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The Tax Institute

Taxation in Australia

Streamlining the tax system for individuals
The Tax Institute

Allocation of professional firm profits: part 2
David Montani, CTA

Trust disclaimers: FCT v Carter
Philip Bender, ATI

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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.

Insights from the Institute

Regular columns

Tax News – at a glance

by TaxCounsel Pty Ltd

April – what happened in tax?

The following points highlight important federal tax developments that occurred during April 2022. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 595 (at the item number indicated).

2022–23 Budget

The 2022–23 Federal Budget which was delivered by the Treasurer on 29 March 2022 contained a number of new tax initiatives. **See item 1.**

Amending legislation

The *Treasury Laws Amendment (Cost of Living Support and Other Measures) Act 2022*, which was introduced into parliament as a Bill on 30 March 2022 and was passed by parliament the same day and received the royal assent and became law on 31 March 2022, contains amendments to the tax laws to give effect to various changes announced in the 2022–23 Budget and several earlier announced changes. **See item 2.**

Deductibility of COVID-19 test expenses

The amending Act referred to above amended the *Income Tax Assessment Act 1997* (Cth) (ITAA97) to provide an income tax deduction for individual taxpayers who incur relevant COVID-19 testing expenses in gaining or producing their assessable income. **See item 3.**

"Connected with"

The Commissioner has released three final tax determinations to help entities determine whether they are "connected with" another entity for the purpose of working out their aggregated turnover under Subdiv 328-C ITAA97. **See item 4.**

FBT: LAFHA reasonable amounts

The Commissioner has released a determination that sets out the amounts that he considers reasonable under s 31G of the *Fringe Benefits Tax Assessment Act 1986* (Cth) for food and drink expenses incurred by employees receiving a living-away-from-home allowance (LAFHA) fringe benefit for the FBT year commencing on 1 April 2022 (TD 2022/2). **See item 5.**

FBT: cents per kilometre

The Commissioner has released a determination that sets out the rates to be applied on a cents per kilometre basis for calculating the taxable value of a fringe benefit arising from the private use of a motor vehicle other than a car for the FBT year commencing on 1 April 2022 (TD 2022/3). **See item 6.**

Employee share scheme expenses

The Commissioner has released a final determination that sets out his views in relation to the deductibility of expenses incurred by an employer company in establishing and administering an employee share scheme (ESS) as part of its remuneration strategy (TD 2022/8). **See item 7.**

Employee share schemes: genuine disposal restrictions

The Commissioner has released a final determination that sets out the principles for working out when an ESS's disposal restrictions are "genuine disposal restrictions" and, if they are, when the employee is no longer genuinely restricted by the scheme for the purpose of determining the ESS's deferred taxing point (TD 2022/4). **See item 8.**

Trust disclaimers not tax effective

The High Court has allowed the Commissioner's appeal from a judgment of the Full Federal Court and held that disclaimers made after the end of the income year by the default beneficiaries under a discretionary trust deed were not effective to relieve them of a liability to tax on their respective shares of the net income of the trust for that income year (*FCT v Carter* [2022] HCA 10). **See item 9.**

GST: registration issues

The AAT has held that the trustees of a complying superannuation fund (the applicant), which was not GST-registered at the time supplies were made by the applicant by way of the sale of lots that had been created by the subdivision of land that the applicant had acquired and subdivided, were required to be registered for GST and, so, the applicant was liable for GST in respect of the sales (*Ian Mark Collins & Mieneke Mianno Collins ATF The Collins Retirement Fund and FCT* [2022] AATA 628). **See item 10.**

President's Report

by Jerome Tse, CTA

The voice of the profession

It's a good time to be part of the Institute, as we work to make your voice heard.

Although we are only four months into 2022, we already have some very good work behind us, and some exciting new developments on the horizon. Our rebrand has revitalised our image and our new website will create a better online home for the Institute. Our structured education programs continue to go from strength to strength and our micro-credential offering is being developed to an incredibly high standard. Our work in the tax policy and technical space has achieved some big wins and continues to support members' needs and interests.

All in all, it's a great time to be part of the Institute.

Bringing value to your professional life

One thing I'm particularly proud of so far this year is that we have resisted the temptation of unnecessarily rushing to be the first to market. Instead, we focus on our fundamental goal of adding genuine value for members. Sometimes that takes a little longer to land on your desk, but I thoroughly believe it is worth the wait.

A recent and pertinent example is our three-part webinar series on professional firm profits. By taking a considered and thoughtful approach, we have offered not only an update on the ATO's guidance, but also useful, implementable insight into what you as a practitioner need to do to follow that guidance in light of existing case law and legislation.

The voice of the profession

With the federal election coming up at the end of this month, the Institute is keeping a close eye on the impact that this has on members and on our vision for the future. Although we are not a political organisation, and politics may play little part in members' careers day-to-day, the tax policy and legislation it influences do play a key part in our work.

As a leading source of tax education for the profession, it's important that we not only stay abreast of policy developments, but also that we act as the voice of the profession on those issues. The work of our Tax Policy and Advocacy team and our volunteer councils and committees allows us to share your feedback, ideas and concerns when it matters most.

This year has seen the Institute take up some key advocacy efforts, including:

- over the last two years, leading various professional bodies and industry associations in advocating for amendments to the NALI/NALE provision. In December 2021, we lodged a submission to Treasury, and in March this year, the government committed to develop this as a priority in close consultation with the professional bodies and industry associations. This is a fantastic outcome after much hard work and we will continue to lead the way in this important conversation;
- escalation of member concerns around the removal of paper activity statements. The Tax Institute escalated the matter to the ATO in late 2020 and has worked with the ATO to design a temporary solution which sees the reinstatement of paper activity statements from the March 2021 quarter. We continue to work toward a permanent solution; and
- our work regarding guidance on s 100A of the *Income Tax Assessment Act 1936*, representing the interests of various professional bodies and industry associations and, most importantly, our members. We were glad to welcome ATO Chief Tax Counsel, Fiona Dillon, CTA, to our panel discussion webinar on this topic so members could discuss the challenging questions with her directly. There is still work to do on this topic and we will continue to lead the way with resources and discussion opportunities that genuinely add value for you.

As we continue to talk about these and other issues in the wider community and through the media, we are also working towards broad, sweeping reform in the tax system. We knew when we started along the road to tax reform that it was not an easy task, however, we are gaining ground in bringing this issue into the national conversation. Tax touches everything and the efficient working of our tax system is important for all Australians.

Support through change

As we head towards the election, the end of financial year and our membership renewal period, please remember that the Institute is here to support you. I encourage you to seek out opportunities to be involved by having your say through our advocacy channels and to further your tax education in ways that suit your needs.

CEO's Report

by Giles Hurst

The home of tax

CEO Giles Hurst reflects on the Institute's place at the heart of our profession.

As we open our annual renewal window, it's an exciting time for everyone. With the Federal Budget last month and a federal election on 21 May, not to mention the end of financial year fast-approaching, there is a lot going on.

As always, your Institute is here to support you. We've long thought of the Institute as the home of tax — a central meeting point for the profession, a hub for news and analysis, a melting pot of ideas and education. It's also what members have come to expect from us, through the community we've built, our leading tax events, and our advocacy work in the tax policy space.

I know I speak for everyone in the organisation, including volunteers and staff, when I say that this reputation is a point of pride for us. A big priority is always to live up to those expectations and remain relevant and of genuine value to our membership.

This year, we've been working hard on your behalf. From producing a thorough and practical analysis of the Federal Budget, to holding events that keep you up to date and enable you to connect with other members of the tax community, we hit the ground running in 2022.

We have also continued to advocate for your interests, both on specific tax policy topics, such as NALE and the Child Care Subsidy, and in a broader way through our work on large-scale tax reform. Those conversations are happening more and more often. The importance of our organisation's perspective on these issues — which in reality is the perspective of members, particularly those who are actively involved through volunteering — is being increasingly recognised.

Even closer to home, we now have a new look and feel for the Institute, which reflects the bright and vibrant future of our organisation. When we were developing this new brand, we wanted to reflect the values that drive our work: being the best version of ourselves; holding ourselves accountable; caring about each other, our members and our wider community; exploring possibilities and not being afraid to take a leap of faith now and then; and a belief in our own power to make a difference.

These values come into play every day as we make decisions about our priorities and work. I know many members probably operate under similar values. I trust that the new brand reflects how you feel about the Institute and what we do, just as well as it reflects how we feel.

And to go with the new brand, we will soon have a new website experience. This has been a long-time coming, and as a project has not been without its own challenges. We are a 79-year-old organisation, with an extensive history and a huge library of resources — that's not a ship that can be turned on a dime. Having said that, our team is dedicated and talented. I am positive that when our new website launches, it will enrich your membership experience.

There's more: hundreds of CPD events either already successfully held or coming up during the rest of the year, exciting new learning options and further improvements to our current education programs and, as always, new resources, analysis and reports to guide your understanding. We would be here all day to list them all, but suffice to say we are putting our all into your membership experience.

Thank you to members

I'd like to thank you sincerely, for your contribution, your time and effort, your support of the Institute. I have said it before, and I will say it again: our members make us what we are. The work that we all do and the commitments we make to that are important, but the people around us are more important.

As we head into our renewals period for another year, please keep in mind that our team is here to help you. If there's something you'd like to see from us or something you'd like to be involved in, we are always eager to hear from you.

Tax Counsel's Report

by Julie Abdalla, FTI

Federal Budget 2022–23

The Federal Budget 2022–23 was delivered on 29 March 2022. We consider the announced tax measures and theme of the increasing cost of living.

As many expected, the Federal Budget 2022–23 was designed with the upcoming election in mind. It contained few tax measures, but was largely focused on alleviating increasing cost-of-living pressures. Significant funding was announced for various sectors, including infrastructure, defence, education and aged care. Coupled with the cost of ongoing support measures in response to the pandemic and other recent events, it is no wonder that we continue to see astounding levels of debt, forecast for years to come.

Unpacking the key tax measures

While certainly not a tax technical Federal Budget by any stretch, there were a number of welcome announcements, including:

- a broadening of the proposed patent box regime to encompass patents in the agricultural sector as well as low emissions technology innovations granted after 29 March 2022. In relation to patents for medical and biotechnology innovations which had been announced last year, changes were announced to expand the regime to apply to patents issued after 11 May 2021, and to recognise patents granted under the United States and European regimes, as well as those granted by IP Australia;
- boosts in the form of additional 20% deductions for eligible small businesses for expenditure incurred on external training courses provided to employees and business expenses, and depreciating assets that support the business' digital adoption;
- making the costs of taking a COVID-19 test to attend a place of work tax deductible for individuals from 1 July 2021. The government also announced it will ensure that FBT will not be incurred from 1 April 2021 by businesses where COVID-19 tests are provided to employees for this purpose; and
- an increase to the low and middle income tax offset (LMITO). Labelled a "cost-of-living tax offset", the government announced an increase to the LMITO for the 2021–22 income year by $420. This will increase the maximum amount of the LMITO from $1,080 to $1,500 (for individuals) and $3,000 (for couples). All other features of the LMITO remain unchanged, including its end date of 30 June 2022.

Helping Australians with the increasing cost of living

A major focus of the Budget was relieving the increasing cost-of-living pressures.

There were several measures introduced under this umbrella, including:

- an increase to the Home Guarantee Scheme — at a high level, to increase guarantees to 50,000 per year for three years from 2022–23, and then 35,000 per year ongoing, to support people to purchase a home with a lower deposit;
- a one-off $250 economic support payment — to be made in April 2022 to eligible recipients of certain payments and to concession card holders;
- a reduction to the fuel excise and excise-equivalent customs duty rate that applies to petrol diesel and all other fuel and petroleum-based products (except aviation fuel) by half to 22.1 cents per litre for six months from 30 March 2022; and
- an increase in the Medicare levy low-income thresholds to take into account indexation — for singles, families, and seniors and pensioners from 1 July 2021.

The Tax Institute welcomes these additional support measures, although we stress the one-off and temporary nature of the relief. Increasing cost-of-living pressures continue to impact Australians, and while these measures do provide some assistance, the effects are likely to be felt beyond their limited scope.

An imminent election: where to from here?

The Tax Institute supports initiatives that alleviate pressures on Australian businesses and households, and indeed those which encourage expansion and growth. We query the investment of time and resources, not only within government, but also of external stakeholders including tax practitioners, in getting temporary measures off the ground and in action. It is a shame to see so many people needing to invest such effort in understanding and delivering these measures, only for them to come to an end, at best, a few years later. Many such measures seen in recent times should be a permanent feature of our tax system, but that is certainly a post-election debate.

With an election scheduled for later this month, it will be interesting to see whether some of the, as yet, unenacted measures will see the light of day, and indeed whether those which have somewhat progressed but lapsed will be revived. Whichever party is ultimately successful in the upcoming election will certainly have its work cut out to bring Australia out of the red. Sustainable tax reform involving permanent measures is, in our view, fundamental to achieving this.

Tax News – the details

by TaxCounsel Pty Ltd

April – what happened in tax?

The following points highlight important federal tax developments that occurred during April 2022.

Government initiatives

1. 2022–23 Budget

The 2022–23 Federal Budget which was delivered by the Treasurer on 29 March 2022 contained a number of new tax initiatives. The more significant of these are noted below.

Cost of living tax offset

The low and middle income tax offset (LMITO) is to be increased by $420 for the 2021–22 income year. LMITO is targeted at low and middle income earners who are most susceptible to cost of living pressures. The LMITO for the 2021–22 income year will be paid from 1 July 2022 when taxpayers submit their tax returns for the 2021–22 income year. This measure is now law (see item 2 below).

