has an income tax liability for the prior 2018-19, 2019-20, 2020-21 or 2021-22 income year(s);
- it has a surplus in its franking account for the year in which it is claiming the tax offset; and
- it has met its tax return lodgment obligations for the income year in which it is seeking to claim the tax offset, and the previous five income years.

If the above criteria are met, a company may *choose* to "carry back" revenue losses generated in the 2019-20, 2020-21, 2021-22 and 2022-23 income years and claim a tax offset against tax paid in relation to the 2018-19, 2019-20, 2020-21 or 2021-22 income years.

From a timing perspective, the loss carry back offset cannot be claimed until the time of lodging the 2020-21 or later income tax returns, even if the company generated a tax loss in the 2019-20 year and is seeking to carry it back to offset tax paid in relation to the 2018-19 year.

There is no monetary cap on the amount of the tax offset that can be claimed. The tax offset is essentially only limited to the amount of tax paid in relation to the previous income year(s) (ie the 2018-19, 2019-20, 2020-21 and/or 2021-22 income years), and capped at the amount of the franking account surplus at the end of the year the claim is made.

What losses are eligible for carry back?

Only tax losses (ie revenue losses) are eligible for carry back. The following types of losses are not eligible for carry back:

- capital losses;
- tax losses that were transferred to or from companies in the same foreign banking group;
- losses transferred to a head company of a tax consolidated group by a joining entity; and
- losses generated as a result of excess franking offsets.

Calculating the loss carry back offset

Section 160-10 ITAA97 sets out how to calculate the loss carry back offset:

- step 1: start with the amount of the tax loss that the entity carries back to the income year;
- step 2: reduce the step 1 amount by the entity's net exempt income for the income year; and
- step 3: multiply the step 2 amount by the corporate tax rate for the loss year.

Taxpayers should also compare the outcome of step 3 with the franking account balance at the end of the loss year and the tax paid in the 2018-19, 2019-20, 2020-21 or 2021-22 income year(s) as the claim cannot exceed these amounts.

The following is an example of the calculation of the loss carry back offset.

Example. Calculation of loss carry back offset

Company A (which is a base rate entity) has:

- a tax loss of $900,000 for 2020-21 (the tax rate is 26%);
- a franking account balance of $260,000 at the end of 2020-21; and
- in the 2018-19 income year, an income tax liability of $130,000 (27.5%) and net exempt income of $5,000; and
- in the 2019-20 income year, an income tax liability (27.5%) of $210,000.

The loss carry back offset can be calculated as follows:

- step 1: $900,000 (being the amount of the loss that can be carried back to the 2018-19 and 2019-20 income years);
- step 2: $895,000 (being the step 1 amount reduced by the net exempt income from the 2018-19 income year); and

Example (cont)

– step 3: $232,700 (being the step 2 amount multiplied by the tax rate for the loss year (ie 26%).

Accordingly, the loss carry back offset should be able to be carried back as follows:

– 2018-19: $130,000 to fully offset the tax liability of $130,000; and

– 2019-20: $102,700 to partially offset the tax liability of $210,000.

After the tax offset, there should still be a surplus in the franking account of $27,300.

The integrity rules

While the loss carry back offset is not subject to the ordinary COT and BCT loss recoupment tests, the new loss carry back regime contains a specific integrity rule.[26] A company cannot carry back a tax loss to an income year if, broadly, there is a scheme for a disposition of membership interests held directly or indirectly in the company that result in a change in control of the company, and, having regard to relevant circumstances listed in the legislation:[27]

> "… it would be concluded that a person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for a purpose (whether or not the dominant purpose but not including an incidental purpose) of enabling the corporate tax entity to get a loss carry back tax offset."

The relevant circumstances include the extent to which the company continued to conduct the same activities or to use the same assets after the scheme as it did before, and the matters referred to in the general anti-avoidance rule (Pt IVA of the *Income Tax Assessment Act 1936* (Cth)). A company will need to self-assess as to whether the integrity rule applies to their circumstances. The general anti-avoidance rule can apply to schemes entered into with the purposes of obtaining a loss carry back tax offset and may be applied where the specific integrity provision does not apply, for example, where there has been a scheme that does not involve the disposition of membership interests.

Claiming the loss carry back offset

For taxpayers claiming the loss carry back offset, there will be new labels and disclosures in the 2021 company tax return forms to evidence and facilitate the claiming of the offset. The new labels in the 2021 tax return forms will require taxpayers to disclose:

– the aggregated turnover of the company;

– the opening and closing franking account balance for the claim year;

– the tax loss for the relevant loss year being carried back;

– the tax rate for the relevant loss year;

– the net exempt income for the 2018-19 and/or 2019-20 income year(s);

– the income tax liability for the 2018-19 and/or 2019-20 income year(s); and

– the loss carry back offset amount.

For the aggregated turnover disclosure, taxpayers will need to select a specific aggregated turnover range where their aggregated turnover is up to A$1b. Where a taxpayer has a A$1b or more aggregated turnover and/or is a significant global entity, a specific dollar number for aggregated turnover will need to be provided.

Determining a company's aggregated turnover can be incredibly complex, costly and time consuming as it is based on the small business definition of "aggregated turnover" in Subdiv 328-C ITAA97, which involves identifying the company's connected and affiliated entities, both in Australia and overseas. The threshold for "control" for connected entities is much lower than the accounting threshold of control, and therefore the entities that may need to be taken into account when determining aggregated turnover can often be broader than the global accounting consolidated group. There is also complexity in calculating aggregated turnover as it includes ordinary income according to income tax concepts, not total income according to accounting concepts. There can also be issues with entities having differing year ends and reporting in different currencies.

In order to address the concerns of taxpayers inadvertently making false and misleading statements, the ATO has publicly stated that taxpayers "will not be penalised in specifying an incorrect category or amount, provided they make their best attempt in calculating their aggregated turnover". If taxpayers are not availing themselves of these measures, the ATO has stated that they will not need to disclose their aggregated turnover.

It should also be noted that, for those early balancing substituted accounting period taxpayers or taxpayers lodging a part-year tax return before the end of June (when the new 2021 tax return forms are released), a separate ATO form must be completed in order to claim the loss carry back offset. It should also be noted that this form *must be lodged five business days before* lodging the company tax return with the ATO in order to ensure the smooth processing of the tax refund.

Key considerations when applying the loss carry back measures.

There are a range of considerations to take into account when applying the loss carry back regime, including:

– corporate tax entities (ie companies or entities taxed like companies) with an aggregated turnover of up to A$5b are the only taxpayers that can access the loss carry back measures. There is no loss carry back relief for individuals or other entities;

– the rules are flexible in the sense that a company can choose to either carry back or carry forward any available tax loss made in the 2019-20, 2020-21, 2021-22 and/or 2022-23 income years. There is no compulsion that a loss be applied as a carry back loss instead of using it in future income years and there are no ordering rules requiring it to be applied to the earliest taxable year. In certain circumstances, it may be better to carry forward losses instead of carrying back a loss, particularly where it may impact on the franking account and the ability to pay franked dividends in the future;

- a debit to a company's franking account will arise when a refund from a loss carry back tax offset is received. Therefore, care should be taken to ensure that the debit to the franking account will not put the franking account into deficit, which could result in a franking deficit tax liability at year end;
- taxpayers should take care when determining eligibility under the aggregated turnover criteria as it can often be much broader that the global accounting consolidated group, especially when held by entities such as managed funds, private equity, government owned enterprises etc;
- the different tax rates that apply to base rate companies (broadly, companies with an aggregated turnover of less than A$50m and which derive certain passive income that represents no more than 80% of its total assessable income) should also be factored into the equation. The reduced tax rate for base rate entities is as follows:
  - 27.5% for the 2019-20 income year;
  - 26% for the 2020-21 income year; and
  - 25% for the 2021-22 and 2022-23 income years;
- while the loss carry back tax offset is not subject to a continuity of ownership or business continuity test that applies to utilise carry forward tax losses, the specific integrity rule applies where there has been a change of control arising from the disposition of membership interests and certain other requirements are met. In addition, the general anti-avoidance rule in Pt IVA can also apply to schemes entered into with the purposes of obtaining the loss carry back tax offset;
- there is a possibility that eligible companies may use other Budget stimulus measures, such as the temporary full expensing measure, to potentially create or increase a tax loss which can then be carried back to claim a cash refund through the offset mechanism. The example below is from the Budget 2020-21 fact sheet *Lower taxes*[28] and shows how the temporary full expensing measure can be used to create a loss which can then be used for the loss carry back offset; and
- as announced in the 2021-22 Federal Budget, the temporary full expensing measure has been extended for one year. The additional year to access the loss carry back ensures that the end date for these measures is in line with the extended end date for the availability of temporary full expensing.

Example. Utilising both the temporary full expensing and the loss carry back measures

Bogong Builders Pty Ltd has an aggregated annual turnover of $60m for the 2021-22 income year. On 1 July 2021, Bogong Builders Pty Ltd purchases a truck-mounted concrete pump for $1m, exclusive of GST. The company's taxable income for 2021-22 was $600,000 before the purchase. Without temporary full expensing, Bogong Builders Pty Ltd would claim a tax deduction of around $300,000, resulting in a taxable profit of $300,000, and a tax bill of $90,000.

Under temporary full expensing, Bogong Builders Pty Ltd will instead deduct the full cost of the asset of $1m,

Example (cont)

resulting in a tax loss of $400,000. Under temporary loss carry back, Bogong Builders Pty Ltd offsets this tax loss against profits in 2018-19, resulting in a tax refund of $120,000. Without the refund, the company may have had to defer the investment until their cashflow position recovered or may not have purchased the new pump at all.