Medicare levy low-income thresholds

The Medicare levy low-income thresholds for seniors and pensioners, families and singles is to be increased from 1 July 2021. The increase in thresholds takes account of recent movements in the consumer price index so that low-income individuals continue to be exempt from paying the Medicare levy. This measure is now law (see item 2 below).

Modernisation of PAYG instalment systems

Companies are to be able to choose to have their pay as you go (PAYG) instalments calculated based on current financial performance, extracted from business accounting software, with some tax adjustments. This is intended to support business cash flow by ensuring that instalments reflect current performance.

The government will consult with affected stakeholders, tax practitioners and digital service providers to finalise the policy scope, design and specifications of this measure.

Subject to advice from software providers about their capacity to deliver, it is anticipated that systems will be in place by 31 December 2023, with the measure to commence on 1 January 2024, for application to periods starting on or after that date.

Small business – skills and training boost

A skills and training boost is to be introduced to support small businesses to train and upskill their employees. The boost will apply to eligible expenditure incurred from 7:30pm on 29 March 2022 until 30 June 2024.

Small businesses (with an aggregated annual turnover of less than $50m) will be able to deduct an additional 20% of expenditure incurred on external training courses provided to their employees. The external training courses will need to be provided to employees in Australia or online, and delivered by entities registered in Australia.

Some exclusions will apply, such as for in-house or on-the-job training and expenditure on external training courses for persons other than employees.

The boost for eligible expenditure incurred by 30 June 2022 will be claimed in tax returns for the following income year. The boost for eligible expenditure incurred between 1 July 2022 and 30 June 2024 will be included in the income year in which the expenditure is incurred.

Small business – technology investment boost

A technology investment boost is to be introduced to support digital adoption by small businesses. The boost is to apply to eligible expenditure incurred from 7:30pm (AEDT) on 29 March 2022 until 30 June 2023.

Small businesses (with an aggregated annual turnover of less than $50m) will be able to deduct an additional 20% of the cost incurred on business expenses and depreciating assets that support their digital adoption, such as portable payment devices, cyber security systems or subscriptions to cloud-based services.

An annual cap is to apply in each qualifying income year so that expenditure up to $100,000 will be eligible for the boost.

The boost for eligible expenditure incurred by 30 June 2022 will be claimed in tax returns for the following income year. The boost for eligible expenditure incurred between 1 July 2022 and 30 June 2023 will be included in the income year in which the expenditure is incurred.

Varying the GDP uplift factor for tax instalments

The GDP uplift factor for PAYG and GST instalments is to be set at 2% for the 2022–23 income year. This uplift factor is lower than the 10% that would have applied under the statutory formula.

The 2% GDP uplift rate will apply to small to medium enterprises eligible to use the relevant instalment methods (up to $10m annual aggregated turnover for GST instalments and $50m annual aggregated turnover for PAYG instalments) in respect of instalments that relate to the 2022–23 income year and fall due after the enabling legislation receives royal assent.

Patent box – extension to the agricultural and low emissions technologies sectors

The patent box regime is to be extended to cover certain low emissions technologies and activities in the agricultural sectors.

More particularly, concessional tax treatment is to be provided for corporate taxpayers which commercialise their eligible patents linked to agricultural and veterinary chemical products listed on the Australian Pesticides and Veterinary Medicines Authority, PubCRIS (Public Chemicals Registration Information System) register, or eligible Plant Breeder's Rights (PBRs).

Eligible corporate income will be subject to an effective income tax rate of 17% for PBRs and patents granted or issued after 29 March 2022 and for income years starting on or after 1 July 2023. Eligible income will be taxed at the concessional tax rate to the extent that the research and development of the innovation took place in Australia.

The expanded patent box will also provide concessional tax treatment for corporate taxpayers which commercialise their patented technologies that have the potential to lower emissions. Eligible corporate income will be subject to an effective income tax rate of 17% for patents granted after 29 March 2022 and for income years starting on or after 1 July 2023. Eligible income will be taxed at the concessional tax rate to the extent that the research and development of the innovation took place in Australia.

Patents relating to low emissions technology as set out in the 140 technology areas listed in the government's 2020 Technology and Investment Roadmap Discussion Paper or included as priority technologies in the government's 2021 and future annual Low Emissions Technology Statements will be within scope, provided the patented technology is considered to reduce emissions.

2. Amending legislation

The *Treasury Laws Amendment (Cost of Living Support and Other Measures) Act 2022*, which was introduced into parliament as a Bill on 30 March 2022 and was passed by parliament the same day and received the royal assent and became law on 31 March 2022, contains amendments to the tax laws to give effect to various changes announced in the 2022–23 Budget and several earlier announced changes.

The following are the more important of the income tax changes that have been made by the amending Act:

- an income tax deduction is allowable for individual taxpayers for relevant **COVID-19 testing expenses** (see item 3);
- the **low and middle income tax offset** is increased for the 2021–22 income year by $420. This amendment implements a 2022–23 Budget proposal (see item 1);
- the **Medicare levy low-income thresholds** for singles, families, and seniors and pensioners are increased consistent with increases in the CPI. This measure applies to the 2021–22 income year and later income years, and implements a 2022–23 Budget measure (see item 1).

3. Deductibility of COVID-19 test expenses

The amending Act referred to in item 2 above amended the *Income Tax Assessment Act 1997* (Cth) (ITAA97) to provide an income tax deduction for individual taxpayers who incur relevant COVID-19 testing expenses in gaining or producing their assessable income.

The deduction is allowable under a new s 25-125 ITAA97 and applies to relevant expenses incurred on or after 1 July 2021, and, in the case of an employee, is subject to the substantiation rules where work expenses exceed $300.

More particularly, a deduction is allowable where the purpose of testing is to determine whether the taxpayer may attend or remain at a place where they:

- engage in activities to gain or produce their assessable income; or
- engage in activities in the course of carrying on a business for the purpose of gaining or producing their assessable income.

To qualify, the test must be one that is:

- a polymerase chain reaction test for testing COVID-19; or
- a test that is included in the Australian Register of Therapeutic Goods for testing COVID-19 (such as an approved rapid antigen test).

From the perspective of employers that provide relevant COVID-19 testing to employees in the course of their work, the otherwise deductible rule that applies for the purpose of FBT will be applicable if the employee would otherwise have been entitled to claim a deduction at the time the benefit was provided had the employee incurred the relevant costs.

The amendments give effect to an announcement made by the Assistant Treasurer on 7 February 2022.

The Commissioner's perspective

4. "Connected with"

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

Aggregated turnover is relevant for the purpose of an entity accessing a range of tax concessions, including temporary loss carry back by companies, temporary full expensing, and a number of small business concessions including the CGT small business reliefs.

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

The three determinations are:

- TD 2022/5: aggregated turnover – application of the "connected with" concept to corporate limited partnerships;
- TD 2022/7: aggregated turnover – application of the "connected with" concept to partnerships, foreign hybrids and non-entity joint ventures; and
- TD 2022/6: aggregated turnover – application of the public entity exception to the indirect control test.

5. FBT: LAFHA reasonable amounts

The Commissioner has released a determination that sets out the amounts that he considers reasonable under s 31G of the *Fringe Benefits Tax Assessment Act 1986* (Cth) (FBTAA86) for food and drink expenses incurred by employees receiving a living-away-from-home allowance (LAFHA) fringe benefit for the FBT year commencing on 1 April 2022 (TD 2022/2).

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

- equal to or less than the amount that the Commissioner considers reasonable; or
- substantiated.

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

TD 2022/2 sets out the amounts that the Commissioner considers reasonable for food and drink within Australia and overseas.

6. FBT: cents per kilometre

The Commissioner has released a determination that sets out the rates to be applied on a cents per kilometre basis for calculating the taxable value of a fringe benefit arising from the private use of a motor vehicle other than a car for the FBT year commencing on 1 April 2022 (TD 2022/3).

The rates are:

Engine capacity	Rate per kilometre
0 – 2500cc	58 cents
Over 2500cc	69 cents
Motorcycles	17 cents

7. Employee share scheme expenses

The Commissioner has released a final determination that sets out his views in relation to the deductibility of expenses incurred by an employer company in establishing and administering an employee share scheme (ESS) as part of its remuneration strategy (TD 2022/8).

The expenditure to which TD 2022/8 relates often includes establishing and administering an employee share trust (EST) that holds shares or rights for employees participating in an ESS as defined in s 83A-10(2) ITAA97.

Establishment expenses (that is, outgoings associated with the creation of an ESS) are not deductible to the employer company as a general deduction under s 8-1 ITAA97 because they are capital in nature.

However, establishment expenses are deductible to the employer company in equal proportions over five years under s 40-880 ITAA97 (business-related costs) to the extent that the business is carried on for a taxable purpose.

Establishment expenses include: legal fees incurred in establishing the EST and ESS plan rules; start-up costs (for example, trustee company commencement charges); and registration fees with various authorities (for example, stamp duty and ASIC fees).

Amendment expenses (that is, expenses incurred when amending an ESS) are not deductible to the employer company as a general deduction because they are capital in nature. However, as with establishment expenses, amendment expenses are deductible to the employer company in equal proportions over five years to the extent that the business is carried on for a taxable purpose.

On the other hand, ongoing expenses associated with the administration of an ESS are deductible under s 8-1 ITAA97 as a general deduction. Such expenses would include brokerage fees, audit fees, bank charges, making new offers to employees under an existing ESS, and other ongoing administrative expenses.

8. Employee share schemes: genuine disposal restrictions

The Commissioner has released a final determination that sets out the principles for working out when an ESS's disposal restrictions are "genuine disposal restrictions" and, if they are, when the employee is no longer genuinely restricted by the scheme for the purpose of determining the ESS's deferred taxing point (TD 2022/4).

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

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

Recent case decisions

9. Trust disclaimers not tax effective

The High Court has allowed the Commissioner's appeal from a judgment of the Full Federal Court and held that disclaimers made after the end of the income year by the default beneficiaries under a discretionary trust deed were not effective to relieve them of a liability to tax on their respective shares of the net income of the trust for that income year (*FCT v Carter*[1]).

The taxpayers were three of the five default beneficiaries under a discretionary trust deed dated 27 July 2005 that established the Whitby Trust. The trust deed provided that, if the trustee did not pay, apply, set aside or accumulate any part of the trust income in a given accounting period, the trustee would hold that income in trust for specified beneficiaries, including the taxpayers. An accounting period was relevantly defined as a 12-month period ending on 30 June. In this way, the trust deed ensured that, in each accounting period, the whole of the trust income was distributed, if not otherwise dealt with.

In the 2014 income year, the trustee failed to pay, apply, set aside or accumulate the income of the trust. As a result, one-fifth of the trust income was held on trust for each of the default beneficiaries. On 27 October 2015, the Commissioner issued an amended assessment to each default beneficiary for the 2014 income year (the 2014 assessments) which included as assessable income one-fifth of the trust income on the basis that they were "presently entitled" to that income within the meaning of s 97(1) of the *Income Tax Assessment Act 1936* (Cth) (ITAA36). On 30 September 2016, the respondents disclaimed their interest in the trust income. They subsequently objected to the 2014 assessments in reliance on the disclaimers.

On appeal on a question of law from a decision of the Administrative Appeals Tribunal, the Full Federal Court relevantly held that the taxpayers' disclaimers operated retrospectively so as to disapply s 97(1) in respect of the 2014 income year.[2]

The High Court has now reversed the decision of the Full Federal Court. The High Court held that s 97(1) is directed to the position existing immediately before the end of the income year for the purpose of identifying the beneficiaries who are to be assessed with the income of the trust. The section looks to the right to receive an amount of distributable income, not the receipt of income. Events occurring after the end of the income year cannot disentitle a beneficiary who was "presently entitled" immediately before the end of the income year. The respondents' disclaimers were therefore not effective to retrospectively expunge the rights of the Commissioner against the respondents which were in existence at midnight on 30 June 2014 and which gave rise to the 2014 amended assessments.

In a joint judgment with which Edelman J agreed, Gageler, Gordon, Steward and Gleeson JJ said that the phrase "is presently entitled to a share of the income of the trust estate" in s 97(1) is expressed in the present tense and was directed to the position existing immediately before the end of the income year for the stated purpose of identifying the beneficiaries who were to be assessed with the income of the trust – namely, those beneficiaries of the trust who, as well as having an interest in the income of the trust which is vested both in interest and in possession, have a present legal right to demand and receive payment of the income.

Their Honours said that the criterion for liability looked to the right to receive an amount of distributable income, not the receipt. That position was expressly reinforced in s 95A(1) ITAA36 which makes clear that a present entitlement of a beneficiary under s 97(1) does not depend on receipt of the income. Section 95A(1) was enacted to ensure that a present entitlement retains its character as such even if the income has been "paid to, or applied for the benefit of, the beneficiary". Indeed, there may be a right to demand payment even though the trustee does not have funds available to pay it.

10. GST: registration issues

The AAT has held that the trustees of a complying superannuation fund (the applicant), which was not GST registered at the time supplies were made by the applicant by way of the sale of lots that had been created by the subdivision of land that the applicant had acquired and subdivided, were required to be registered for GST and, so, the applicant was liable for GST in respect of the sales (*Ian Mark Collins & Mieneke Mianno Collins ATF The Collins Retirement Fund and FCT*[3]).

The applicant was registered for GST and paid GST on rental receipts from the unsubdivided land. However, it applied to have its registration cancelled before the sales occurred. In response to the application, the Commissioner cancelled the applicant's registration.

The AAT noted that the applicant would have been required to be registered for GST only if it carried on an enterprise and its GST turnover met the registration turnover threshold. It was common ground that the applicant, as the trustee of a superannuation fund, was taken to have carried on an enterprise (s 9-20(1)(da) of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GSTA99)).

The issue for determination was whether the applicant's turnover met the annual registration turnover threshold (currently $75,000 pa). Under s 188-10(1) GSTA99, an entity has a GST turnover that meets a turnover threshold if (inter alia) the entity's projected GST turnover is at or above the turnover threshold.

So far as is relevant, s 188-10(2) GSTA99 provides that an entity has a GST turnover that does not exceed a turnover threshold if the entity's projected GST turnover is at or below the turnover threshold. The issue that arose for decision was whether the AAT was satisfied that the applicant's projected GST turnover was below the registration turnover threshold.

Subject to exceptions that are not relevant, s 188-20 GSTA99 defines an entity's projected GST turnover at a time during a particular month as "the sum of the values of all

supplies that you have made, or are likely to make, during that month and the next 11 months". However, when working out an entity's projected GST turnover, s 188-25 GSTA99 requires the following to be disregarded:

> "(a) any supply made, or likely to be made, by you by way of transfer of ownership of a capital asset of yours; and
>
> (b) any supply made, or likely to be made, by you solely as a consequence of:
>
> (i) ceasing to carry on an enterprise; or
>
> (ii) substantially and permanently reducing the size or scale of an enterprise."

To discharge its burden of proof, the applicant would have needed to prove that its projected sales of the subdivided lots were properly characterised as supplies made or likely to be made:

- "by way of transfer of ownership of a capital asset" (s 188-25(a));
- "solely as a consequence of … ceasing to carry on an enterprise" (s 188-25(b)(i)); or
- "solely as a consequence of … substantially and permanently reducing the size or scale of an enterprise" (s 188-25(b)(ii)).

The AAT accepted that, for the purpose of s 188-25(a), the character of an asset must be determined at the time the supply is made (or likely to be made).

The AAT said that, while inevitably it became a matter of scale and impression, the applicant's undertaking amounted to more than a mere realisation of the property in an enterprising way. The works required to achieve the subdivision were substantial. The applicant acknowledged that it spent in total $4,538,757 in developing the property in the context of land that in aggregate sold for around three times that amount. The extent of the works was reflected in the nature of the development as stated in the advertising material for the subdivided lots. The AAT was not persuaded that the supplies of the subdivided lots were or were likely to be made by way of transfer of ownership of capital assets.

The Commissioner submitted that the enterprise referred to in s 188-25(b) – in respect of both s 188-25(b)(i) and (ii) – must be the same enterprise that the applicant acknowledged it carried on, that is, carrying out activities as trustees of a complying superannuation fund. Accordingly, the Commissioner submitted, the applicant's argument under s 188-25(b)(i) must fail because it did not cease to carry on that enterprise. The AAT, in rejecting this submission, said that s 188-25(b) in its terms referred to "an" enterprise and there was nothing in the context of the provision which would warrant limiting the enterprise referred to in s 188-25(b) to a particular enterprise.

Accordingly, while accepting the applicant's submission that it was sufficient to demonstrate that the sales were made solely as a consequence of the applicant ceasing to carry on an enterprise of subdividing and selling the subdivided lots, the AAT was quite unable to see how it could be said that the sales would be made solely as a consequence of ceasing to carry on the land development enterprise. That enterprise did not cease before the last of the sales were completed.

The AAT said that the applicant's characterisation of the sales or even the final sale as made as a consequence of ceasing to carry on the land development, let alone solely as a consequence of the ceasing of that enterprise, was not reasonably open. A land development venture may be said to cease as a consequence of the sale of the subject lands or perhaps the final sale. But that is the inverse of what s 188-25(b)(i) requires. It would be quite artificial to say such sales occur in consequence of the business ceasing. The sale of lands is the central objective of a land development enterprise and occurs as part and parcel of – as a consequence of – the ongoing conduct of the enterprise. The sales do not occur as a consequence of the enterprise ceasing.

Also, the AAT said that the characterisation of the sales or even the final sale as made in consequence of a substantial and permanent reduction in the size or scale of the applicant's land development enterprise was not reasonably open. The sales were made in the course of, and as a consequence of, carrying on the enterprise, not as a consequence of a reduction in its size or scale.

The AAT pointed out that, additionally, the applicant's approach under either limb of s 188-25(b) would mean that land developers could escape GST on the footing that land sales transacted in the ordinary course of their businesses were made solely in consequence of ceasing or substantially and permanently reducing the size or scale of their enterprise. A construction with such outcomes for a substantial sector of the economy, which the GSTA99 plainly contemplates being subject to GST, is unlikely to have been intended, especially when it depends on inversion of the natural application of the statutory words.

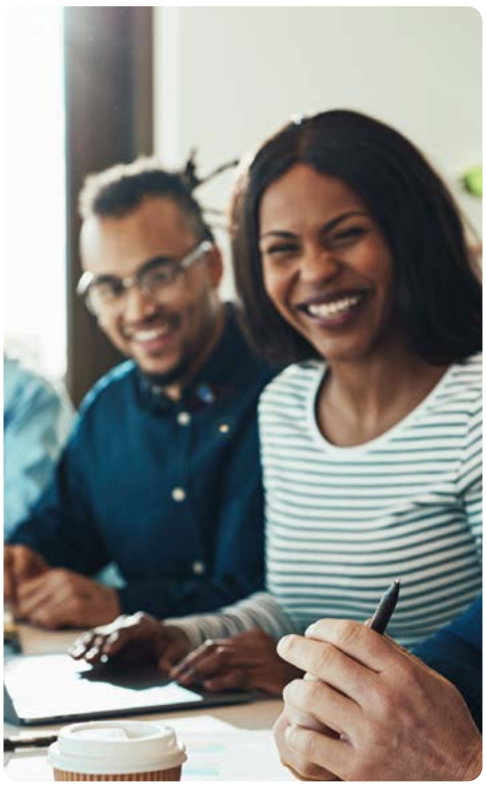
TaxCounsel Pty Ltd
ACN 117 651 420

References

1 [2022] HCA 10.

2 See *Carter v FCT* [2020] FCAFC 150.

3 [2022] AATA 628.



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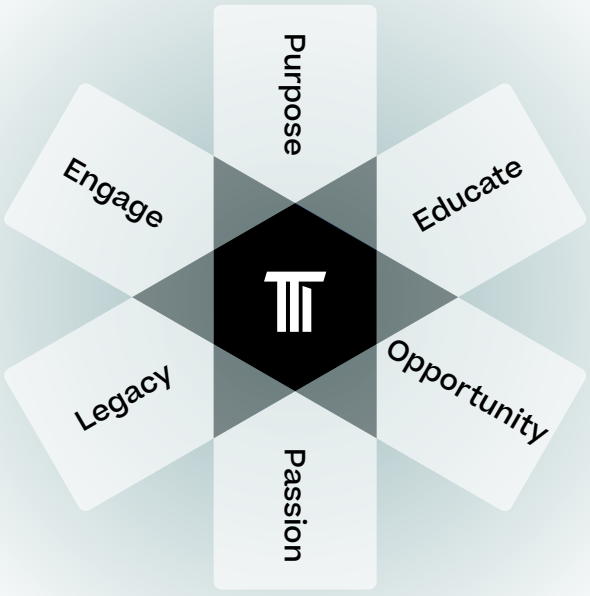

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Tax Tips

by TaxCounsel Pty Ltd

Jointly owned land

Where land is owned by two or more persons, there are tax issues to consider.

Background

Land is frequently owned by more than one person, whether the land is for use for private purposes (such as a main residence), for business purposes (such as factory premises) or for renting out, and the owners may be individuals, companies, the trustees of two or more trusts, or a combination of any of these entities.

Where land is jointly owned, a number of ordinary income tax, CGT and GST issues may, depending on the circumstances, arise. This article briefly considers some of the more important of these issues.

Tenants in common or joint tenants

If land is held by two or more persons, it will be held by them either as tenants in common (in equal or other undivided shares) or as joint tenants.

Where the land is held as tenants in common, each person has a proportionate interest in the land; each is seised of his, her or its ownership of the land. On the other hand, if the land is held as joint tenants, the joint tenants do not have a proportionate share in the land; rather, each joint tenant is seised of the whole, along with the other joint tenants. An inherent feature of a joint tenancy is the right of survivorship, that is, when one joint tenant dies, the whole of the land remains with the surviving joint tenant or joint tenants.

For most federal revenue purposes, however, joint tenants are effectively treated as tenants in common. For example, s 108-7 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) provides that individuals who own a CGT asset as joint tenants are treated as if they each owned a separate CGT asset constituted by an equal interest in the asset and as if each of them held that interest as a tenant in common. This overcomes a possible difficulty if, for example, two joint tenants of land were to transfer the land to themselves and another person as joint tenants. Having regard to the nature of joint tenancy, there could otherwise be a possible argument that there would be a transfer of the whole of the land by the existing joint tenants (and not only a one-half of each of their interests).

It is, however, possible for joint tenants of land to hold in equity as tenants in common in equal shares. This may be the case where there is a partnership at general law and the land is a partnership asset. This kind of case is illustrated by the decision of Windeyer J in *Spence v FCT*.[1]

An important point is that, apart from statutory modification, it is only possible for natural persons to be joint tenants of land (because of the survivorship rule). This has been altered in some jurisdictions so that a company may hold land as a joint tenant (see, for example, ss 25 and 26 of the *Conveyancing Act 1919* (NSW)[2]).

Ordinary income tax

If joint owners of land (whether tenants in common or joint tenants) are in receipt of assessable income from the land (typically, rent), the owners (if not partners at general law) will be a partnership for ordinary income tax purposes (s 995-1 ITAA97). The net income of such a partnership will be taxed to each owner in accordance with the owner's proportionate interest in the land (*FCT v McDonald*[3]). See further under "Partnership issues" below.

CGT

As pointed out above, individuals who own a CGT asset as joint tenants are treated for CGT purposes as if they each owned a separate CGT asset constituted by an equal interest in the asset as if each of them held that interest as a tenant in common (s 108-7 ITAA97). The CGT provisions also contain a provision that sets out what the CGT consequences are where a joint tenant dies (s 128-50 ITAA97).

This CGT rule for joint tenants only applies in the case of a CGT asset that is owned by individuals as joint tenants. As pointed out above, in some jurisdictions at least, it is possible for a company to hold an interest as a joint tenant in land. It is considered likely that a court would adopt a purposive approach to the application of the CGT provisions in such a case that would result in the severing of a joint tenancy when one or more joint tenants are companies. This would mean that there were no CGT consequences.

There is also a specific provision that governs the operation of CGT where an individual who is a joint tenant dies (s 128-50 ITAA97).

GST

Joint owners of land who or which are a partnership within the extended income tax definition of partnership (see below) will also be a partnership (and, so, an entity) for ABN and GST purposes (s 195-1 of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GSTA99); s 41 of the *A New Tax System (Australian Business Number) Act 1999* (Cth) (ABN Act). Typically, such a partnership will be carrying on an enterprise for ABN and GST purposes and, accordingly, may be required to be GST registered. Residential rent is, however, input-taxed.

It should not be overlooked that there may be situations where land which is owned by two or more persons is sold and one or more (but not all) of the owners is liable for GST. An example of this is provided by the facts considered in ID 2004/807.

Those facts briefly were that an entity that was a property developer and registered for GST owned a fractional interest in vacant land, as a tenant in common. The entity acquired the fractional interest in the land from a deceased estate (the co-owner). The acquisition resulted from the settlement of a debt owed by the deceased estate to the entity in respect of its enterprise activities. The entity and the co-owner were proposing to sell their respective interests in the land. The entity and the co-owner were not carrying on an enterprise in partnership. ID 2004/807 states that, as tenants in common, the entity and the co-owner would be making separate supplies of their respective interests in the vacant land in their own capacities. Further, the entity and the co-owner were not carrying on an enterprise in partnership. Thus, they were not making a single supply of the whole land. Rather, each was supplying its individual interest in the vacant land. As the entity acquired its fractional interest in the vacant land as the settlement of a debt in respect of its enterprise, the supply of its fractional interest in the vacant land would be in the course or furtherance of its enterprise as a property developer and thus would be a taxable supply.

Severance of a joint tenancy

Where a joint tenancy of land is severed, the joint tenants become tenants in common in equal shares. If there is merely a severance of a joint tenancy, this should have no federal tax issues.

Thus, if a joint tenancy of land between individuals is merely severed, this will have no CGT consequences (TD 13W).[4] The severance would merely bring the ownership interests into conformity with the position that is deemed to exist for CGT purposes by virtue of s 108-7 ITAA97. For the position where a company is a joint tenant in a jurisdiction that permits this, see above.

Partition of jointly owned land

If there is a partition of land that is jointly owned (whether as tenants in common or as joint tenants), each co-owner becomes the sole owner of a particular part of the land. A partition may be voluntary or, where there is an absence of agreement, by court order under a statutory provision.

In some cases, a particular part of the land which a co-owner becomes the owner of is equal in value to the interest that the co-owner had as a joint owner. In other cases, it may not be the same and, in such a case, monetary consideration is usually provided by way of adjustment.

The concept of a partition is also used to cover the situation where co-owners transfer the land to one or more, but not all, co-owners.

Ordinary income tax

Where there is a partition of land that is jointly owned, ordinary income tax issues may arise, for example, where consideration is paid from one co-owner to another co-owner.

CGT

Where there is a partition of land, the consequences for CGT are that each co-owner will:

1. acquire from the other joint owner(s) an interest in the land that the other joint owner(s) ceased to have; and
2. dispose to the other, or each other, joint owner an interest in the land to which the other joint owner(s) becomes entitled to.

Accordingly, for example, where an owner who or which acquired his, her or its interest in the jointly owned land post-CGT, a capital gain or capital loss will be potentially made from the happening of CGT event A1. A joint owner will, of course, have a further interest or interests in the land (acquired from the other joint owner(s)) which will be separate CGT assets (TD 2000/31).