General strategies to maintain and utilise losses

Throughout this article, the authors have discussed some of the key considerations and strategies in order to preserve and utilise tax losses under the COT, the BCT and the loss carry back provisions, as well as considering the implications of the tax consolidation rules with the loss provisions. Given the disruption that COVID-19 has caused, where businesses have tax losses or anticipate generating tax losses, they should consider the current and future implications of their losses based on their particular facts and circumstances to determine whether any of these strategies and considerations may apply.

Outlined below are some key strategies that should be considered when looking to maintain and utilise losses. This list is not exhaustive, but it is a starting point, especially where there is concern that satisfaction of the COT and the BCT may be jeopardised as a result of the unforeseen impact of COVID-19.

1. Bringing forward assessable income/deferring deductions in order to refresh losses

Circumstances may exist which mean that a company should be implementing strategies to minimise the generation of tax losses and/or increase the utilisation of tax losses in the current year. This may be wise in instances where:

- there is concern over the availability of carry forward or current year losses in future years (such as where a change of ownership or change in business is likely to occur, or has already occurred during the current year);
- there is a concern over a lack of franking credits (ie tax losses mean that no tax is payable and thus no franking credits arise), and the distribution policy of the corporate tax entity dictates that franked distributions be paid or the benchmark franking rule requires distributions paid by the company to be franked;
- the entity's assessable income includes income in respect of which foreign tax has been paid. As you can only claim a foreign income tax offset (FITO) in the income year the tax is paid, a company may wish to generate assessable income in order to utilise the FITO and, accordingly, may choose to defer the utilisation of any carry forward tax losses; and
- similarly, a company may wish to generate assessable income where there could be a loss of deductions in the current year for otherwise deductible gifts (due to the deduction cap imposed by s 26-55 ITAA97).

Where it is the entity's preference not to generate tax losses in the current year, it is important that, when planning the likely tax outcome, relevant strategies are considered and implemented before then end of the income year. This may include:

– measures to bring forward the derivation of assessable income including, for example, electing a different valuation for trading stock at year-end, bringing forward the sale of an asset (to generate a revenue or capital gain) or triggering a balancing adjustment by disposing of a depreciating asset in circumstances where an assessable balancing charge will arise under Div 40 ITAA97; and/or
– deferring deductible expenditure, including, for example, a review of prepayment policies or, where available, making a choice to not claim the temporary full expensing and backing business investment concessions on otherwise eligible depreciating assets, or re-assessing the effective lives of depreciating assets under Div 40.

2. Eligibility for Div 166 COT concessions

As mentioned earlier in this article, when determining whether the concessional tracing rules in Div 166 ITAA97 apply, the company only needs to be a "widely held company" and/or an "eligible Div 166 company" at all times during the income year in which the loss is sought to be recouped, not at all times during the ownership test period. This means that a company which was not a "widely held company" or an "eligible Div 166 company" in an earlier year (including the loss year), but becomes such a company in the income year in which the loss is sought be recouped, can still apply the concessional Div 166 rules when testing whether they have satisfied the COT.

3. Funding options where you have transferred losses

Where a group has losses subject to an available fraction, be mindful that any additional capital funding that is injected into the tax consolidated group (or MEC group) will likely reduce the rate of utilisation of the transferred losses due to the available fraction adjustment rules in Subdiv 707-C ITAA97. Accordingly, where possible, consider alternative funding strategies such as putting in place arm's length debt instead of equity where you have losses subject to an available fraction.

4. Monitor changes to business operations where the BCT applies

To the extent that the COT has been failed, or you are unable to determine whether the COT has been passed or failed, carefully manage any decisions to restructure or change your business operations. This is relevant for all businesses subject to the BCT, but especially tax consolidated and MEC groups where the BCT applies to the group as a whole, and not on a single entity basis.

5. Consider cancelling losses

Tax consolidated and MEC groups may wish to consider cancelling losses of a joining entity where it provides a better outcome for the ACA calculation and existing available fractions of the group. Bear in mind that, once an election to cancel the losses has been made, the election cannot be revoked.

6. Using COVID Budget measures to generate tax loss

The loss carry back tax offset can be claimed in conjunction with other COVID-19 stimulus measures such as the temporary full expensing of depreciating assets, ie if the depreciation deductions create an overall tax loss for the company, that loss can be carried back and offset against tax payable in a prior year.

Conclusion

Never has it been more relevant to consider the impact of the loss recoupment rules to your losses. It would be particularly unfair and unconscionable if, due to the unprecedented impacts of COVID-19 which are outside anyone's control, businesses have not only suffered economic losses but have then not been able to utilise those losses due to inadvertently failing the loss recoupment tests. The application of the loss recoupment rules can be extremely complex and onerous. However, in recent years, there has been a relaxing of some of these rules with the introduction of new laws to address unequal share rights, the introduction of the SiBT and, most recently, the loss carry back measures. This article has sought to highlight key considerations and strategies to ensure that, in such hard and challenging times, companies don't lose their losses.

Sarah Saville
Partner
PwC

Roop Sangha
Manager
PwC

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Share sale and purchase agreements

by Victoria Lanyon, Senior Associate,
King & Wood Mallesons

This article provides an overview of some key considerations to be taken into account when drafting and reviewing sale agreements from a tax perspective. In particular, it takes a high-level look at the nature and scope of the tax indemnity (including the distinction between an indemnity and a covenant to pay) and tax warranties, and the role of warranty and indemnity insurance. It also considers those clauses in the agreement that assign control of, or limit the parties when dealing with, tax matters, both before and after completion. Finally, it briefly touches on the clauses covering the consideration payable under the agreement and the drafting of clauses addressing foreign resident capital gains withholding tax.

Introduction

Mergers and acquisitions (M&A) can be fast paced. The transaction documents are long. There can be a lot of "it's market practice". For those new to practice, or just new to these types of transactions, knowing where to start can be a daunting experience.

This article by no means purports to cover all tax issues raised in M&A transactions. Rather, it focuses on share sale agreements and is intended as a roadmap of where to start when considering tax issues in sale documentation, providing some key points to look out for, and some general principles to keep in mind when reviewing and negotiating the terms of these agreements.

The words "M&A transactions" can of course catch many different types of transactions, from share sale agreements and asset sale agreements to demergers and bonus share issues. The nature of the transaction, and the tax issues involved, can also vary greatly depending on the underlying business being sold. While each transaction will therefore have its own specific tax aspects to be considered, this article focuses on those issues which are more common and apply to a greater number of transactions.

The tax indemnity[1]

The most obvious place to start when reviewing a sale agreement from a tax perspective is the tax indemnity. The tax indemnity functions quite differently from the contractual treatment of most other liabilities of the target entity. For most matters (eg environmental, employment etc), the approach generally is that any liability is passed to the buyer. If loss is then suffered, the warranties operate to allow the buyer to recoup that loss from the seller. Tax generally receives more fulsome treatment under the sale agreement than other liabilities, as a consequence of a broad tax indemnity regime.

Tax indemnity versus covenant to pay

While we commonly use the term "tax indemnity" in sale agreements in Australia, in most cases, the clause is drafted as a "covenant to pay". A covenant to pay is a "price adjustment mechanism" where "the amount of adjustment is quantified by reference to the tax payable by the target company".[2] By contrast, an indemnity is "a separate, enforceable contract to hold someone harmless against loss".[3]

In either case, but particularly in the case of a covenant to pay, the trigger for the provision should be considered. For example, is the provision drafted as applying to any "tax payable" or does it instead apply in the context of an amount arising under a tax notice (usually defined by reference to tax assessments and returns etc)? If the first formulation is adopted, an argument may be made that the tax liability does not need to have crystalised before the covenant to pay arises.

Coverage

Time period

In the case of taxes, the general approach is to draw a line in the sand. Tax liabilities which occurred before that time (ordinarily, completion) will be to the account of the seller. Taxes arising after that time will be to the account of the buyer. While, of course, it is never quite that simple, returning to that base objective can be helpful when reviewing the clause and accompanying carve-outs.

The tax indemnity seeks to provide a quick and efficient way for the buyer to be put in funds by the seller in respect of tax liabilities.[4] The tax indemnity generally relates to a period when the buyer did not control the company (or, in some transactions, where the parties may have agreed that the risk and reward of the company will pass).

Treating tax in this way is a product of the negotiated position, rather than any specific tax law that says it must be so. There are a number of circumstances where it might not be appropriate to treat tax in this way. An example is where the buyer already owns part of the target entity, particularly in circumstances where they have some ability to control. A seller may argue that, given the buyer's control, no tax indemnity should be included in the sale agreement. The buyer, of course, is likely to maintain that the seller should be liable for their portion of any tax liability arising during the time of their ownership on the basis that it may not have otherwise been factored into the price for the shares.

Acts, events and transactions prior to completion

Having drawn the line in the sand, it is also necessary to consider what falls on each side. Most tax indemnities seek to cover time periods before completion, and also "acts, events, or transactions" entered into prior to completion. The logic is that the seller should also be liable for taxes arising from actions undertaken by them. While time periods before completion are generally uncontroversial, some debate may be had regarding "acts, events, or transactions" on the basis that these can, in some circumstances, extend the tax indemnity forward.

The entity is providing the indemnity

In a standard transaction, the tax indemnity will be given from the seller to the buyer. One scenario where this may not be sufficient is in the context of an entity, or a group of entities, leaving a tax consolidated group.

In consolidation, the head company will be responsible for paying any tax liabilities of the group.[5] If the head company fails to pay, the Commissioner may pursue the other group members who have joint and several liability[6] subject to the existence of a valid tax sharing agreement.[7] Where a company has left a consolidated group, ordinarily clear exit provisions will be included in the sale agreement to help mitigate the risks of ongoing liability for contribution amounts. In circumstances where a valid tax sharing agreement is not in place, the party giving the indemnity is of particular importance. The subsidiary should only be jointly and severally liable where the head company has failed to discharge the tax liability of the group. That same entity is the one providing the indemnity. In these circumstances, it may be appropriate to request an indemnity further up the chain (eg the ultimate owners) to address liabilities of the tax group that the entity has just left, although commercially this may be difficult to achieve.