GST

GST issues will potentially arise, for example, where the joint owners are a partnership, whether as a general partnership law or a tax law partnership.

Partnership issues

For federal revenue purposes, the concept of a partnership includes, but extends beyond, the concept of a partnership according to the general law of partnership (persons carrying on a business in common, with a view of profit). The extension treats as a partnership an association of persons in receipt of assessable income jointly (s 6(1) ITAA36; s 995-1 ITAA97; s 195-1 GSTA99; s 41 ABN Act). Such an association of persons is often referred to as a tax law partnership

A partner can be any kind of legal entity (an individual, a company or the trustee of a trust) and the partners in a partnership can be any combination of one or more of these entities (for example, an individual and a company, or a company and the trustee of a trust).

Tax law partnerships

As just noted, an association of persons in receipt of assessable income jointly are treated as being a partnership for federal revenue law purposes. In such a case, each person in the association is to be treated as a partner (*Tikva Investments Pty Ltd v FCT*[5]).

A familiar example of a tax law partnership is where joint owners of property lease the property out without a business being carried on. In that event, the net income or partnership loss for an income year is attributed to the owners of the property in accordance with their interests in the property; it is not possible for the owners to alter the fractional attribution (*FCT v McDonald*[6]).

Ordinary income tax

Under the partnership provisions of the income tax law (Div 5 ITAA36), the net income or partnership loss of a partnership for an income year (determined as if the partnership were a resident taxpayer) is attributed to each partner according to the partner's individual

interest in it (ss 90 and 92 ITAA36). There is provision for an adjustment to the net income or partnership loss that is attributable to a partner where the partner is not a resident for the whole or part of the income year and ex-Australian source income has been derived by the partnership.

A partner's individual interest in the net income or partnership loss is treated as any other assessable income or allowable deduction of the particular kind of entity the partner is.

CGT

The CGT provisions are not generally relevant when calculating the net income or partnership loss of a partnership for an income year.

In a partnership situation (whether a general law partnership or a tax law partnership), the CGT provisions treat as the relevant CGT asset each partner's interest in a partnership asset and in the partnership. It is specifically provided that any capital gain or capital loss from a CGT event happening in relation to a partnership or one of its assets is made by the partners individually (s 106-5(1) ITAA97).[7] The CGT anti-overlap rules operate to reduce the capital gain made by a partner by that partner's share of the relevant amount of the assessable income of the partnership (s 118-20 ITAA97).

Where, on the formation of a partnership, a CGT asset owned by one of the partners is brought into the partnership and becomes a partnership asset, there will be a change of interests in the asset, so CGT event A1 will happen for the partner who formerly owned the asset, and the other partner or partners would each acquire a CGT asset represented by their interest in the asset.

GST

A partnership is an entity for GST purposes and, accordingly, may be (or may be required to be) GST registered. The partnership is, therefore, what may be called a "GST taxpaying entity" (although, as between the ATO and a partnership, liability to pay the ATO is a joint and several liability of the partners).

The ATO has released two lengthy public rulings on how GST operates in the context of a partnership. One relates to general law partnerships (GSTR 2003/13) and the other relates to tax law partnerships (GSTR 2004/6).

Various GST issues associated with the application of the definition of a tax law partnership are considered in GSTR 2004/6. Points of particular interest in the ruling are:

1. a tax law partnership exists only if there is an association of persons "in receipt of [assessable] income jointly". To be in receipt of income jointly, it is not necessary to have actually received the income. It is considered that there is receipt of income jointly if there is a joint entitlement to income;
2. the expression "in receipt of" may be read broadly to include not only the actual receipt of income, but also all of the steps leading to the right or entitlement to that income; and
3. the expression "in receipt of ordinary income … jointly" suggests that two or more persons have commenced an activity which gives rise to, or will give rise to, a right or an entitlement to receive jointly an amount or a payment of a revenue nature.

Formation of a tax law partnership

The view is taken in GSTR 2004/6 that, for GST purposes, an association of persons in receipt of income jointly is a tax law partnership from the time that the persons jointly commence an activity from which the income is or will be received jointly (the "time of association" approach). This view is taken on the basis that the expression "in receipt of income jointly" broadly includes all of the steps leading to a joint right or entitlement to income. There must be a logical and timely progression between all of the steps that lead to the joint right or entitlement to income. The time between each step must be reasonable having regard to the facts and circumstances of each case.

GSTR 2004/6 gives the example of two or more co-owners who or which acquire vacant land for the purpose of constructing commercial premises for leasing. The acquisition of the vacant land may be the first step in a series of consecutive steps leading to the right or entitlement to rental income. The acquisition of the land, the engagement of surveyors and architects, the building of the premises and the appointment of a property manager, and the leasing of the premises under a lease agreement may be regarded as logical and progressive steps culminating in a joint right or entitlement to income. It is accepted in the ruling that, in these circumstances, a tax law partnership exists from the time of the joint acquisition of the vacant land. However, if the land is left vacant for a considerable period of time, this may indicate that the activity from which income is to be derived jointly has not yet commenced.

It is stated in the ruling that the "time of association" approach is intended to allow for a practical and sensible approach to determining when a tax law partnership is formed, and in the application of the GSTA99 to transactions involving tax law partnerships. The approach allows the partnership to claim input tax credits on creditable acquisitions made in the commencement of its enterprise, for example, at the time a property is acquired, even though there has not yet been an actual receipt of income jointly.

Change in identity of partners

Ordinary income tax

If there is a change in the identity of the partners in a partnership and the assets of the partnership include trading stock, there is a deemed disposal by the former owners to the new owners that is taken to be outside the ordinary course of business and, so, at market value (s 70-100 ITAA97). However, if there is at least a 25% continuity of interest and the trading stock continues to be trading stock of the business carried on by the transferee,

an election can generally be made that cost, rather than market value, be used if this would be a lesser amount.

CGT

Where there is a change in the identity of the partners in a partnership (whether a general law partnership or a tax law partnership), there will be changes of interest in each partnership asset for CGT purposes, with the possibility of capital gains and capital losses arising.

GST

The Commissioner's practice in relation to general law partnerships and continuity provisions is noted below. In the case of a tax law partnership, if there is a change in the identity of the partners, the Commissioner will not treat this as being a continuity of the partnership and a new GST entity will come into existence. If the former tax law partnership is deregistered, this registration would be cancelled, with the possibility of increasing adjustments under Div 138 GSTA99.

Where there is a change in the identity of the partners who or which comprise a partnership (whether a general law partnership or a tax law partnership), there will be a new partnership. This can potentially have significant consequences which the Commissioner has alleviated by administrative practice in the case of a general law partnership where there is a relevant continuity.

Continuity of partnership

In the case of a general law partnership, if there is an express or implied continuity provision in the partnership agreement, a change in the identity of the partners in the partnership will not be treated by the Commissioner as giving rise to a new entity for ordinary income tax and GST purposes (GSTR 2003/13).

Under general law, any change in the membership of a general law partnership leads to its dissolution. However, the dissolution may not lead to the winding-up of the partnership. The continuing partners and any new partner may conduct the business of the partnership without any break in its continuity. This is referred to as a reconstituted partnership.

Whether or not there is a reconstituted partnership depends on the intention of the parties and the terms and conditions of the partnership agreement.

A written partnership agreement may expressly provide for the continuation of the firm or business in the event of a change in the membership of the partnership. This provision is often referred to as a continuity or non-dissolution clause. In the absence of a written agreement, such a clause may be implied by the conduct of the partners following the retirement or death of a partner, or the introduction of a new partner.

Continuity clauses: are they effective for GST purposes?

To regard a change in the membership of a partnership as leading to a winding-up of an existing partnership and the formation of a new partnership would lead to administrative and compliance difficulties for the partnership and its partners. This would be the case particularly for partnerships that experience frequent membership changes. Every change in membership would require cancellation of the partnership's GST registration (and ABN registration) and a re-application for a new GST registration (and ABN) by the continuing partners.

For GST purposes, GSTR 2003/13 states that it is open and appropriate for the Commissioner to accept that a change in membership does not necessarily result in the general dissolution and winding-up of the partnership.

The view that there can be continuity of a partnership for GST purposes means that the partnership is dissolved only as far as a retiring or deceased partner is concerned. The retiring or deceased partner's interest in the partnership crystallises as a debt owing by the partnership to that partner. The reconstituted partnership continues as far as the continuing partners are concerned.

For a partnership to be treated as reconstituted, there needs to be an express or implied continuity clause in the partnership agreement, and there should be no break in the continuity of the enterprise or firm. Indicators of continuity of the enterprise or firm include:

- substantially all of the partnership assets remain with the continuing partnership;
- the nature of the enterprise remains substantially unchanged;
- the client or customer base remains substantially unchanged; and
- the business name or name of the firm remains unchanged.

None of these indicators is conclusive evidence of a reconstituted partnership, nor is its absence necessarily indicative of a dissolution that results in the winding-up of the partnership. The position is determined on the facts and circumstances of each case.

Observations

It will be appreciated that, where the joint ownership of land is being contemplated or if land is jointly owned some change is being considered, the potential revenue considerations must be taken into account.

The discussion in this article considers in a general way federal tax issues but it must be kept in mind that there are often state tax issues, such as stamp duty and land tax, that may need to be considered.

TaxCounsel Pty Ltd

References

1 [1967] HCA 32.

2 It is provided in s 25(2) of this Act that, where a body corporate is a joint tenant of any property, on its dissolution, the property shall devolve on the other joint tenant.

3 87 ATC 4541.

4 TD 13 has been withdrawn. However, the withdrawal notice points out that the determination was issued in relation to the repealed *Income Tax Assessment Act 1936* (Cth) (ITAA36) provisions, and that the rewritten ITAA97 provisions are clear and unambiguous and do not effect a change in the operation of the repealed provisions in the ITAA36.

5 [1972] HCA 68.

6 87 ATC 4541.

7 The way that partnership law characterises a partner's interest in a partnership asset (as to which see *Commissioner of State Revenue (Vic) v Danvest Pty Ltd* [2017] VSCA 382 and *Commissioner of State Revenue v Rojoda Pty Ltd* [2020] HCA 7) is not relevant for the purposes of CGT.

Higher Education

Meet the newly appointed student representative

Hansini De Fonseka will act as a strong advocate for our candidate community and offer a student perspective to help shape the future of our education programs.

Hansini De Fonseka
Senior Accountant
in Business Advisory,
William Buck,
South Australia

Please tell us a bit about your tax career.

My career in public practice started in 2017 after I graduated from the University of Wollongong with a Bachelor of Commerce (Dean's Scholar), double majoring in accounting and finance. I was fortunate to get my first job as a junior accountant in one of the largest accounting firms on the far south coast of New South Wales, Booth Partners in Nowra. This is where I had my first glimpse into the world of accounting and taxation. While working at Booth Partners, I gained in-depth experience and training in the preparation of financial statements and tax returns for individuals and other entities. I also had the opportunity to engage in audit and assurance services which helped immensely in developing my critical thinking and analytical skills.

After three years, I relocated to South Australia and became part of the William Buck Group. I am currently working as a senior accountant in the business advisory division of William Buck Adelaide, where I deal with complex business groups and structures, as well as high net wealth individuals. I am a CPA and an associate member of The Tax Institute, where I am also an active candidate in the Graduate Diploma of Applied Tax Law Program.

What is your role as the student representative for The Tax Institute Higher Education?

As the student representative of the Academic Board, I will provide a student perspective about academic governance, quality assurance, policymaking, integrity and strategy. I am a strong advocate for promoting better teaching programs to all candidates who are keen on expanding their knowledge in taxation, and I look forward to contributing to improving the standards and quality of the programs on offer.

How did you first hear about the Graduate Diploma of Applied Tax Law and why did you choose to enrol?

After my initial months working as an accountant, I wanted to learn more about the tax legislation and systems in Australia. I was looking for value-add programs that would enhance my knowledge in taxation, and that's when I came across the Graduate Diploma of Applied Tax Law.

After further research, I found that the program is structured to give students an in-depth understanding of key tax compliance principles and processes. Furthermore, the program covers important tax topics that I frequently visit as a tax accountant, such as CGT, small business entity concessions, GST etc. The content and program structure appealed to me and this, together with the flexibility in choosing subjects and the ability to transition to the Chartered Tax Adviser Program as a result of common subjects in both programs, were key factors in my decision.

What are the top skills and knowledge you've taken away from your studies?

CTA1 Foundations and CTA2A Advanced are structured to give an in-depth understanding of the fundamental principles of tax legislation, which has been extremely useful in performing my role in public practice, and my research and analytical skills have been greatly improved as a result of the subjects.

How did you juggle study, work and other commitments?

It is never an easy task, but I believe time management is the key to success. I have always been a very methodical and organised person and I try to plan my days in advance so that I can fit work and study into a happy and balanced lifestyle. It is important not to get overwhelmed by study and exams and to take a break if feeling overly stressed because the more you stress, the less productive you become.

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

This program is worth your time and money. It is well structured and dives deep into important tax topics and legislation that we come across daily as tax professionals. The program broadens your knowledge and exposure across the different tax specialisations and is a good refresher on the latest tax updates and legislative changes.

After undertaking the course, I felt that my capabilities and confidence grew, allowing me to better carry out my role as a tax professional. The learning materials offered throughout the program are detailed and the topics discussed are relevant to what we do at work, therefore making the acquired knowledge invaluable.

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Member Spotlight

Phil Shepherd

Member since:	**2015**
Member level:	**CTA**
Current role:	**KPMG, South Australia**

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

I started my career as a naïve young lad trying to find my way in the accounting profession. After a year of working in a chartered firm, a senior employee started putting the *Taxation in Australia* journal on my desk every month. It was his way of encouraging me to move into a specialist tax role. That was where my passion for tax started. While it can be demanding, there is satisfaction in working with great people and helping our clients achieve the best possible outcomes in a complex tax landscape.

How is your membership beneficial to your practice and clients?

The conferences and seminars that The Tax Institute puts on throughout the year are a great opportunity to network with peers and to hear from specialists across all sectors. Having access to insights from professional practice, industry and the ATO is a huge help in identifying opportunities and highlighting potential tax risks in a timely manner.

What is your most memorable career achievement to date?

Over the 15 years in practice, there have been a lot of great wins for clients and celebrations of milestones for the team. But for me personally, it was a privilege to be nominated for the Tax Adviser of the Year Awards in 2021 and a huge honour to be named a winner – particularly after what was a very challenging year for tax professionals. To have earnt that respect from both clients and peers is a great feeling.

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

The industry has been through a period of change in the last few years and technology has played a big part in that. Embracing technology and using it to provide pro-active, meaningful advice to clients in a timely manner will be both a challenge and an opportunity. The regulators are doing it exceptionally well and we as advisers need to keep up.

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

Patience, technical excellence and an ability to communicate complex issues in a simple way.

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

Make sure you understand the policy intent behind the legislation. If you understand what the law is trying to achieve, it makes that a little bit easier to apply in practice and find the opportunities for clients.

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

Work–life balance means getting the job done while making sure I set time aside to tell "knock-knock" jokes to my six-year-old son, give shoulder rides to my four-year-old daughter, and find the time to sit and enjoy life with my beautiful wife. Finding this balance is not always possible, but working from home during the pandemic has certainly meant that I see a lot more of my kids – which I'm very thankful for.

What does it mean to have won a prestigious Tax Adviser of the Year Award for 2021 and why?

To be included among the winners was an absolute honour. There are a lot of great tax advisers out there and to be acknowledged by my peers is a very special thing. The outbreak of the pandemic was devastating for a lot of people and their businesses. There were a lot of late nights and many hours spent advocating for clients who were going through a tough time. It is very humbling to be recognised for that effort.

Streamlining the tax system for individuals

by The Tax Institute

While political parties all seem to be presently shying away from any tax reform, the individual tax settings will continue to remain among the most problematic for Australia into the foreseeable future. Completely out of step with the rest of the world, personal income tax is the most important and largest source of government revenue, consistently raising approximately half of total revenue since the 1970s. While the rest of the world has shifted to balance individual and corporate taxation with consumption taxation, Australia continues to be overly reliant on taxes that tend to create disincentives and act as productivity brakes on our economy. Moreover, the ongoing failure of successive governments to address the lack of integration of the tax and social security systems has resulted in ludicrous effective marginal tax rates for certain groups — more often for those at the most potentially productive stages of life. The challenges and opportunities for designing a future tax and transfer system for Australia have been identified in this section of the *Case for Change*.

Overview

This chapter of the *Case for Change* paper considers Australia's individual tax and transfer system and issues arising in the current system that require reform. Individuals income tax is the most important and largest source of government revenue, consistently raising approximately half of total revenue since the 1970s.[1] The following challenges and opportunities for designing a future tax and transfer system for Australia have been identified:

- **marginal tax rate system lacks transparency:** the interactions between the individual tax system and transfer system, such as the various rates, thresholds, offsets and concessions, has resulted in non-transparency and lack of clarity as to how the marginal tax rate system applies to individual taxpayers;
- **workforce participation disincentives for the secondary income earner:** this tax-induced distortion reduces the scale of Australia's labour workforce and has a profound economic and social impact;
- **unnecessary administrative processes for individual tax compliance, e.g. work-related deductions:** there are difficulties in correctly quantifying work-related costs, in apportioning expenses between income-earning purposes and private (domestic or capital) purposes, and in correctly claiming deductions;
- **investment assets:** the operation of the negative gearing regime in conjunction with the CGT rules creates the perception of a potential tax advantage and encourages investment behaviour based on CGT discount gains upon sale or disposal. There is a lack of consistent policy across different forms of investment income;
- **residency:** the current legislation is outdated and not appropriate for today's working environment. The current residency rules are considered most difficult for Australian expatriates and inbound workers; and
- **personal services income (PSI):** the practice of income splitting continues to pose a significant threat to the government's revenue.

The individuals income tax system

'Individuals income tax' is broadly defined as the tax paid on an individual's personal assessable income, less any expenses incurred in generating that income. Personal income typically includes salary and wages, investment income, interest, net capital gains from investments, and distributions from trusts and partnerships. Individuals also receive fringe benefits, as a form of non-cash remuneration, from employers as part of an employment relationship.[2]

Rates and thresholds

A progressive personal income tax regime has been a well-established feature of Australia's tax transfer system.[3] The amount that is subject to tax is referred to as 'taxable income' and the applicable tax rate is determined by the schedule of marginal rates and thresholds (refer below) and impacted by levies, concessions or tax offsets where relevant.[4] Above the tax-free threshold, the rates specified at each bracket is the 'marginal' tax rate and is the amount of tax payable on a taxpayer's next dollar of taxable income. This is distinct from the 'average' tax rate on the individual's entire taxable income.[5]

Schedule of resident marginal tax rates 2021–22

Table 1 sets out the rates applicable to individuals who are Australian residents for tax purposes.

Concessions and offsets

A broad array of tax concessions can reduce the tax liability of individuals, subject to meeting eligibility criteria. The Australian individuals income tax system offers relatively few concessions on labour income (for example, work-related deductions); however, there are various concessions for income from savings (such as superannuation and capital gains) and income from carrying on a business (for example, CGT concessions targeted at small business entities). Further to this, there are certain tax offsets built into the tax system to assist particular groups

of taxpayers, such as the low income tax offset and the low and middle income tax offset.

Levies

The main permanent levy in the individuals income tax system is the Medicare levy, which helps fund Australia's public health system. Similar to the social security contributions used in other countries, the Medicare levy is a 2% flat rate applied on an individual's taxable income. Low income individuals and households may pay a reduced amount of the Medicare levy or are exempt, depending on the circumstances.[7]

Table 1. Individual income tax rates

Taxable income	Tax on this income
0–$18,200	Nil
$18,201–$45,000	19 cents for each $1 over $18,200
$45,001–$120,000	$5,092 plus 32.5 cents for each $1 over $45,000
$120,001–$180,000	$29,467 plus 37 cents for each $1 over $120,000
$180,001 and over	$51,667 plus 45 cents for each $1 over $180,000

Source: ATO[6]

Work-related expenses

Work-related expenses incurred by an individual during the production of assessable income are generally deductible. The regime for the availability of deductions is intended to improve the equity of tax treatment between individuals who incur costs in producing assessable income and those who do not. However, the rules can be complex and difficult to comprehend and apply correctly by individual taxpayers without tax adviser assistance. This issue is explored in further detail below.

CGT discount

Following a recommendation in the Ralph review,[8] the CGT discount was introduced on 21 September 1999 for assets acquired on or after that date, replacing the indexation method.[9] It allows eligible capital gains (discount capital gains) to be reduced by, generally, 50%.[10] To be a discount capital gain, the capital gain must result from a CGT event happening to a CGT asset that has been held for at least 12 months.[11]

The CGT discount was designed to replace the indexation method — a method of applying indexation to the cost base to account for inflationary increases in the value of the asset. Taxpayers who held a CGT asset for at least 12 months could index the cost base of the asset to ensure that inflationary gains would not be assessed.[12]

Since the introduction of the CGT discount in 1999, Australia has been in a low inflation environment. For example, comparing inflation between September 1984 and September 1985 yields a weighted average inflation rate increase of 7.6%, whereas between September 2018 and September 2019, the same inflation rate increased by only 1.7%.[13] Effectively, inflation is not rising with the same velocity as it was when the CGT discount was introduced. In simple mathematical terms that would suggest that the discount should be around 11%. Clearly, such a discount rate would be politically unpalatable, but the point of the comparison is that the current rate no longer reflects the policy it was originally designed to replace. Moreover, it is inconsistent with the tax treatment of other unearned income, such as rents and interest.

Main residence exemption

The main residence exemption (MRE) disregards for CGT purposes any capital gains or losses from a CGT event that happens to a dwelling that is the taxpayer's main residence, provided that certain conditions are met.[14] While there have been various iterations of the MRE since the introduction of CGT in September 1985, the core principle underpinning the MRE has always been to exclude the taxpayer's primary residence from the purview of the CGT regime.[15]

According to the 1985 draft white paper on tax reform, the Prime Minister's decision to spare owner-occupied homes from being subject to CGT was based on ensuring that Australia's approach was consistent with overseas practices at the time.[16] Indeed, most countries still provide some form of concessional treatment of gains derived from the sale of a taxpayer's home or main residence.[17]

The MRE is regarded as 'sacred' by many.[18] This perception has caused many governments to remain gun shy about making changes that would lessen the generous concession available to homeowners. The MRE is the government's largest tax expenditure item, according to the latest annual *Tax expenditures statement 2017*,[19] which estimates the revenue foregone in 2017–18 due to the MRE at $74b.

In a post-COVID-19 world, the government will need new sources of revenue, which begs the question as to whether the government can afford to continue providing this concession in its current form to homeowners.

Changes to the main residence exemption for foreign residents

A change in the law arising out of the *Treasury Laws Amendment (Reducing Pressure on Housing Affordability Measures) Act 2019*[20] means that foreign residents (i.e. those who are not Australian residents for taxation purposes) are not entitled to the MRE unless:

- the taxpayer is a foreign resident for no more than six continuous years and, during that time, the CGT event which would ordinarily trigger the MRE occurred as a result of a specified 'life event' (whereby the taxpayer, the taxpayer's spouse or the taxpayer's child under 18 years has developed a terminal medical condition or died); or
- the CGT event happened on or before 30 June 2020 and the taxpayer held a continuous ownership interest in the main residence dwelling throughout the period starting just before 7:30pm (AEST) on 9 May 2017 and ending just before the CGT event happens.[21]

Investment income

Different taxation applies to different forms of investment income in the hands of individuals. This was pointed out in the Henry review:[22]

> "Comprehensive income taxation, under which all savings income is taxed the same as labour income, is not an appropriate policy goal or benchmark.
>
> The essential reason for treating lifetime, long term savings more favourably is that income taxation creates a bias against savings, particularly long-term savings. Taxes on savings income, including the taxation of inflationary gains, can discriminate against taxpayers who choose to defer consumption and save. The longer the person saves and reinvests, the greater the implicit tax on future consumption (see Chart 4.3). These individuals pay a higher lifetime tax bill than people with similar earnings who choose to save less.
>
> ...
>
> Current arrangements lead to tax outcomes that vary widely depending on the form of saving undertaken (see Chart 4.4). Interest has the least favourable tax treatment. The entire return, including inflationary gains, is included annually in taxable income, generating an effective marginal tax rate on the real return greater than the statutory marginal personal tax rate. In contrast, shares benefit from the CGT discount, while domestic shares also benefit from dividend imputation.
>
> Rental properties benefit from the differential treatment of gains and losses, driven by the capital gains discount and exacerbated by high levels of gearing. Returns from owner-occupied housing are untaxed, giving rise to a zero effective tax rate. For superannuation, the ability to make contributions out of pre-tax income (rather than post-tax income as for other savings, including your own home), can result in a negative effective marginal tax rate on saving through superannuation.
>
> ...
>
> There is considerable evidence that such tax differences can have large effects on the assets in which a household's savings are invested (OECD 2007a). The large variations in tax treatment can therefore alter the allocation, ownership and the management of the nation's savings. This can have adverse impacts on overall economic efficiency, capital market stability and the distribution of risk between individuals. The tax advantages from borrowing to invest in a rental property, also relevant for shares, leads to investors taking on too much debt and distorts the rental property market."

The Henry review recommended a discount to the rate of tax for investment income to remove the inherent taxation bias against savings or income from capital.

However, having regard to the considerable amount of investment capital in the global financial system (sometimes colloquially referred to as 'money looking for a home'), the question of whether the bias needs to be addressed and differential taxation for capital income verses earned income may have changed over the past 12 years such that the matter should be re-examined. In this context, the question arises whether there should be different approaches to capital income taxation for resident individuals as compared to other types of investors, including institutional and foreign investors.

Negative gearing

During 1985, the federal government introduced legislation to abolish 'negative gearing' for real estate investors only in an attempt to address any tax leakage from revenue sources.[23] The legislation applied to real property bought after 17 July 1985. Due to various pressures, the government repealed the measure, effective from 1 July 1987.[24] Justification for the reversal of the measure was reported on two main grounds. Firstly, the uniformity of tax treatment of interest costs for all types of investment, and secondly, that the perception that tax benefits offered to high income earners by negative gearing were adequately countered by other tax reform measures (for example, with the introduction of the CGT regime).[25]

Current state

Under the current tax system, income from investments, such as rent, dividends or interest, form a part of taxable income. Investment-related expenses, such as interest, council rates and maintenance costs, are generally deductible from taxable income. Where these deductions for property investment exceed the value of investment income from the same asset class, they can be used to offset other income, including other investment income, or income from salary and wages, often referred to as 'negative gearing'. The role of negative gearing in driving investment in rental properties and the broader societal impact on housing affordability and entry to the property market is a contentious issue.

In 2017–18, over 2.2 million individuals owned one or more rental properties, with approximately 1.3 million individuals claiming a net rental loss.[26] Deductions relating to rental property (i.e. interest, capital works and other rent-related expenses) exceeded gross rental income by $3.6b.[27]

The tax treatment of investment properties is the same as it is for any investment asset resulting in a mix of current income and capital gain. The rental income is taxed at the individual's marginal tax rate as it is earned and, generally, the capital gain is taxed at 50% upon realisation or disposal of the asset.[28]

Individual tax residency and source

Generally, an Australia resident is assessable on their worldwide income derived from all sources, but a non-resident is assessable only on Australian-sourced income.[29] There are also numerous other provisions that are affected by an individual's residency, including provisions relating to:[30]

- marginal tax rates;
- temporary resident rules;

- working holiday maker rules;
- non-resident withholding payments;
- CGT (including the MRE, access to CGT discount, CGT event I1);
- access to franking credits;
- residency of companies and trusts and superannuation funds; and
- application of double tax agreements.