Carve-outs

The tax indemnity is subject to carve-outs. While it may be subject to the general carve-outs relating to claims under the sale agreement, there is also usually a set of specific carve-outs just for tax claims. Some examples of common carve-outs include where the buyer has failed to lodge a return or an objection or to claim a refund after completion, where taxes have been paid prior to completion, and where taxes have been provided for in the completion accounts. The seller may also seek to carve out where the buyer has taken an inconsistent position from the seller in respect of a tax matter.

In the case of a buyer's failure to lodge a return or an objection, to claim a refund, or similar carve-outs relating to buyer conduct, the seller's position is generally that their liability should only extend to matters which were in their control. Therefore, if there is $100 of tax due in respect of a pre-completion period but the target was entitled to claim a refund of that $100, the seller's position will be that they should not be required to pay out that amount. The target would be in a $0 tax payable position had the refund been claimed.

The seller may use similar arguments in the case of an inconsistent position being taken. That is, the tax liability in respect of the pre-completion period has arisen because of matters outside the seller's control.

Taxes paid is not a controversial carve-out. It is appropriate that, if tax has already been paid by the target, it should not be possible to make a claim for that tax despite the tax arising pre-completion. The inclusion of this carve-out is required where the breadth of the indemnity is such that tax paid would otherwise be caught.

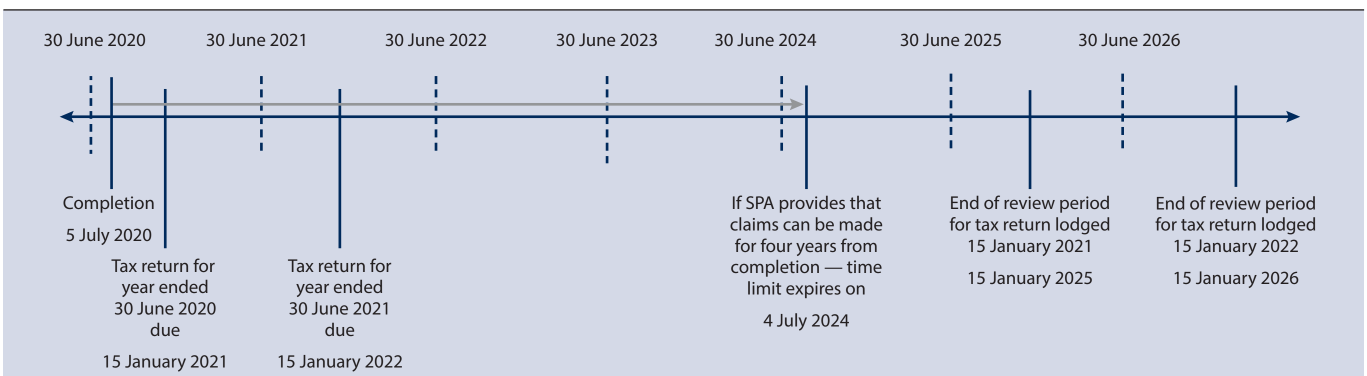
The taxes provided for in the completion accounts are similar to taxes paid, and the same argument for a similar carve-out can be made. While the seller should not be liable for tax that has already been paid, it is also appropriate that tax which has been taken into account when determining the purchase price as part of the transaction should not form part of the indemnity as this would allow the buyer a double benefit (a reduction in the purchase price and an ability to claim that same amount under the tax indemnity). While this concept is straightforward, in practice, the position is less clear. For example, where the completion accounts include $100 for tax, is that the same tax as that which forms the basis of the claim? It may be unclear.

Time limits

The time limits for tax claims can vary greatly but are generally between four and seven years. For a while, the time limits were becoming increasingly short (eg four years). The concern with a time limit of less than five years is that there may still be assessments open when the limitation period ends (see example in Diagram 1).[8]

The increasing prevalence of warranty and indemnity (W&I) insurance has seen these time limits being pushed back

Diagram 1. Interaction between open assessments and time limits in sale agreement



again towards seven years as parties often agree to match the time limit in the policy.

While a time limit of longer than seven years is unusual, where there is particular sensitivity to specific risks such as transfer pricing, even seven years may be insufficient (again, on the basis that the seven-year period commences from the time the Commissioner gives the notice of assessment to the entity).[9]

Consistent with the legislation, the time limits will generally not apply in cases of fraud.[10]

Tax warranties

With a comprehensive tax indemnity in place, the question may be asked, "why do we need any tax warranties?". For some tax warranties, the answer is often "you don't". They are covering the same ground as the tax indemnity. But this is not the case for all warranties. Before considering specific types of tax warranties, it is first useful to recall the difference between warranties and an indemnity.

A claim for breach of a warranty is a contractual claim. In order to claim under a tax warranty (or any warranty), the buyer must show that there has been a breach of that warranty, and that the breach has caused a loss. It is also necessary to discharge any duty to mitigate the loss. By contrast, an indemnity gives rise to a debt claim, so "the right to payment has accrued … and no obligation to prove damage or mitigate loss" is required.[11]

The tax warranties can be broken into two broad categories:

- category 1: information-gathering. These warranties may be covered by the tax indemnity but nevertheless provide useful information to the buyer; and
- category 2: warranties impacting post-completion matters. These warranties are not covered by the tax indemnity.

Category 1

An example of a warranty that clearly falls into category 1 is the taxes paid warranty. An example of a "taxes paid" warranty is:

> (Taxes paid) All Taxes for which a Target Entity is liable that relate to a period or part period up to and including completion, including any penalty or interest, have been paid.

The tax indemnity will typically already cover this. Nevertheless, a warranty of this nature is nearly always included in a sale agreement. The value in this warranty is in the information that it provides which allows the buyer to price the target appropriately. Even if the buyer does have recourse to the tax indemnity, the buyer is still interested in knowing, before buying an entity, whether there are large outstanding tax liabilities so the buyer can better consider how it might run the entity in the future.[12] As noted above, there is also often a cap on the value of tax claims. Information-gathering is important as it also provides the buyer with some comfort that any claims which may be made under the tax indemnity are unlikely to exceed any cap (or perhaps negotiate for a higher or uncapped indemnity if that does not appear to be the case).

Category 2

The other category of tax warranties is those which may not be covered by the tax indemnity. Most notably, this includes warranties which are related to matters where the tax liability would arise in a future period, for example, warranties regarding agreements or arrangements made with a tax authority. In this circumstance, if the buyer was not aware of the agreement, the buyer may undertake an action post-completion which causes the target entity to breach that agreement or arrangement. If the relevant period in which the target breached the agreement or arrangement was following completion, the buyer may rely on the breach of warranty in respect of its loss arising from not knowing about the agreement or arrangement.

> *"The tax indemnity functions quite differently from the contractual treatment of most other liabilities of the target entity."*

Interaction with the W&I regime

Having established a "base case" position, given the prevalence of W&I insurance in the market, it may be helpful to consider how that insurance may impact the position. Warranty and indemnity insurance is, as the label says: if a claim is made for a breach of a warranty or under an indemnity, the insurance will, subject to the conditions of the policy, cover the liability that would otherwise have been payable by the seller. The advantage of W&I insurance is that it allows the seller to exit their investment and may reduce the need for funds to be held in escrow or for the seller to retain funds to meet potential claims.

While sellers often seek to have a sale agreement provide for "sole recourse" to the W&I policy, this is not always acceptable to the buyer. For example, W&I insurance will rarely, if ever, cover transfer pricing (unless a specific separate policy is obtained). Where this is of concern, there are two possible solutions for the sale agreement:

1. the seller can "stand behind" the standard tax indemnity. If this option is adopted, the seller will be responsible for matters where the buyer is unable to claim under the W&I policy, or where the claim exceeds the policy (subject to the limitations in the sale agreement); or
2. a separate tax indemnity can be included specifically covering the issue of concern (in this case, claims arising from transfer pricing). This approach is generally preferred as it limits the matters that the seller is liable for to the specific tax concern raised by the buyer for which the specific indemnity is drafted.

Warranty and indemnity insurance also impacts uninsured transactions. As mentioned above, a change that has resulted from the introduction of W&I insurance is that time limits for uninsured deals have pushed back out towards seven years to match the time limit generally adopted in the W&I insurance policy. Similarly, as W&I insurance carves out matters disclosed, sellers are increasingly requesting that the tax indemnity be subject to disclosure in uninsured deals also (although this is usually strongly rejected by the buyer).

Assigning control of tax matters under the sale agreement

Having assigned the liability for taxes between the parties, the next broad grouping of tax provisions in the sale agreement is aimed at regulating the conduct of the parties. Broadly, these provisions regulate who can do what, and when.

Tax returns

The most obvious of these clauses are those addressing the completion and submission of tax returns. Most commonly, the seller will be responsible for preparing returns for periods ending before completion, and the buyer will be responsible for preparing returns for periods which "straddle" completion (that is, the period starts before completion and ends after completion). In either case, the buyer will ordinarily be required to submit, or procure that the company submits, the return.[13] In practice, however, who is responsible for the preparation of any given return will depend on the parties involved, the dynamics of the transaction, and each party's respective tax functions.

Sale agreements sometimes provide for review rights for the party that did not prepare the return, and a tie-breaker mechanism (usually an independent tax adviser) to resolve a dispute when the parties disagree on some aspect of the return.