The definition of a 'resident' is set out in s 6(1)(a) ITAA36. By contrast, a 'non-resident' is defined as being 'a person who is not a resident of Australia'. Accordingly, an individual will be a resident of Australia if they satisfy any one of the four tests — resides test, domicile test, 183-day test or the superannuation test.[31]

On face value, the definition of a 'resident' appears relatively simple. However, in practice, the application of the definition requires detailed factual analysis and reverting to common law principles that have been established through case law. To assist with the interpretation of the current individual tax residency rules for the primary resides test, the Commissioner has listed factors in TR 98/17 that he considers relevant when determining residency, including physical presence, intention and purpose, family, business or employment ties, maintenance and location of assets, and social and living arrangements.[32] However, an approach that involves working through a 'checklist' of factors has attracted widespread criticism from both the courts and from the AAT.[33] Ultimately, where an individual resides is a question of fact and degree and requires consideration of all the relevant circumstances.

In the 2021–22 Federal Budget, the government proposed to amend the definition of 'individual resident' to adopt what is touted as a simpler and more certain test. While the proposed primary test of 183 days in Australia is clear and simple to apply, the secondary test presents difficulties in application resulting in curious outcomes. To attract overseas talent and enhance knowledge transfer, one of the fundamental issues is whether a temporary worker should be considered a resident for tax purposes. While rules exist to prevent certain temporary workers from effectively bringing foreign assets into the Australian tax net, the current proposal potentially operates contrary to that principle. Clarity is necessary on this point.

Moreover, the proposal on individual residency has been driven, in part, by a significant rise in cases and ruling requests on the resident/non-resident question. That rise only occurred after a change in 2009 restricting the exemption for foreign overseas employment income.[34] Apart from reducing the number of ruling applications and cases going before the AAT and the courts, reinstating the former breadth of that exemption would be both completely consistent with the approach taken for companies in respect of foreign-sourced active income,[35] as well as encouraging the international movement of people and the associated knowledge transfer benefits that generally arise.

Personal services income

Australian individuals have long used a variety of means to split or alienate income from personal exertion to reduce their overall tax liability. The practice of income splitting poses a significant threat to the government's revenue. Initial attempts by the government to address these practices involved application of the general anti-avoidance provision of Pt IVA ITAA36 and its predecessor.[36] This had limited success and was at significant administrative cost and effort by the ATO. In response and using the proposal raised in the Ralph review,[37] the specific anti-avoidance provisions for PSI were introduced from 1 July 2000.[38] However, there are shortcomings in practice that still require the Commissioner to resort to Pt IVA in certain circumstances and there are arguments that the existing PSI rules offer limited certainty to taxpayers making a self-assessment.

PSI is income that is for an individual's personal efforts or skills, or would be so if it was the income of the individual who did the work. The PSI rules were designed to improve the integrity of, and equity in, the tax system by ensuring that individuals cannot reduce or defer their income tax by alienating or splitting their PSI through the use of interposed companies, partnerships or trusts, known as the 'personal services entity'.[39]

In order to determine whether the rules apply, a threshold question is whether the individual is an employee or a contractor. The rules do not apply if an individual provides their personal services to a service acquirer as an employee; the income derived in this capacity will be the ordinary assessable income of the individual. However, if the individual is not an employee of the service acquirer, the PSI rules may apply.

Typically, the personal services entity receives the PSI of one or more individuals and is interposed between the individual providing the work or services and the service acquirer.[40] The rules do not apply where an individual can establish that they are carrying on a personal services business (PSB). To be a PSB, there is a PSB determination in force or one of following tests must be met:

- results test;
- unrelated clients test;
- employment test; or
- business premises test.

Issues

The individuals income tax system: marginal rate taxation

Due to the progressive personal income tax regime and the impact of a variety of levies and tax offsets, the headline marginal rate that may apply can differ greatly to the effective rate of tax ultimately paid by the individual.

For example:

- an individual may start with their applicable marginal rate of tax and have additions of the Medicare levy (2%)

and the Medicare levy surcharge (1%, 1.25% or 1.5% depending on their taxable income bracket and for those without adequate private patient hospital insurance); or

- an individual may start with their applicable marginal rate of tax and may be entitled to the low income tax offset and may also be relieved from the Medicare levy.

These examples illustrate that, due to the various levies, concessions and tax offsets in the system, the applicable tax bracket for an individual may not be easily identified and therefore the tax rate they face lacks transparency and could be improved.

Tax and transfer system interactions: workforce participation

The current design of Australia's tax and transfer system deters the workforce participation of secondary income earners. This tax-induced distortion reduces the scale of Australia's workforce and has a profound economic and social impact. Secondary income earners in family units are often female, with 46% of females employed part time compared to 17% for males.[41] It is reported that the economic productivity foregone annually from disincentives for female participation in the workforce is estimated at $11b.[42]

A recent KPMG report further states:[43]

> "… if the gap between Australia's male and female workforce participation rates could be halved, our annual GDP would be $60 billion greater in 20 years' time, and over the period our cumulative measured living standards would be raised by a massive $140 billion."

Specifically, once the tax and transfer system interactions are accounted for, including higher childcare costs, higher income tax payable and loss of government benefits, the effective marginal tax rate of secondary earners becomes extremely high — in some cases, over double the top marginal personal income tax rate of 47% (as shown in Figure 1).[44]

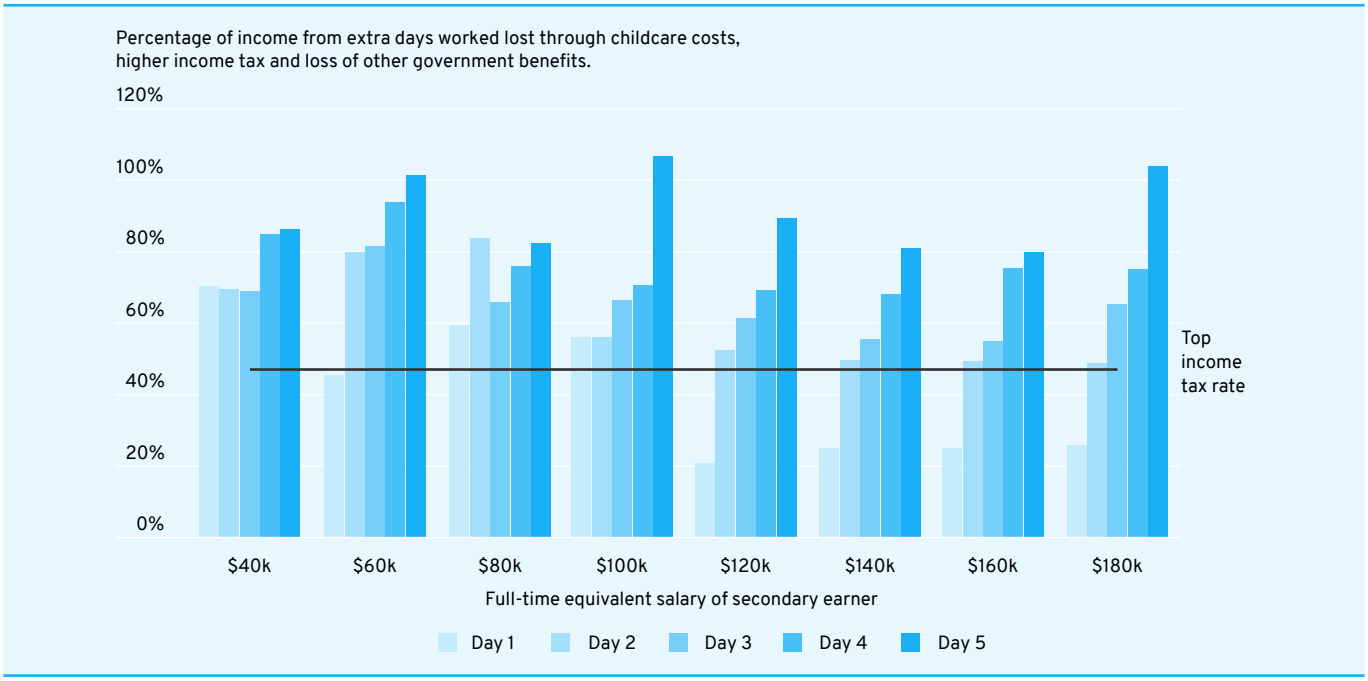
The evidence shows that these extremely high effective marginal tax rates deter women, especially those with young children, from working more.[45] For example, a secondary earner on a full-time annual equivalent salary of $60,000 faces an effective marginal tax rate of over 80% when they increase working days from one day/week to two to three days/week (compared to the top marginal personal income tax rate of 47%). Similarly, for secondary earners working on a full-time basis, the effective marginal tax rate is at or above 80% regardless of full-time equivalent salary level. At some income levels, the effective marginal tax rate exceeds 100%.

Furthermore, it is interesting to note that the tax and transfer system uses different bases, for example, joint income base (transfer system) versus individual income base (tax system). The current childcare subsidy is means tested and conducted on joint income, which is consistent with the design of most transfer payments in Australia. Interestingly, research has found that the majority of Australian families are effectively taxed on a joint income basis and have a marginal tax rate schedule that 'tends towards an inverted U-shaped profile' and is 'no longer progressive'.[46]

Work-related expenses

The regime for the availability of deductions imposes complexity and additional compliance costs on individuals seeking to claim legitimate expenses due to the substantiation rules, particularly where there is a private component to the relevant expense. Determining the extent

Figure 1. Workforce disincentives for secondary earners



Source: Grattan Institute, 2020, p. 26.[47]

to which, if at all, certain expenses satisfy the nexus test with income adds to the complication.

Examples of common work-related expenses include home office running expenses, telephone and internet usage expenses, and motor vehicle expenses. These expenses are generally associated with the use of private assets for income-producing purposes.

Based on the latest ATO statistics for 2017–18, the total value of work-related expenses was approximately $21.7b.[48] It is reported that work-related expenses is the main contributor to the net tax gap for individuals being approximately $4.4b out of a total tax gap for individuals of $8.3b in 2017–18.[49] The ATO has issued a raft of guidance on work-related expense deductions generally and for employees in specific industries to assist them to understand what they may be entitled to claim. This stream of ATO guidance evidences that the rules around deductibility of work-related expenses can be complex and are not easy to navigate by individual taxpayers without assistance.

Therefore, under the current framework, there are difficulties in correctly quantifying work-related costs, in apportioning expenses between income-earning purposes and private (domestic or capital) purposes, and in correctly claiming deductions.

Settings of CGT discount

Rate of CGT discount

The CGT discount was introduced with effect from 21 September 1999 to replace the more complicated indexation method calculation. Division 115 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) enables a taxpayer to receive a 50% discount on a capital gain when the CGT asset has been held for at least 12 months. The policy rationale for the 50% CGT discount was presented in the Ralph review, which described it as being 'designed to enliven and invigorate the Australian equities markets, to stimulate greater participation by individuals, and to achieve a better allocation of the nation's capital resources'.[50]

The primary issue with the current settings of the CGT discount is whether, given today's relatively low inflation climate, the existing general CGT discount rate of 50% is still appropriate.[51] Inflation is not rising at the same rate as the period between the introduction of CGT in September 1985 and the introduction of the CGT discount in September 1999. This suggests that, while a discount rate of 50% may have been considered appropriate in 1999, the rate is now too generous.

Further, the flat rate of the current CGT discount raises an equity issue surrounding the tax impact of the disposal of a CGT asset held for 12 months plus one day as compared with long-term asset holdings. It is not fair or equitable that an eligible taxpayer who holds on to an asset for 12 months and one day (assuming the asset is not held as part of a profit-making undertaking[52]) is eligible for the same CGT discount as a taxpayer who holds a CGT asset for 20 years. It cannot be argued that a CGT asset usually experiences inflationary growth of 50% in just 12 months. In a low inflationary period (which has occurred since 1999), the taxpayer who holds the asset for just over 12 months receives a significant benefit for holding on to an asset for a short period of time. The discount should better reflect the impact of inflation, given it was originally designed to be a simpler mechanism to replace the indexation method.

The need for reform of the 50% CGT discount has been recognised at both the political and policy levels:

- in 2009, the Henry review recommended the implementation of a reduced CGT discount rate of 40%;[53] and
- in 2019, the ALP campaigned on a proposed reduction of the rate of the CGT discount from 50% to 25%.[54]

The Tax Institute considers a renewed conversation on the CGT discount is warranted.

Main residence exemption

Design of the main residence exemption

There are manifold issues with the current design of the MRE.

The MRE is a regressive policy. The exemption benefits high-income and high-wealth households more than low-income households, and renters are unable to benefit from the exemption at all. According to the 2016 Census of Population and Housing, around 67% of Australians have their name on a property title and, of that 67%, around 52% have a mortgage.[55] This means that the lost revenue stemming from the MRE can effectively flow to active property owners and those who are able to accrete land around their main residence block (up to two hectares).