Tax disputes

Sale agreements generally provide for which party is able to control the conduct of a dispute with the ATO, and what approvals are required before any dispute is settled or compromised. Some sale agreements have a dedicated tax demands clause which is separate from the more general third-party claims clause. This has the advantage of allowing the tax lawyers to debate the clause independently of the broader commercial negotiation. However, a tax dispute with the ATO is similar to any other dispute with a third party (particularly any other government regulator) and, increasingly, parties (and their advisers) are comfortable with keeping all third-party claims, including claims against the ATO, in the one provision. Where the seller has the option to take control of the dispute, the sale agreement will sometimes provide the buyer with the opportunity to "step in" if they wish. Where this option is exercised, ordinarily the buyer will no longer be entitled to recover under the tax indemnity from the seller.

Conduct pending completion

It is not uncommon to see a series of restrictions on the seller between the date of the agreement and completion. These restrictions usually include a number of specific tax items, such as not settling or compromising tax disputes, and not paying dividends unless they are "permitted" (usually requiring that they are paid from cash, they do not breach the benchmarking franking rules, they do not cause a franking deficit etc). These provisions aim to protect the buyer by restricting the ability of the target to alter the tax profile of the business after the buyer has entered into the sale agreement (and after the due diligence process, if any, has been completed).

Pre-completion tax matters

Sellers may request the inclusion of a clause restricting the buyer's ability to engage with revenue authorities in respect of pre-completion tax matters. Where such a provision is included, specific consideration should be given to the interaction between pre-completion tax matters and the third-party claims clause. When dealing with tax matters, it is important that there be clarity about who has control at what stage in any interaction with the ATO.

Clear exit

As discussed above, where an entity (the target) is exiting a consolidated group, there may be some concern that the target has an ongoing liability for contribution amounts under a tax-sharing agreement for the group from which the target is exiting. One way that the buyer may obtain some comfort with respect to this risk is by the inclusion of "clear exit" provisions. These provisions require the seller to provide evidence that the entity has calculated, and to the extent necessary, paid, the amount required to achieve a clear exit.

Consideration

Most transactions are for cash. In these circumstances, where the full amount of the consideration is paid at completion, the amount received will generally be capital proceeds for the seller[14] and form part of the cost base for the buyer.[15]

Generally, a sale agreement will include a clause stating that payments made by the seller or the buyer under a claim will be an adjustment to the purchase price.[16] However, care should be taken when the consideration is paid in less straightforward transactions (for example, where there is a pre-completion dividend,[17] or an earn-out arrangement[18]).

In some transactions, instead of paying cash, a buyer may instead be exchanging scrip (that is, the seller will be exchanging their shares in the target for shares in the buyer, or a member of the buyer group). Where all shareholders (of voting shares) are entitled to participate and an offer has been made to all owners of interests of a particular type on the same terms, the sellers may be able to obtain CGT roll-over relief to the extent of that scrip consideration.[19] The "replacement interest" (being the consideration shares) must be in the buyer, or, if the buyer is a member of a wholly owned group, the ultimate holding company.[20] Other conditions include that the buyer is becoming the owner of 80% or more of the shares in the target (although this can include increasing an already existing ownership to an amount over 80%).[21]

From a drafting perspective, the sale agreement is slightly more complicated as it must state the number of shares each seller is to receive, or the formula to determine the number of shares. However, from a tax perspective, it is a relatively mechanical exercise of working through Subdiv 124-M ITAA97 to ensure that each of the conditions are met and documented as required. More complicated is the decision regarding whether any adjustments arising from the completion statement or claims are to be paid in cash or to occur by way of exchange of scrip (either handing some scrip back to the buyer, or the buyer issuing more scrip).

Foreign resident capital gain withholding

Foreign resident capital gains withholding is perhaps not the most pressing of tax issues in a sale agreement, yet differing approaches mean that there is often still some jostling over the drafting. There are also, of course, quite substantive consequences (being 12.5% of the CGT asset's cost base after the acquisition) if the correct declarations are not received.

Two approaches are generally adopted when dealing with foreign resident capital gains withholding declarations:

1. the declaration can be drafted into the document itself; or
2. the ATO form (NAT 74879-06.2016) can be used.

Provided the declaration is in writing and meets the requirements in s 14-225 of Sch 1 TAA53, either option is acceptable. Each option does, however, have positives and negatives. A key advantage with the first option is that it reduces the pieces of paper that the seller must sign. This can be particularly useful where there are multiple sellers. The second option helps to ensure that the sellers have turned their mind to the matter. This can be helpful, particularly where the seller is not an Australian resident, and the declaration is instead that the sale shares are not an "indirect Australian real property interest".[22]

The legislation provides that a declaration is valid for six months from the date the declaration is made.[23] In circumstances where it is anticipated that completion will occur more than six months from the date of signing, thought should be given to the process for refreshed certificates to be provided to ensure that the whole of the period from signing to completion is covered.

Who is the party providing the declaration?

A particular area where attention should be given for foreign resident capital gains withholding declarations is where the seller is a trust. The ATO has stated that the name of the seller on the declaration is to be the same as the seller under the sale agreement.[24] In the case of a trustee selling shares held by the trust, the seller will be the trustee (as the entity with legal title to the asset), not the trust.[24]

Declarations or clearance certificates

In the case of an asset sale where some of the assets are real property and some of the assets are shares, often both a clearance certificate and a declaration are obtained from the seller. This is on the basis that the exception in s 14-210(2) of Sch 1 TAA53 only applies to the CGT asset listed in s 14-201(1)(e) of Sch 1 TAA53, being taxable Australian real property and a limited subset of indirect Australian real property. It does not apply to indirect Australian real property generally.

Boilerplate clauses

When reviewing a sale agreement, there can be a tendency for tax lawyers to be asked to look "just at the tax indemnity", or "just at the tax provisions". This should of course be avoided.

As discussed above, if the tax disputes are dealt with separately from third-party claims, having regard to the third-party claims provisions will be important in ensuring consistent treatment between both. More generally, many of the non-tax specific clauses may impact on tax matters, including the retention of records, the disclosure of confidential information, and the counterparts (the clause that provides that multiple copies of the same agreement, known as counterparts, can be executed by the parties) clauses. These provisions should be reviewed to ensure that they do not cut across any of the agreed specific tax provisions and that they do not otherwise result in an unexpected or adverse commercial outcome on tax matters.

Conclusion

While there are numerous tax considerations to be taken into account when undertaking M&A transactions, having a broad understanding of the key tax clauses, and taking a principles-based approach, can help to establish a framework for both the drafting and negotiation of sale agreements from a tax perspective.

Victoria Lanyon
Senior Associate
King & Wood Mallesons

An earlier version of this article was presented at The Tax Institute's NSW 13th Annual Tax Forum held in Sydney on 20–21 May 2021.

References

1 References are made in this article to a "tax indemnity" despite the fact that the clause may be drafted as a "covenant to pay".

2 T Sanders and P Ridgway, *Tax indemnities and warranties*, 3rd ed, Tottel Publishing, 2009, p 30.

3 Ibid p 2.

4 Ibid p 184.

5 S 701-1 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).

6 S 721-15(1) ITAA97.

7 S 721-15(3) ITAA97.

8 Item 4 of the table in s 170(1) of the *Income Tax Assessment Act 1936* (Cth).

9 S 815-150 ITAA97.

10 *Income Tax Assessment Act 1936* (Cth) s 170(1) item 5.

11 Sanders, op cit, p 26.

12 Sanders, op cit, p 184.

13 In order for a return, notice, statement, application or other document to be given to the Commissioner, a declaration must be signed that the information is true and correct (ss 388-60 and 388-75 of Sch 1 to the *Taxation Administration Act 1953* (Cth)). The declaration must be signed by someone authorised by the company to sign, usually the public officer. As the seller generally will no longer own the target, they will ordinarily not be in a position to sign the declaration required for the lodgment of the pre-completion return.

14 S 116-20 ITAA97.

15 S 110-25 ITAA97.

16 Ss 110-45(3) and 116-50 ITAA97.

17 See, for example, D Wood, "Mergers and acquisitions in financial services", paper presented at The Tax Institute's Financial Services Taxation Conference, 7 to 9 February 2018.

18 See, for example, G Ellis and T Sherman, "CGT treatment of earn-outs", paper presented at The Tax Institute's 3rd Annual Tax Forum, 18 May 2010.

19 S 124-780 ITAA97. The availability of this roll-over relief is currently being considered by the Board of Taxation as part of its review of CGT roll-overs.