Complexity of the main residence exemption provisions

In their basic form, the MRE rules seem simple enough — a homeowner can disregard the capital gain (or loss) they make on the sale of their home. However, it is apparent from a deeper dive into Subdiv 118-B ITAA97 that the rules have been designed to cater to almost every personal and familial circumstance. There are provisions which deal with:

- what is an ownership interest in a dwelling that is a main residence;
- the treatment of adjacent land (up to two hectares) — the requirements that the adjacent land also be used primarily for private or domestic purposes, and that the same CGT event that happens to the dwelling also happens to the adjacent land, confounds many taxpayers;
- delays when moving into a property;
- changing main residence, which provides a six-month overlap rule — this rule is poorly understood, and it is doubtful whether all deferred capital gains arising from exceeding the six-month period attributable to the new main residence are fully accounted for when the latter main residence is sold many years into the future;
- absences from the dwelling, which allows for a (resettable) six-year absence period where the property

is used for an income-producing purpose or indefinitely otherwise — the six-year rule is very poorly understood, particularly when it comes to dwellings being made available via sharing economy platforms (such as Airbnb);

- properties that are compulsorily acquired or destroyed;
- the construction, repair or renovation of a dwelling, which allows for a maximum four-year period accompanied by a mandatory three-month rule for the dwelling to be the main residence following the construction, repair or renovation — this rule is also poorly understood;
- the destruction of a dwelling;
- spouses or a dependent child having different main residences;
- marriage or relationship breakdowns;
- partial exemptions where the dwelling was a main residence for only part of the ownership period or was used to produce income;
- dwellings owned by or passing through deceased estates — these are particularly complex rules given their interaction with Div 128 ITAA97;
- dwellings owned by special disability trusts; and
- dwellings owned by foreign residents.

This approach to cater to almost every personal and familial circumstance is admirable but makes the rules inherently complex. Once multiple properties, holiday homes, divorces, deaths and foreign residency are thrown into the mix, the law becomes incredibly complicated to apply in practice.

> "... the economic productivity foregone annually from disincentives for female participation in the workforce is estimated at $11b."

2019 changes for foreign residents

The changes made in December 2019 were designed to deny foreign residents access to the MRE from 7:30pm (AEST) on 9 May 2017, subject to a 30 June 2020 transitional rule for existing properties held prior to this date.

The change in the law for foreign residents is not equitable and too complicated. The measures seem to apply prospectively, as they apply to CGT events happening from 7:30pm on 9 May 2017 (or 1 July 2020 under the transitional rule). However, the calculation of the capital gain is based on the original cost base.

The practical effect of these measures is the retrospective denial of the MRE as far back as 20 September 1985, being the commencement of the CGT regime and the MRE. Under the amendments, the availability of the MRE to a taxpayer is based on their tax residency status *at the time of the CGT event, irrespective of the use of the dwelling or the taxpayer's residency status throughout the ownership period.* This has a significant impact on Australian expatriates who sell their former Australian homes while they are a non-resident.

There are some exclusions, but these are, in many cases, not practical or complex to apply. The exclusions ensure that a taxpayer is not subject to the new rules if they:

- return to Australia and establish their tax residency before the CGT event;
- satisfy the 'life events test' which requires that, during their first six years of foreign residency, one of the following specified circumstances occurred or the CGT event occurred in relation to a family law matter:
  - terminal medical condition of the taxpayer, their spouse or child under 18 years of age;
  - their spouse or child under 18 years of age died; or
  - divorce or separation.

The following problems arise under these measures:

- the calculation of the capital gain based on the original cost base is inherently unfair, and takes no account of the taxpayer's residency status or the way the property was used throughout the holding period of the property;
- the effective application of the rules as far back as 20 September 1985 means that foreign resident taxpayers are required to establish the cost base of the property, in most cases, without adequate records (see below); and
- the above point is compounded in the case of deceased estates which not only have the same record-keeping issue, but are also subject to additional complex rules — the tax outcome depends not only on the residency status of the foreign resident property owner at the time they died, but also how the beneficiary of the estate uses the property on inheriting it, and the beneficiary's residency status at the time they sell the property.

Complexity and retrospective record-keeping requirements. The compliance burden on foreign residents is unreasonably high. A foreign resident who is subject to CGT as a result of the disposal of a property that was previously their main residence is required to establish the original cost base of the property. However, they were not to know until 2017 at the earliest (many did not realise until some time later) that they had to keep records, which makes it incredibly difficult to correctly calculate the capital gain.

In addition to determining the purchase price and incidental costs of acquiring the property to establish the property's cost base (which will include stamp duty, legal costs etc.), the taxpayer is also required to retain the necessary records related to any non-deductible holding costs (third element of cost base), such as rates notices, bank statements (for mortgages), receipts for repairs and maintenance, and insurance policy statements. For taxpayers who have held their property for a substantial length of time and who may not have envisaged becoming a non-resident for taxation purposes or the change in the tax law, the burden of being able to accurately substantiate these costs with the relevant records is unnecessarily onerous.

Unclear outcomes in the case of marriage or relationship breakdown. The measures are silent on the interaction between s 118-110(3) and s 118-178 where a CGT roll-over is available under Subdiv 126-A. Accordingly, the impact of the measures on a resident individual who sells a dwelling and whose former spouse[56] is a non-resident at the time of the CGT event is unclear. It is possible that the individual selling the property could be adversely affected by the measures, notwithstanding that they are a resident at the time of the CGT event.

Assume that:

1. the resident spouse sells a dwelling in Australia which was transferred from their former spouse under a family law settlement;
2. the property is eligible for a CGT roll-over under s 126-5 ITAA97;
3. the resident spouse continues to treat the dwelling as their main residence until they sell it; and
4. the former spouse is a non-resident at the time the CGT event happens to the resident spouse.

There are two possible interpretations:

1. the CGT event doesn't happen to the non-resident former spouse, so there is no impact on their main residence days — accordingly, the resident spouse can take into account the main residence days of their non-resident former spouse and would be eligible for a full MRE on the sale of the property; or
2. notwithstanding that the CGT event doesn't happen to the non-resident former spouse, they are a non-resident at the time the CGT event happens to the resident, so the main residence days of the non-resident former spouse are zeroed out as if they had never lived there — in this case, when the resident spouse sells the property, they will be eligible for only a partial exemption.

This second outcome is an extraordinary one, given that the explanatory memorandum states:[57]

> "Individuals who are Australian residents for taxation purposes at the time a CGT event occurs to a dwelling are not affected by this measure."

However:

- the resident may not even know whether their former spouse is a non-resident at the time of the CGT event;[58]
- existing family law settlements would not have taken these measures and this possible outcome into account; and
- it would be very difficult to negotiate a future family law settlement and quantify the tax impact so that an equitable settlement could be reached to take into account the contingency that the former spouse may, one day and following the family law settlement, be a non-resident at the time the resident spouse sells the property.

Investment properties

Negative gearing

As a result of costs arising from investment assets being deductible for income tax purposes, taxpayers are effectively able to shelter income from sources other than their investments, such as employment income. This is perceived to give rise to a distortion in the tax system in favour of individuals. This perception is exacerbated by the potential tax advantage that comes on the income side from the taxation of the capital gain earned from the asset. In other words, the ability for eligible individual investors disposing of capital assets to claim deductions and additionally receive a 50% reduction in the taxable capital gain upon disposal, contributing to an overall reduction in the tax cost of investing in capital assets.[59] There is also general concern that income from investment properties is not independently verified like other kinds of income. There is also interesting consideration of whether income from investments should be taxed differently to income from personal exertion.[60]

This presents an opportunity for the government to consider improvements in the interactions of the current tax and transfer system and to address the potential tax advantage from investment assets and the economic and social impact by the attractiveness of the CGT discount incentivising investment behaviour.

Depreciation for residential rental properties. Made under the guise of 'housing affordability', the measures were designed to prevent taxpayers from resetting the cost of depreciating assets acquired when purchasing an existing property for use in gaining or producing assessable income from the use of residential premises for the purposes of residential accommodation. In some cases, taxpayers were obtaining quantity surveyor reports that set the cost of some assets above the amount paid by the previous owner of the property. While some change in the law may have been warranted, the design of the new rules is not understood by many and there is some anecdotal evidence of unintended non-compliance with the new law.

Where a taxpayer is unable to claim a deduction for the depreciation under s 40-27 ITAA97, a capital loss under CGT event K7 may arise. The taxpayer must allocate the purchase price as well as the sale price between the amount attributable to the land and buildings and the amount attributable to the depreciable plant and equipment in the property to correctly calculate the capital loss under CGT event K7. In practice, this will generally involve the taxpayer having to obtain a quantity surveyor report on acquisition (which is typical) as well as on disposal (not common). The average tax practitioner does not have the skills or experience to allocate a purchase or sale price between the amount attributable to the land and buildings and the amount attributable to the depreciable plant and equipment.

Further, the limitation in s 40-27 applies only to depreciable assets that have been 'previously used'. This means that, if a taxpayer replaces an existing depreciating asset in the property (such as an oven) with a second-hand asset, they will not be able to claim depreciation for that asset and

will have to calculate a capital loss under CGT event K7, whereas if they replaced an existing depreciating asset with a new asset (such as a new hot water unit), they can claim depreciation on the new asset. This distinction makes it complex for landowners and their advisers to correctly characterise and treat the asset under the tax law, as any prior use of the asset by another person needs to be ascertained.

Deficiencies in vacant land rules. The policy to deny deductions from 1 July 2019 for expenses associated with holding vacant land was announced[61] as part of the 2018–19 Federal Budget on 8 May 2018 in the following brief terms:

> "This is an integrity measure to address concerns that deductions are being improperly claimed for expenses, such as interest costs, related to holding vacant land, where the land is not genuinely held for the purpose of earning assessable income."

The meaning of 'vacant land' is set out in s 26-102 ITAA97 and is subject to a range of exclusions and conditions. There is a widespread misconception that the measures only apply to land that is vacant, i.e. it does not have any buildings or other permanent structures. However, for the purposes of s 26-102, it means land that has:[62]

> "… no substantial and permanent structure in use or available for use on the land having a purpose that is independent of, and not incidental to, the purpose of any other structure or proposed structure;"

This is far broader and includes properties which have a dwelling or some other substantial and permanent structure but they happen not to be in use or available for use.[63]

Some amendments were made to the measures as they were before the parliament in October 2019 to improve the operation of the rules. However, some of the inserted provisions are deficient and fall short of addressing the concerns raised with the government before the Bill was enacted. The effect of the rules means that there is overreach, exceptions are poorly constructed and they deny deductions to taxpayers who are unquestionably using the land for a taxable purpose.

Individual tax residency and source

Residency is a "fundamental cornerstone for determining how an individual will be taxed".[64] The current rules for determining individual tax residency were enacted in 1930[65] and have remained predominantly unchanged. Assessing whether an individual is a resident or non-resident is a question of fact and degree. In 2017, the Board of Taxation commenced a review of the income tax residency rules for individuals which found that the current rules are no longer appropriate and require modernisation and simplification.[66] The Board has since been undertaking further consultation on the design of the new residency rules.

With increasing global mobility in the workforce, the current legislation is said to be outdated and not suitable for today's working environment.[67] The current residency rules are considered most difficult for Australian expatriates and inbound workers.[68] However, the difficulties with the rules are also a reflection of the attempt to ensure that nuanced situations are addressed as 'not one-size-fits-all'. Thus, while relying on well-established principles over some 80 years, the indicia established by the courts must be applied to individual circumstances. This provides a level of equity for each set of circumstances. Alternatives offered include some level of subjectivity or regard to criteria that can give rise to inappropriate outcomes. Nonetheless, a simple 183-day test as reflected in most treaties is a better starting point for determining residency.

Exemption of certain income earned by Australians working overseas

Most of the recent litigation on residency matters has been in relation to individuals working overseas who sought to have their foreign earnings treated as exempt income following the 2009 changes which greatly restricted the availability of the exemption for foreign employment earnings under s 23AG ITAA36. This exemption was a relatively simple way of addressing income earned during overseas service. The narrowing seemed to be the catalyst for the change in behaviour that led to several taxpayers attempting to argue that they were non-residents for tax purposes.

The narrowing of the provision also enforced a requirement for a continuous 91-day period offshore which is inflexible and unreasonable for foreign expatriates based in Australia with regional responsibilities (e.g. executives).

Personal services income

As mentioned, the practice of income splitting poses a significant threat to the government's revenue. Its popularity among Australian taxpayers is the product of having individuals as a 'tax unit' together with progressive tax rates.[69] Major incentives for income splitting (and retention of PSI) include the difference between the company tax rate and the top individual marginal tax rate, and the progressive individual tax brackets which encourage income splitting in order to obtain more than one tax-free threshold and multiple progressive tax rates. Although there has been a recent reduction in tax rates, these incentives still remain for high-income earners.

In releasing the Board of Taxation's review in 2009,[70] the government announced that the Board had found "evidence of a low level of compliance and a degree of uncertainty or 'greyness' around the rules", and furthermore, "the alienation of [PSI] rules in their current form [did] not provide acceptable levels of integrity and equity".[71]

Due to the evolving labour workforce, with individuals increasingly becoming 'incorporated contractors' and with the rising modern working arrangements from the gig/service-based economy, the problem has become more widespread. Latest statistics report that the gig economy grew nine-fold between 2015 and 2019, reaching $6.3b in total consumer spend and involving as many as 250,000 workers.[72]

Part of the complexity is related to the differing tax treatment and lack of harmonisation of the definition

between classifications of employee, contractor and 'worker' from the gig economy. The issue has been identified by various reports and consultations, including the OECD,[73] the Black Economy Taskforce, the Board of Taxation[74] and the Henry review. In conjunction, the ATO recently released working guidance in the form of TR 2021/D2 (to combine its former rulings TR 2001/7 and TR 2001/8 and to clarify the view in consideration of relevant judicial decisions).