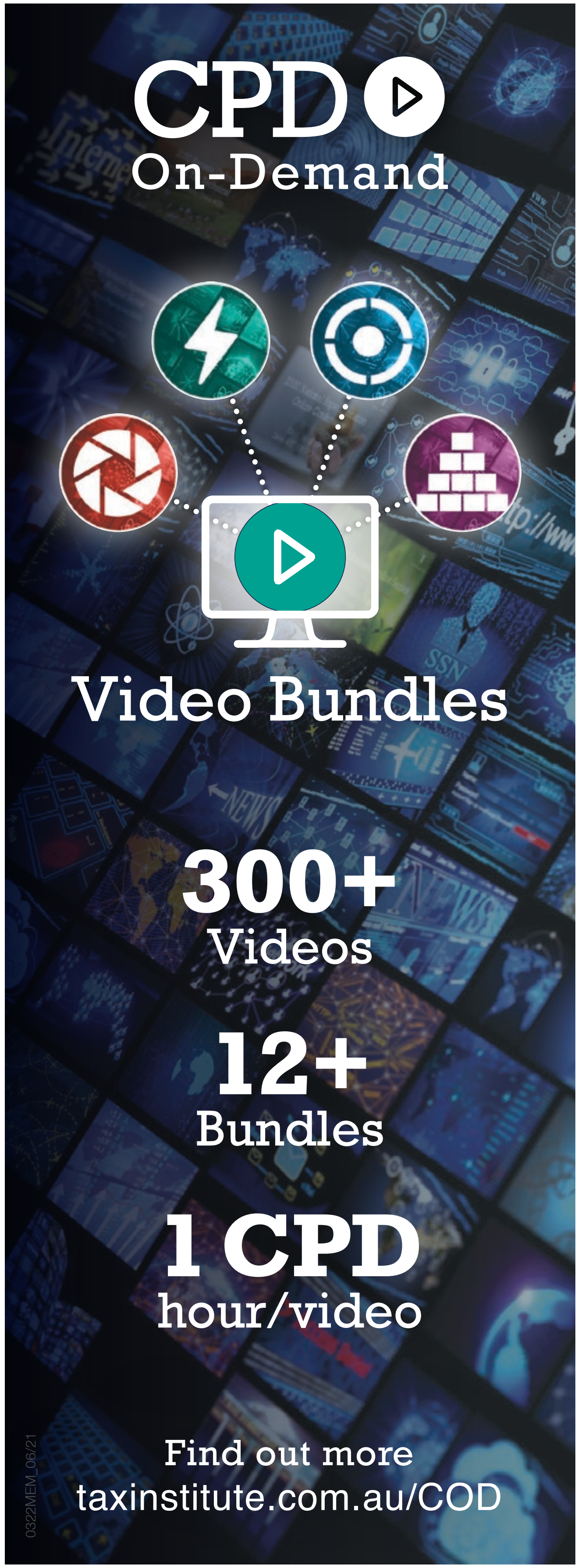
20 S 124-780(3)(c) ITAA97.

21 S 124-780(2)(a) ITAA97. See also TD 2000/50.

22 S 14-225(2) of Sch 1 TAA53.

23 S 14-225(3) of Sch 1 TAA53.

24 Australian Taxation Office, *Capital gains withholding: Impacts on foreign and Australian residents, Vendor declarations.* Available at www.ato.gov.au/general/capital-gains-tax/in-detail/calculating-a-capital-gain-or-loss/capital-gains-withholding--impacts-on-foreign-and-australian-residents/?page=6.



A Matter of Trusts

by Laura Spencer and Rob Jeremiah, CTA, Sladen Legal

Certainty and establishing a trust

To create an express trust, there must be certainty of intention, subject matter, and beneficiaries. In the absence of such certainty, will the trust fail?

Where not provided in a trust deed, the rules of equity, together with legislative instruments, may provide a settlor with the ability to revoke a trust, embolden a trustee with powers,[1] duties and liabilities, and outline the rights of beneficiaries under a trust. However, before seeking to administer or vest a trust, an often-overlooked question is: has the trust in fact been created?

In practice, the question of the existence of a trust often arises where:

– the parties have been incorrectly identified in a trust deed;
– the deed was not executed;
– assets comprising the fund of the trust have not been registered in the trustee's name;
– the settled property has not been transferred;
– the terms and provisions of the trust as contained in the trust deed are inadequate, uncertain and/or lack clarity; or
– the trust deed has been lost.

Despite such issues arising, a trust will be upheld pursuant to the rules of equity where the trust can be enforced and controlled. Critical to the ability to enforce and control a trust is the long-held principle of the "three certainties" articulated by Lord Langdale MR in *Knight v Knight.*[2] The principle states that, for a trust to be created (and thus enforced and controlled), the settlor must, whether by declaration, transfer or direction, create certainty of:

– the creation of, or intention to create, the trust;
– the subject matter, being the property the settlor provides to the trust; and
– the object, being the identity of the beneficiary or beneficiaries of the trust.

Today, 181 years since Lord Langdale's formulation of the three certainties, they remain pivotal to the formulation of a trust. Doubt of the existence of any of the certainties may arise as a result of errors or conflicting provisions in a deed or failures of procedure in the settlement of the trust. As a result, a trust may be deemed to fail, the actions of a trustee may be found to be invalid, the assets of a trust may be unintentionally exposed to risk and undesirable tax consequences may be triggered for unsuspecting trustees and/or beneficiaries.

In this article, the authors consider each of the three certainties in further detail and consider how advisers should approach drafting, reviewing or dealing with trust deeds in order to answer this essential first question: has a trust been created?

Certainty of intention

A well-drafted and documented declaration by a settlor of their intention to establish a trust on the payment of the settled sum to a trustee for the benefit of beneficiaries should provide a clear intention to create a trust. While the courts have accepted that the word "trust" is not necessary to demonstrate the creation of a trust, it is best practice to include terms in a trust deed that are specific, accurate and clear.

In the recent case of *Re McGowan & Valentini Trusts*[3] (*McGowan*), the plaintiffs sought advice from the Supreme Court of New South Wales on a number of issues arising as a result of a series of procedural and drafting errors contained in the deeds of two trusts dated 14 February 1977 (trust deeds).

While the settlor had clearly expressed in the trust deeds their intention to declare the trusts, the Supreme Court was asked to consider whether errors in the identification of the trustee invalidated the settlor's intention to create a trust. The settlor had nominated a trustee that was not in existence at the time of the execution of the trust deeds. For the following 19 months, the trustee entity remained unregistered and two individuals, purportedly in their capacity as director of the trustee, administered the trusts.

In addressing this error Macaulay J stated:[4]

> "Equity will not allow a trust to fail for want of a trustee because, generally, that would be contrary to the settlor's intention."

An exception to this may be deemed to exist where the settlor provides that the trust should only exist during the lifetime of a specified trustee. In the trust deeds, no such limitation existed and, as such, the Supreme Court determined that the settlor, by the terms of the trust deeds, intended to declare a trust and would not have wished the trust to fail simply for the lack of a trustee.

From an administrative perspective, the question arose as to whether the trusts had existed for the 19-month period during which there was not a trustee. Macaulay J determined that the two individuals, who later became the directors of the trustee, were deemed to be the trustees during that interim period and their actions during that period (if any) were taken to be valid.

McGowan highlights the importance of a well-drafted declaration of trust. In the absence of such a clear declaration, it is likely that there would have been greater scrutiny on the intention of the settlor in the creation of the trusts. Additionally, the case also highlights the importance of ensuring that a deed is accurate and consistent in its terms so as not to open the trust to challenge as to its validity. While the decision in *McGowan* was favourable for the plaintiffs, it is a costly exercise to seek guidance or advice from the Supreme Court as a result of inadequate attention to detail, fundamental principles, and the requirements for the creation of a trust.

Certainty in the subject matter

To create a trust, there must be certainty as to the property to be subject of the trust. It is common practice in the establishment of a trust for a nominal settled sum, for example, $20, to be gifted by the settlor to the trustee to be held on trust for the beneficiaries. The payment of the settled sum by the settlor to the trustee must occur and the receipt of the settled sum by the trustee should be documented.

In the Victorian case of *Aston (Aust) Properties Pty Ltd v Commissioner of State Revenue (Taxation)*[5] (*Aston*), the lack of evidence to demonstrate the payment of the settled sum led the tribunal to find that a number of trusts had not been established.

The applicants in *Aston* were 11 companies which each held various investment properties purportedly on trust for 67 trusts. Mr Corcoris was a director and shareholder of most of the 11 companies and had prepared the trust deeds himself without any guidance or direction from a legal professional.

The companies had been assessed by the Commissioner of State Revenue for land tax and duty in relation to a number of transactions. The applicants objected to the assessments on the basis the properties were held in trust. However, the tribunal noted that no evidence of the payment of the settled sums for each trust could be provided. The tribunal found this to be significant as a trust cannot exist without trust property. In the absence of evidence of the settled sums or a declaration by the trustee over property, it was found that there was no certainty in the subject matter and ultimately the trusts did not exist.

The failure to provide certainty as to subject matter by simply transferring and documenting the receipt of the settled sums was a costly mistake in *Aston*. As a result of the decision, the applicants were not eligible for tax benefits available to trustee companies, and while not considered in the decision in the absence of the existence of a trust, the various properties would have been exposed to claims against the trustee.

The *Aston* case serves as a reminder to advisers to ensure, particularly if proposing to act as settlor, that the settled sum is paid and documented. Failure to transfer the settled sum to the trustee of a trust will cast doubt on the certainty of the subject matter and ultimately would likely lead to the trust being deemed to have failed.

In the case of testamentary trusts, additional consideration should be given to the drafting of the clauses which detail the property to form the subject matter of the trust. The exact property which forms the subject matter of a testamentary trust may alter between the signing of the will and the creation of the trust (on the death of the testator). Even a marginal degree of ambiguity or vagueness as to what constitutes the subject matter in such circumstances may lead to the trust being deemed to be void or subject the estate to legal proceedings to confirm the correct interpretation of the subject matter.

Certainty of objects

The extent of the certainty of objects or beneficiaries of a trust differs depending on the nature of the trust.

Discretionary trusts

In discretionary trusts, beneficiary clauses are often drafted widely to provide the trustee with flexibility when making distributions. For the purposes of validly creating a trust, such clauses, while permitted to have breadth, must be sufficiently clear for the purposes of identification of the beneficiaries. Where the beneficiaries of a trust cannot be identified with reasonable certainty, the trust will not have been validly created and will fail. Words such as "associates" or "supporters" are, for example, ambiguous and are likely to fail the certainty test.

The High Court in *Kinsela v Caldwell*[6] (*Kinsela*) stated that certainty of objects does not necessitate that all beneficiaries are ascertainable at the date of the trust, but rather that they can be identified at the date of a distribution provided the period between creation and distribution does not breach the law of perpetuities.

When drafting a discretionary trust deed, consideration should also be given to which persons and what entities the beneficiaries are to potentially comprise or are to be specifically excluded.

Foreign duty surcharge applies in all states in Australia.[7] Where trustees of foreign trusts acquire residential property[8] or property which the trustee intends to develop into residential property, surcharge duty applies. A discretionary trust will be a foreign trust if more than 50% of the capital of the trust can be distributed to a foreign entity or their associates. Given the wide classes of beneficiaries in a standard discretionary trust, many discretionary trusts will be foreign trusts unless the deed contains an appropriate exclusion clause.

Additionally, surcharge rates of land tax also apply in Victoria, NSW, Queensland and the ACT if the objects of the trust include foreign or absentee owners. There are variations between the jurisdictions in the definitions of foreign or absentee owners.

The Supreme Court of NSW recently addressed this issue in *Re Dion Investments Pty Ltd*[9] (*Dion*). In addition to not excluding foreign persons from benefiting under the trust, the trust deed also did not provide the trustee with the power to disclaim or surrender the power to appoint income and/or capital to a foreign beneficiary of the trust or the power to exclude such beneficiaries as beneficiaries. To prevent the future application of the land tax surcharge, the trustee was required to undergo the costly exercise of requesting the Supreme Court to grant the trustee the necessary power under the *Trustee Act 1925* (NSW).

Dion demonstrates the importance of "getting it right from the start". It serves as a reminder to ensure that trust deeds are appropriately drafted and identify the natural persons and entities who comprise the objects of the trust. If all known tax and asset protection issues are duly considered at the time of the execution of a trust, the selection and nomination of beneficiaries should minimise any unintended tax and asset protection consequences and/or exposures.

Fixed trusts

In the case of fixed trusts, the beneficiaries must be clearly identifiable and their fixed rights and interests specified. Where the rights, entitlements and interests of the beneficiaries in a trust deed are not fixed in any respect and can be varied without their consent, the trust will not be a fixed trust.

In *West v Weston Matter No. 4365/96*[10] (*West*), the Supreme Court of NSW revisited *Kinsela*. The Supreme Court considered what time frame should apply to the task of compiling a list of beneficiaries.

The testator had provided in his will for his estate to be held on trust and divided equally among the issue of his four grandparents living at his death as attained the age of 21 years. The executor of the estate engaged a genealogist who identified, by the date of the trial, 1,675 beneficiaries who satisfied the definition of beneficiary. If the genealogist had continued to search, the list would continue to grow. As a result, it was not possible to determine the identity of each and every beneficiary and the quantum of their share.

The Supreme Court acknowledged that, in the absence of such a determination of a list of beneficiaries, the trust would fail. However, the court modified the High Court's principle in *Kinsella*, noting that:

> "… if, within a reasonable time after the gift comes into effect, the court can be satisfied on the balance of probabilities that the substantial majority of the beneficiaries have been ascertained and that no reasonable inquiries could be made which would improve the situation."

The Supreme Court found that, provided the trustee could be comfortable that the majority of beneficiaries had been determined, certainty of subject matter would have been achieved and the trust found to be valid.

While this modification of the principle of the High Court in *Kinsella* appears practical and has been applied in subsequent cases such as *Re Meyerstein*,[11] it has received criticism and should not, at least until a High Court ruling on point, deter drafters from being clear in detailing the natural persons and entities that comprise the objects of the trust.

Concluding comments

The cases discussed in this article serve as a reminder of the importance of the three certainties when establishing a trust. Further, the cases and commentary demonstrate that it is critical to have precise drafting and to comply with all formalities when establishing trusts. Failing to do so may create unintended tax consequences and expose assets to risks from which, at the time of creation of the trust, it was intended its assets be protected.

Advisers should be mindful that, to create an express trust, there must be certainty of intention, subject matter and beneficiaries. The absence of any of the three certainties will cause the trust to fail.

Laura Spencer
Senior Associate
Sladen Legal

Rob Jeremiah, CTA
Principal
Sladen Legal

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1 The authors note that a trustee has no implicit power to amend a trust deed. In the absence of an express power, any purported variation to a deed is likely to be invalid. For further comments on this question, see E Hennebry, "Interpreting and varying trust deeds", (2020) 54(8) *Taxation in Australia* 444.

2 [1840] EngR 862.

3 [2021] VSC 154.

4 Ibid at [37].

5 [2012] VCAT 48.

6 [1975] HCA 10.

7 Foreign purchaser duty does not apply in the Australian Capital Territory or the Northern Territory.

8 An additional 0.5% foreign purchaser duty also applies to primary production land in Tasmania.

9 [2020] NSWSC 1661.

10 [1998] NSWSC 419.

11 [2009] VSC 564.

Superannuation

by Daniel Butler, CTA, and William Fettes, DBA Lawyers

Contribution reserving: hurdles and risks

In many instances, a reserved contribution will trigger an excess contributions determination and subsequent assessment which will need to be dealt with and rectified as part of a contribution reserving strategy.

When discussing contribution strategies with clients, advisers should be mindful not to present contribution reserving as a straightforward exercise, as there are a number of practical issues and potential risks that should be carefully considered before proceeding with a contribution reserving strategy.

This article discusses some of the common hurdles and risks to assist in making an informed decision on whether contribution reserving is a strategy where the limited upside is justified after assessing the potential downside and related risks.

What is contribution reserving?

A contribution reserving strategy typically involves a fund member or their employer making a contribution (usually a concessional contribution (CC)) in one income year, with arrangements in place to hold the contributed amount in an unallocated suspense account or a contribution reserve account (CR account) until the subsequent income year. The fund trustee then allocates the contribution to the relevant member's accumulation account within 28 days from the start of the following income year pursuant to the timing rules in reg 7.08 of the *Superannuation Industry (Supervision) Regulations 1994* (Cth) (SISR94).

This article focuses on contribution reserving for personal deductible contributions as this is consistent with the example in the ATO's public ruling on this topic, namely, TD 2013/22.

Treatment of "reserved" amounts

Subject to a number of provisos (see, for example, TD 2013/22), the broadly accepted treatment of contributions that are appropriately reserved is as follows:

- the contribution is only counted for general capping purposes (for example, for the member's CC cap) in the income year that it is allocated. Thus, in the income year of the contribution, the amount held in the CR account does not count towards the member's CC cap;
- the contribution is deductible in the year it is made. Thus, a personal deductible contribution made by a member to a CR account is deductible in the income year the contribution is made to, or received by, the fund, assuming the relevant requirements in Div 290 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) are met;
- the contribution is included in the assessable income of the fund in the income year it is received by the fund; and
- the contribution is only counted as a CC for the purposes of calculating the member's adjusted taxable income under Div 293 ITAA97 in the income year the contribution is allocated to the member's accumulation account. Income for Div 293 purposes includes taxable income, reportable fringe benefits, total net investment loss, and CCs. Thus, contribution reserving can assist with managing Div 293 tax where claiming a larger deduction in year one is beneficial for Div 293 purposes.

Risks with contribution reserving

Contribution reserving should not be undertaken lightly due to the risks of ATO scrutiny arising, including in relation to being asked to supply the requisite documents that support the strategy. These documents would typically need to include an SMSF deed with relevant express powers to support contribution reserving, appropriate trustee resolutions to cover the treatment of the contribution as part of a CR account, reserving strategy documents, and allocation resolutions. Naturally, these documents should be in place before any contribution is reserved and serious penalties can apply for any backdating of documents. If appropriate documentation is not in place before the strategy is implemented, the strategy may fail and result in the ATO investigating whether any false and misleading statements have been made.

In many instances, a reserved contribution will trigger an excess contributions determination and subsequent assessment which will need to be dealt with and rectified as part of a contribution reserving strategy.

Naturally, the likelihood of clients being exposed to ATO scrutiny and the associated risks, including the possibility that an objection may need to be made against an excess contributions assessment, should be explained to any client who is contemplating this strategy.

The authors are aware of numerous clients who have incurred considerable expense dealing with excess contribution issues arising as a result of contribution reserving. For these clients, the excess arose as a result of differences in timing of lodgments of SMSF and personal tax returns compared with when the ATO processes the "Request to adjust concessional contributions" form (NAT 74851) that needs to be lodged by the SMSF trustee or their agent to report a reserved contribution. This form is processed manually by the ATO, and an excess contributions notification may be automatically generated by the ATO's systems as soon as the SMSF and member's tax returns have been processed. The request to adjust CCs, by itself, does not cancel an excess contributions assessment. Thus, considerable work may be involved in seeking to have an excess contributions assessment adjusted. This work can be time-consuming and costly for an adviser to attend to on a client's behalf, unless, of course, the adviser has been requested by the client to fix the problem that they (the adviser) have created at their own cost.

Only a discrete contributed amount can be reserved

Another issue that often arises in relation to contribution reserving is making sure that only a discrete contribution is reserved and not part of a larger amount.

The ATO generally does not accept that part of a contribution can be reserved under the allocation rules in reg 7.08 SISR94, and the ATO does not accept that part of a contribution can be allocated to the member's account, with the remaining part of the contribution being applied to a CR account.

Therefore, to comply with the ATO's view, the amount of a contribution that a member intends to be held in a contributions reserve should be a discrete amount that is separate to any other contributions being made to the fund.

Total superannuation balance implications

It is important to note that a contribution reserving strategy cannot be used to circumvent total superannuation balance (TSB) testing which is relevant to various superannuation caps and concessions, including and non-concessional contributions caps and the carry forward rules for unused CCs.

A member's TSB is broadly equal to the sum of all of their interests in all relevant Australian superannuation funds. The TSB value of a member's accumulation entitlements is broadly determined based on what would be payable if the individual voluntarily caused their interest to cease pursuant to s 307-205 ITAA97. Thus, a reserved contribution would be reflected in a member's 30 June TSB testing, despite the fact that an SMSF's financial statements may not reflect a reserved contribution in the member's account as of 30 June.

Financial services law implications

For advisers with an Australian financial services licence (AFSL), consideration should also be given to whether a statement of advice or record of advice should be provided. For advisers without a licence, they need to determine whether they are authorised by law to give such advice on the basis that it is merely tax or factual advice and does not involve any recommendation in relation to a financial product (ie an SMSF). Special documentation is required by non-licensed advisers to ensure that they do not contravene the AFSL restrictions in the *Corporations Act 2001* (Cth) in this instance.

Is the limited upside justified, given the potential downside and related risks?

If a contribution reserving strategy is successfully implemented with appropriate supporting documentation, for example, say a $25,000 amount is contributed in mid-June 2021 and $27,500 is contributed on 25 June 2021 which is allocated to a CR account, the strategy seeks to have $25,000 counted against the member's CC cap for FY2021 and, on allocation of the $27,500 from the CR account to the member's account prior to 28 July 2021, the $27,500 is counted towards the member's CC cap for FY2022.

Thus, the member's contribution cap for FY2022 is used up by the reserved contribution made in FY2021. The member can next contribute on 1 July 2022 for FY2023, or make a contribution that is reserved, say, on 30 June 2022, which is allocated in early July 2022 for FY2023.

In broad terms, once a member starts a contribution reserving strategy, there is generally only a one-off upfront timing advantage. Therefore, the question must be asked: is all of the risk and potential downside worth proceeding with a strategy that has a limited upside?

While a member who has a prior 30 June TSB of less than $500,000 may have the ability to make a larger contribution that is reflective of their unused CC caps since FY2019, the contribution reserved amount for FY2022 would add a potential $27,500 on top of the member's CC figure. This may appear appealing, especially if that person has made no CCs since 1 July 2018, as a $75,000 contribution could be made for FY2021, with a potential $27,500 being reserved for FY2022, being a total of $102,500. However, the $27,500 tax deduction is again largely a timing difference occurring in FY2021 rather than FY2022. It should also be noted that a member cannot obtain a deduction that exceeds their taxable income under s 26-55 ITAA97.

Conclusion

Many advisers seem to treat contribution reserving as a "walk in the park" and do not mention the risks and potential downside (outlined above) to their clients. Thus, advisers discussing contribution reserving with clients should be mindful that there are a number of risks involved in the strategy, and clients should only proceed with their eyes wide open to such risks. An adviser would potentially be liable if they did not warn their clients of the risks involved with the strategy, as well as any potential upside, so their clients are in a position to make an informed decision on whether they intend to proceed with a contribution reserving strategy or not. The best way for an adviser to minimise their legal risks is to provide a comprehensive statement or letter of advice in writing to clients well before they enter into the strategy.

Daniel Butler, CTA
Director
DBA Lawyers

William Fettes
Senior Associate
DBA Lawyers

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Alternative Assets Insights

by Rachael Cullen and Rebecca Huang, PwC

NSW wind farm: fixtures and valuation issues

Taxpayers will need to consider the impact of the *SPIC* case when valuing infrastructure assets for calculating stamp duty and whether such assets are fixtures for income tax purposes.

The NSW Supreme Court recently handed down its decision in *SPIC Pacific Hydro Pty Ltd v Chief Commissioner of State Revenue*[1] and *SPIC Pacific Hydro Pty Ltd v Chief Commissioner of State Revenue (No. 2)*[2] (collectively, the *SPIC* case). This case considered the status of wind farm assets on leasehold land as fixtures or chattels at common law, and the appropriate valuation methodology to be adopted for stamp duty purposes.

In summary, the court held that:

– the wind farm equipment (including turbines) were fixtures at common law (not chattels);

– the lessee's interest in the wind farm equipment arose as part of its leasehold rights, rather than some other equitable interest in land;

– the value of the leasehold interest and improvements was to be determined using a profit rental methodology (ie based on expected rental return on the assets), rather than determining separate values of the lease and the plant and equipment (ie under a depreciated optimised replacement cost (DORC) methodology); and

– even though SPIC was not successful in all of its arguments, as it was successful in having the original assessment revoked and a fresh assessment being issued for a substantially reduced duty amount (by approximately $2.5m in duty or 20% of the original assessment), it was entitled to costs from Revenue NSW.

The fixture/chattel classification has limited future relevance from a stamp duty perspective as a result of changes to the rules across almost all states and territories which mean that items are generally dutiable if they are "fixed" to land, even if they are easily removable and would not be fixtures at common law. However, the classification of assets as fixtures or chattels continues to be important when determining whether the taxable Australian real property (TARP) rules under Div 855 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) apply.

This decision also raises a number of questions about the appropriate valuation methodology to be used when valuing fixtures from both a stamp duty and an income tax perspective. Both the Commissioner and the taxpayer had put forward valuations using a DORC methodology. However, the court rejected this approach based on the statutory context, preferring instead a profit rental approach. This is a departure from the valuation approach commonly used for most leasehold improvements and non-building plant and equipment on freehold land for both stamp duty and income tax purposes, and it creates uncertainty regarding whether this alternative approach should also apply in the statutory context of the amended stamp duty laws (in NSW and elsewhere, the amended laws now include the express deeming provisions) or the income tax legislation.

The *SPIC* case is still subject to appeal periods and both parties have filed a notice of intention to appeal.

In detail

In 2016, SPIC (the taxpayer) acquired all units in the Taralga Holding Land Trust (Taralga). At the time of the purchase, Taralga held long-term leasehold interests in land on which it had built a wind farm (along with some minor freehold assets). The wind farm comprised 51 wind turbine generators housed in custom-designed towers which were bolted into substantial concrete foundations. It also had a switchyard and power substation, a control building, hardstands for heavy equipment, meteorological masts, and 23 km of road access.

The Chief Commissioner determined that Taralga had landholdings with a value of $223.6m and assessed the taxpayer for $12,394,573.37 in landholder duty (based on the value of landholdings and dutiable goods). The taxpayer submitted that the wind farm assets on the leases were chattels rather than fixtures and so no landholder duty should apply, or alternatively, if they were fixtures, the dutiable value should be lower than the value adopted by the Chief Commissioner.

Fixtures versus chattels

When considering whether the wind farm assets were fixtures or chattels, the court considered the degree of annexation (ie how attached they were to the land) and the object of annexation (the purpose/objective intention for attaching them to the land). The court noted that, when making this classification, every case turns on its own facts, and held that the wind farm assets were fixtures, noting the following points:

– the wind farm equipment should be considered as a part of an interconnected whole rather than individual items, as none of these items had a function or use independent of the wind farm operation conducted on the land;

– these assets were substantially affixed to the land, with the turbines on towers 80 m above the ground and the towers held in place by substantial concrete foundations (and a number of sturdy bolts) and connected by predominantly underground cables. Removal of the assets (including 51 turbines) would require cranes, take eight to 13 weeks, and still leave some permanent changes to the land;

- while it was relevant that the parties had agreed in the leases that the lessee had the right to remove the relevant assets, this alone was not determinative of whether they were fixtures or chattels;
- the turbines were designed to maximise the electricity generation from the particular site based on 18 years of wind data;
- the wind farm equipment was intended to remain in place for a substantial period of time and, while there was a clear intention for the assets to be removed from the land at the end of the lease, the evidence before the court did not indicate that it was a "realistic commercial possibility" that the assets would actually be removed from the lease before the end of their effective lives; and
- these assets were installed on the leasehold land so that the land could be used as a wind farm. This was for the better enjoyment of the land (which is three-dimensional and includes the wind space above the land).

The court accepted that some assets, namely, development costs, construction costs, furniture and fittings, spare parts, and those parts of the electronic control system not affixed to the land were not fixtures (totalling approximately $18.5m out of approximately $227.1m of value). The roads and tracks (about $7.2m of value) were held to be landlord's fixtures rather than tenant's fixtures.

These conclusions are a direct contrast to the recent Victorian Supreme Court decision in *AWF Prop Co 2 Pty Ltd v Ararat Rural City Council*[3] (the *Ararat* case) where the court held that above-ground wind farm assets were chattels at common law. The turbine foundations, roads, fences, carpark and underground cabling were the only assets considered fixtures. The *Ararat* case was distinguished by the NSW Supreme Court in the *SPIC* case on the basis that:

- the *Ararat* case considered a different statutory regime (ie a fire services levy) which required the determination of the value of the freehold land without regard to any lease, whereas the *SPIC* case was considering NSW landholder duty, which required identification and value of the interest in land owned by Taralga (ie a leasehold interest);
- as the wind farm was located on leasehold land in Victoria, it was subject to s 154A of the *Property Law Act 1958* (Vic) which gives the lessee a statutory right to remove any improvements they have placed on the land, and has been held in other cases to prevent the improvements from becoming part of the land (colloquially referred to as "statutory severance"). There was no equivalent provision applicable to the NSW wind farm assets considered in *SPIC*; and
- the judge in the *SPIC* decision considered that, while the terms of the development consent and leases (in particular, the inclusion of an obligation to remove the equipment at the end of the lease and a statement that they continue to be owned by the lessee) were relevant factors, he disagreed with the conclusion that they should be determinative.

These points highlight the importance of carefully considering the specific statutory regime which is being applied and the particular circumstances of each project (including the impact of other local or asset-specific statutes) when determining whether assets should be classified as fixtures or chattels. This is important when considering whether similar assets are fixtures or chattels for determining whether an entity is land rich under the TARP rules under Div 855 ITAA97 and, in turn, whether capital gains tax is payable by a non-resident on the sale of the relevant holding entity.

It means that it is possible that the classification may potentially be different for similar types of projects located in different states/territories (notwithstanding that income tax is a federal regime) or governed by different types of industry specific legislation (eg telecommunications or specific electricity infrastructure legislation).

Tenant's fixtures

The court held that it was incorrect to classify the lease and the tenant's fixtures as two separate interests in land, being a leasehold estate in the land and an equitable interest in the tenant's fixtures. A tenant's interest in unsevered leasehold improvements arises from, and is governed by, the terms of the lease and rights under the common law (as it would be unnecessary for equity to intervene during the term of the lease). However, the court noted that there is still an unresolved issue about whether an owner of land can transfer a legal interest in unsevered fixtures and, if so, whether this might give rise to any interest in land, but the court did not consider it necessary to conclude on this point in the current case.

Valuation methodology

Both parties (SPIC and Revenue NSW) had prepared valuations which valued the leasehold interest and wind farm equipment separately. The parties' valuers prepared a joint valuation report which valued the wind farm equipment using a DORC methodology and reached an agreed value for these assets of A$227,182,500. The leases were valued at nil. This is consistent with the approach commonly used for valuations of this type of asset for stamp duty, income tax and accounting purposes.

However, the court held that this approach was inconsistent with the statutory context and the court's determination of the nature of the interest to be valued. As noted above, the court held that a tenant's interest in the unsevered fixtures is a right that it derives from the lease and, accordingly, it is not appropriate to value the lease and fixtures separately. In terms of the statutory context, the court held that the landholder duty provisions required all of the assets of the landholder to be valued on a going concern basis (ie on the assumption that they would all be transferred together).

To give effect to this, the court held that it was necessary to value the rights under the lease, including the right to remove the plant and equipment affixed to the land during the term of the lease and at its expiry.

SPIC had also prepared an alternative valuation which valued the landholdings in accordance with these principles, which was ultimately adopted by the court. This valuation determined the value of the lease and fixtures using a profit rental method, which involved the following:

- step 1: determining the fair annual rack rent that could be maintained for the leased site (based on the terms of the

lease, an inspection of the property, and an inspection of any existing comparable properties);
- step 2: ascertaining whether there was a profit rental under the lease by subtracting from the fair annual rack rental the rent and outgoings actually payable under the lease;
- step 3: estimating the percentage rate of return to capital which a prospective purchaser could be expected to require on their investment (ideally based on comparable properties); and
- step 4: multiplying the amount of profit rental (step 2) by the rate of return (step 3) and subtracting the estimated cost of repairs or renewals that may be needed to sustain the current rack rental. If the terms of the lease also require the lessee to meet any costs at termination (eg make good), that should also be subtracted from the value (also discounted to present value).

When applying this to the leases and the wind farm equipment in question:

- the valuer noted that the typical market rental for assets such as wind farms and solar farms was usually 8.5% to 11%. This was determined based on the market rate of return applied to the DORC value of the wind farm assets and lease (excluding the assets identified above as not being fixtures, or as being landlord's fixtures, eg development costs, moveable assets, roads and tracks);
- to quarantine the benefit of the lessee paying no rental for the fixtures, the rental sums were adjusted downward for the actual rental being paid by the lessee to determine the "net underletting";
- the value of the lease was then determined by taking this "net rental" multiplied by the number of years remaining under the lease at an appropriate discount rate, less the deferred rectification liability at the end of the lease (at net present value);
- SPIC's valuer adopted a discount rate of 20%;
- the court accepted all of the approaches above except for the discount rate. Instead, it substituted a 9.5% discount rate, being the upper end of the discount rate suggested by the Commissioner's valuer (and higher than the rate adopted in SPIC's transaction modelling for the actual acquisition, where a 9% discount rate would have resulted in the project being not financially feasible); and
- this resulted in a landholdings value of A$201.6m in the initial judgment, which was reduced to A$177.3m as part of the final orders. This was substantially lower than the Commissioner's assessment of A$223.6m.

Ultimately, the landholdings value determined under this approach was less than the value determined under the DORC approach (which has been the common historical practice for fixed plant and equipment). However, from a practical perspective, it does add extra complexity and compliance costs to determining the value of assets of this nature, given that a DORC valuation was still required as an input into the profit rental valuation approach.

Another question that arises is whether the preferred valuation approach is impacted by the subsequent changes to the landholder duty statutory regime. New South Wales (along with all other states/territories, other than the ACT) now includes assets "fixed" to land, in addition to fixtures as landholdings. This may support an argument for moving back to a DORC methodology for the separate "fixed to land" assets, as these items are specifically identified as landholdings. There will be a few issues to balance and resolve when determining the most appropriate valuation methodology within the new NSW "fixed to land" regime (which is similar to the regime in other states/territories), such as:

- tenant's fixtures may be captured in the value of landholdings on the basis that the right to remove these fixtures adds value to the leasehold interest (as in the *SPIC* case). They now also fall within the definition of "landholdings" on the basis that they are "fixed to land". However, it would be a highly anomalous outcome for the value of the same asset to be counted more than once (especially in light of the "going concern" comments below);
- if a different valuation approach is required to be used for tenant's fixtures versus chattels that are fixed to land, it means that the fixture/chattel classification would once again become important from a stamp duty perspective, which is clearly contrary to the legislative intent of moving to a fixed to land regime; and
- the judgment in *SPIC* was quite clear about the importance of applying a going concern approach to valuations for landholder duty purposes and the shift to a "fixed to land" regime should not change this.

If there is to be a retention of the historical DORC approach, it may be borne out of practicality and compromise rather than based solely on the difference in the statutory regime. This is because a DORC valuation:

- results in lower compliance costs as it would be required for both methods as either the standalone valuation or an input to the profit rental value (favourable to the taxpayer);
- gives rise to less overall subjective elements and areas for potential disagreement or dispute, eg the profit rental approach adds additional variables, such as profit rate and discount rate etc (favourable to both parties); and
- may potentially result in higher values as it values the item of plant and equipment itself rather than the benefit of the use as part of the lease (for the term of the lease) and associated right to remove (favourable to the revenue offices).

Costs

As noted above, while SPIC was not successful in all of its arguments, the Chief Commissioner was required to pay SPIC's costs. This is because, while SPIC was not successful in all of its submissions, it was successful in having the Chief Commissioner's initial assessment of duty substantially reduced by approximately A$46m of landholdings value, which equates to approximately A$2.5m of duty, or 20% of the original assessment.

The takeaway

The judgment in the *SPIC* case highlights the potential difficulties when determining whether certain assets (particularly infrastructure assets) should be treated as fixtures or chattels, and it is a reminder of the importance of taking into account the impact of the relevant statutory regime and other specific facts or regulations that may impact the particular asset. The need to classify assets as fixtures or chattels has been largely removed in a duty context but is still relevant in a number of other areas, including income tax.

The decision has also created uncertainty regarding the appropriate valuation methodology for these kinds of assets. While, on the face of it, the guidance is quite clear, in practice, it is likely to mean greater complexity and increased compliance costs.

Rachael Cullen
Partner
PwC

Rebecca Huang
Director
PwC

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1 [2021] NSWSC 395.

2 [2021] NSWSC 486.

3 [2020] VSC 853.

Addendum to Alternative Assets Insights in *Taxation in Australia*, vol 55(10)

Following the publication of "NSW build-to-rent land tax and stamp duty reforms" in *Taxation in Australia* on 7 May 2021, the NSW Chief Commissioner of State Revenue published Revenue Ruling G O14 — Build to Rent (the BTR ruling) on 18 May 2021 (issued and effective from 1 April 2021). Some of the key topics and examples covered by the BTR ruling include:

- under s 9E(2)(c) of the *Land Tax Management Act 1956* (NSW), the reference to "significant proportion of labour force hours" means 10% or more over the life of the construction;
- evidentiary materials required to prove the "significant proportion of labour force hours" for each of the various classes of workers are set out in a schedule in the BTR ruling;
- examples of property that may be considered as falling within the meaning of "build-to-rent property" include onsite management apartments, swimming pools, storage areas, tennis courts, recreation areas, gyms, storage spaces, and car parks. Note: if these are available for use by both tenants and non-tenants, the calculation will be on a further 50% proportionate basis. This is regardless of the actual percentage used by tenants compared with non-tenants;
- examples of property that will not be considered as "build-to-rent property", even if used by tenants, include shops, cafes, restaurants, hairdressers, and similar commercial ventures; and
- if a building is sold or transferred without being subdivided within 15 years, and the building will continue to be used and occupied for a build-to-rent purpose by the new owner, the approval will not be revoked (ie the new owner will continue to receive the benefit of the 50% reduction of land value for NSW land tax purposes).

Events Calendar

July/August 2021

STATE/EVENT	DATE	CPD
Online		
21st Annual States Taxation Conference – online	29/7/21	12
2021 National Transfer Pricing Conference – online	5/8/21	10
South Australia		
Local Tax Club – Part 6: Corporate tax issues with perks	27/7/21	1.5
21st Annual States Taxation Conference	29/7/21	12
Victoria		
2021 National Transfer Pricing Conference	5/8/21	10

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

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Level 37, 100 Miller Street
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General Manager – Commercial Transformation & Special Projects
James Paterson

Content Delivery Manager, Knowledge & Learning
Carla Reddy

Managing Editor
Deborah Powell

Content Consultant
Bob Deutsch

Graphic Designers
Mei Lam
Claus Huttenrauch

Typesetter
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Advertising
Business Relationship Manager
Brian Martin 08 6165 6600

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National Office

CEO: Giles Hurst

Level 37, 100 Miller Street
North Sydney, NSW 2060

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

State Offices

New South Wales and ACT

Chair: Glen Hutchings, FTI

Level 37, 100 Miller Street
North Sydney, NSW 2060

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

Victoria

Chair: Fiona Knight, CTA

Level 3, 530 Collins Street
Melbourne, VIC 3000

Tel: 03 9603 2000
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Chair: John Ioannou, CTA

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

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

Western Australia

Chair: Bill Keays, CTA

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

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

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Chair: Nick Wilkins, CTA

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

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

Tasmania

Chair: Ian Heywood, CTA

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

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

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