Personal services business tests

The PSI rules were introduced to overcome problems with using Pt IVA, yet the general anti-avoidance provision must still be resorted to when an entity passes a PSB test but is retaining income, splitting PSI or making excessive payments to associates of the 'test individual'. Further, the Board of Taxation and the Black Economy Taskforce have raised concerns with the following specific tests:

- **abuse of the 'results' test:** the 'results' test is at risk of being gamed due to the self-assessment system or misunderstood. Examples of the system being manipulated so as to self-assess as an independent contractor include structuring a contract to seemingly look like a 'results-based' contract when it is not. Examples of payments that do not constitute a result were identified to include 'hourly rate, daily rate, piece rate, percentage of a fee and commission only';[75] and
- **the 'unrelated clients' test is out of step with the modern economy:** the 'unrelated clients' test is not fit-for-purpose in the context of the gig economy. The evolution of online gig platforms has become extraordinarily sophisticated, with transaction data reporting three broad categories, private transport, meal delivery and task-based, e.g. respective examples being Uber, Deliveroo and Airtasker.[76] These online platforms have made it "far too easy to conduct minor work for two unrelated clients";[77] and
- based on the Black Economy Taskforce's findings, the assessment and collection of tax for the gig economy is not being accurately assessed.

Options

The individuals income tax system: marginal rate taxation

The Tax Institute supports the application of a fully transparent personal marginal tax rate system which simplifies the system and allows individual taxpayers to clearly identify their marginal tax bracket and tax rate. As such, we recommend that the government review the factors that contribute to making the marginal tax rate system non-transparent, and suggest that they could be addressed by changes to the marginal tax rate system. Additional levies and income tax offsets unnecessarily complicate the individuals income tax system and distort the real impost of tax by managing social security matters through the tax system. On this basis, there is merit in conducting a holistic review to determine whether all current levies and tax offsets should be varied, retained or removed.

Furthermore, one of the key issues that has failed to be addressed by successive governments is the high cost to individual taxpayers that arises because the tax, superannuation and social security systems are not properly integrated. To address the inequity arising from the high effective marginal tax rate on secondary income earners in working families, the current design of the tax and transfer system should be reconsidered and reformed.

An adjustment of the tax rate structure could widen the tax base. It has been suggested that the current tax-free threshold is too high and should be reduced. This is, in part, because the tax-free threshold benefits all taxpayers — even those on the top marginal rates. Any reduction in the tax-free threshold would widen the tax base in line with optimal taxation theory. This may require some level of compensation for some 'new' taxpayers and enable tax rates to be lowered for low and middle income earners. Any change to the tax-free threshold or any other part of the marginal tax rates should take into consideration the effective marginal tax rate created by the interaction of the tax and transfer system. The individual marginal tax rate should be fully transparent so that individual taxpayers can clearly identify which marginal tax bracket they fall into and the rate of tax that will therefore apply.

Tax and transfer system interactions

Workforce participation

The current effective marginal tax rate for secondary income earners penalises the secondary income earner (typically female workers), which disincentivises workforce participation. Removing those disincentives should widen the tax base through increased labour force participation rates, improve productivity and economic efficiency, provide fiscal sustainability, and promote gender equality.

To address the high effective marginal tax rates for secondary income earners (which are a function of individual tax rates, childcare costs and social security benefits), consideration could be given to either expanding the childcare subsidy or providing universal free childcare.[78]

Work-related expenses

Standard deduction for employees. As an option for the short-term, The Tax Institute supports recommendation 11 of the Henry review — the introduction of a standard work-related deduction for employees.[79] Employees with expenses above the standard deduction threshold should retain the ability to claim actual expenses with full substantiation above a nominated threshold. This would reduce the administrative burden for all stakeholders involved (individuals and the ATO) by simplifying the tax compliance obligations. The standard deduction could be factored into the 'tax tables' produced by the ATO to assist employers in determining the amounts of tax to withhold from salary and wages via the PAYG withholding system.[80] Automatically factoring in the standard deduction to amounts of tax withheld from employees would help to alleviate the compliance burden for individuals.

Other suggestions include:

- no deduction for work-related expenses at all (similar to the New Zealand model);
- a lower standard amount be set (e.g. $1,000), with a cap at, say, $5,000; or
- a deduction set as a percentage of salary and wage income (the assumption being, although not verified, that higher levels of income may necessitate higher costs).

This is not meant to be a comprehensive list of options nor be taken as an endorsement of these alternatives. Each would need to be accompanied with reductions in personal tax rates.

As technology advances and data automation becomes more sophisticated, with current examples being the use of enhanced data collection and the use of technology such as pre-fill information in myTax including myDeductions, there will be further administrative savings. Tax processes and the tax function have the potential to become so advanced that automated apportionment methodologies may start to be introduced (for example, GPS-related technology in the determination of deductible car expenses).

Comparable international jurisdictions. As an alternative and longer-term option, there are comparable international jurisdictions which operate simpler systems for individuals with more basic tax affairs or allow for deductions for work-related expenses on a more narrow and limited scope. While we acknowledge that no tax system can achieve perfect compliance, Australia could consider drawing on elements of comparable countries' systems to model its own system for individuals. We refer to Table 2 with a summary of this comparison.

CGT discount

The tax system should encourage long-term asset ownership rather than rewarding short-term speculative-type behaviour. To encourage this behaviour, there are four potential options for reforming the CGT discount.

Lower discount percentage

The CGT discount rate could be lowered so that it operates as a more accurate proxy for today's low inflation environment. This would require a policy decision as to the appropriate settings for a lower rate, taking into account contemporary rates of inflation in Australia.

Eligibility based on a longer holding period

This option for reforming the CGT discount is aimed at improving the equity issue around aligning the treatment of a taxpayer who holds a CGT asset for 12 months and one day with that of a taxpayer who holds a CGT asset for a much longer period. To ameliorate the disparity, perhaps a longer period of at least two, three or five years before which a taxpayer would be eligible for the CGT discount would be more suitable.

Scaling rate of CGT

An alternative option to basing eligibility for the CGT discount on a longer holding period could involve implementing a scaling rate of CGT. Under this mechanism, a scaling rate would entitle a taxpayer to a higher rate of CGT discount the longer the CGT asset is held. This avenue would provide a greater reward for those taxpayers who hold CGT assets for longer periods.

Revert to indexation method

A more radical option would be to abolish the CGT discount in its entirety and revert solely to the indexation method to more accurately reflect inflationary trends. However, it is noted that the indexation method involves a more complex calculation and commentators have largely agreed that a CGT discount in some form is preferable to reverting to the CGT discount's predecessor.[81]

Reduce the complexity of the main residence exemption rules

The design of the MRE provisions should be simplified to make it easier for taxpayers to determine whether they are entitled to the MRE and, if so, to what extent.

Table 2. Comparable jurisdictions: deductions for work-related expenses

Country	Deductions for work-related expenses?	Scope of deductions and arrangements
Australia	Yes	Incurred in gaining or producing an employee's assessable income.
Canada	Limited	Only deductions specifically legislated, e.g. accounting and legal fees.
Netherlands	Yes – narrow	Most work related are not deductible. Limited exceptions for transport, education and home office expenses. There is an employed person's tax credit.
New Zealand	No	No requirement for individuals whose earnings are limited to salary, wages, dividends and interest income to lodge a tax return. Therefore, no deductions allowable for work-related expenses for employees.
UK	No	No apportionment of expenses, i.e. it is either used wholly and exclusively for work or it is not deductible (also known as the 'wholly and exclusively' test).

Source: Adapted and updated from the Henry review, p. 54; OECD *Taxing wages 2020*.

The MRE rules could be reformed in the following respects:

- the operation of the six-month overlap rule in s 118-140 ITAA97 is clumsy to apply in practice as it operates to set the maximum overlap six months back from when the ownership interest in the existing main residence ends. It would be easier to apply in practice if taxpayers were permitted the MRE on two properties at the same time, but only for six months from when the ownership interest in the new main residence starts; and
- the operation of the six-year absence rule in s 118-145 ITAA97, its interaction with the cost base resetting rule in s 118-192 ITAA97, and its application in the context of the sharing economy is not well understood. Many taxpayers think that temporary absences from the property, rather than the property ceasing to be the main residence of the taxpayer, entitles them to apply the six-year absence rule. The law should be amended to clarify that the six-year absence rule is not available for temporary absences (such as renting the property for a short period through a sharing economy service provider) and there are CGT implications when the property is sold.

Other thoughts on the main residence exemption

A more drastic option for reforming the MRE is to abolish it in its entirety. The primary argument in favour of this approach is that the MRE encourages Australians to invest in 'unproductive' assets (i.e. assets that are not used for an income-producing purpose). If the MRE were to be abolished, that capital or level of investment could be better directed towards income-producing assets or activities. Therefore, from a purely economic perspective, there is an argument not to retain the MRE. It is also worth noting that, if the MRE were to be abolished, the CGT discount would apply to most capital gains made from the disposal of a dwelling that is the taxpayer's main residence. Accordingly, it would be uncommon for the entire capital gain to be taxable.

From a political and policy perspective, however, the argument in favour of retaining the MRE in some form is stronger. The taxation system ought to support Australian home ownership and, as noted above, a system that offers some form of concessional treatment on the sale of the family home is consistent with the worldwide approach.

2019 changes for foreign residents

The changes made in 2019 produce unfair and retrospective tax outcomes for property that was previously the main residence of Australian expatriates who are foreign residents at the time of the CGT event.

There are two potential options for reforming the application of the MRE to foreign residents and altering the law to make it fairer for Australian expatriates. The MRE could generally be denied to foreign residents, but if the foreign resident had previously been an Australian resident taxpayer, either one of the following two concessions below could apply, both of which are designed to simplify the law and make it more equitable. Either of these modifications would provide a fairer outcome for Australian expatriates without undermining the original policy intent of the measures.

Reset the cost base of the property to its market value

The law should be amended to allow Australian expatriates to reset the cost base of the property to its market value on the day they became a non-resident. This approach is based on the mechanism in s 118-192 ITAA97, which deals with situations in which a taxpayer initially uses as a property solely as their main residence and subsequently uses the dwelling to produce assessable income. When the taxpayer starts to use the property to produce assessable income, only a partial exemption from CGT is available when the property is sold.

In these situations, s 118-192 provides that, for the purpose of calculating the capital gain, the taxpayer is taken to have acquired the property at the first time the taxpayer uses the dwelling to produce assessable income. The cost base is taken to be the market value of the property at that time. This effectively 'resets' the cost base to the time when the taxpayer's circumstances changed, recognising that a full exemption would have been available had the CGT event happened just before the first use to produce assessable income and the taxpayer has most likely not kept the necessary records to substantiate the cost base for the period it was their main residence. This approach would calculate the capital gain only on the increase in the value of the property since they ceased to be a resident.

Allow Australian expatriates a partial exemption for the number of days they were a resident

This could be achieved by prorating the main residence days for which the individual was an Australian tax resident and lived in the dwelling as their main residence. This approach would be similar to the mechanism in s 115-115 ITAA97, which allows a prorating of the residency days for CGT discount purposes for certain foreign residents. For assets acquired after 8 May 2012, the CGT discount is unavailable to foreign residents. However, s 115-115 apportions the CGT discount where a CGT event happens after 8 May 2012 and the foreign resident had a period of Australian residency after that date. In a similar vein, the law could be amended to allow the MRE to apply following the disposal of a main residence proportionately based on the number of days the taxpayer was an Australian resident for tax purposes.

Improve operation of vacant land rules

Adult children

The current provisions do not address the common scenario where parents own primary production land and make it available for their adult children to continue to carry on the business.

The wording in s 26-102(2) ITAA97 should be amended to include adult children, not just those under 18 years of age.

Land is genuinely held for the purpose of earning assessable income

The explanatory memorandum sets out the policy intent of the rules which was to ensure that deductions could not be being improperly claimed for expenses related to holding vacant land, where the land is not genuinely held for the purpose of earning assessable income.

However, the effect of the rules is to deny deductions where land is genuinely held for the purpose of earning assessable income. A taxpayer who rents vacant land, even on an arm's length basis, to someone who is not carrying on a business cannot use the exemption in s 26-102(9) because of para (b). In this case, there is no need to rely on the taxpayer's assertion that they are using the land for the purpose of earning assessable income as this can be evidenced by corroborating evidence such as rental income receipts.

The wording in s 26-102(9) should be amended to remove para (b) to restore the original policy intent.

Primary production land containing residential premises

The current provisions do not allow landowners to apply the exemptions in s 26-102(8) or (9) where the vacant land contains residential premises. It is common for primary production land to contain residential premises. Allowing taxpayers to use the exemptions in s 26-102(8) or (9) where primary production land contains residential premises is not inconsistent with the policy intent.

The wording in s 26-102(8) and (9) should be amended to remove para (c) in each subsection to restore the original policy intent.

Investment properties

Negative gearing

The current tax system for negative gearing and the CGT discount on investment properties provides an environment to incentivise investment in real property driven by financial gain (i.e. losses in a current year can reduce taxes at an individual's marginal tax rate and any capital gains on property attract the 50% CGT discount). The interaction of the two measures has a much broader economic and social impact on the property market, for example, volatility and reduced home ownership.

Introduce quarantining rules. There is a strong case for principle-based reform such that losses on investments should not be deducted from salary and wage income.[82] The introduction of rules to quarantine losses so that they are unable to be written off against salary and wage income would reduce the tax-driven incentive towards such investments.

There are different approaches to quarantining and how the rules should be designed:

- allow losses on investments to apply to all *non-salary and wage income*, including all forms of investment income (such as rental income and interest);
- allow losses on investments to apply only to investment income from the *same asset class* — for example, losses on a property investment could be applied to reduce gains on another property but not against dividends from shares. A similar regime exists in the United Kingdom and existed for a short while in Australia's history (between 1985 and 1987, refer above to 'Overview'); or
- allow losses on investments to apply only to income (including future capital gains) from the *same asset*.

There are some economic arguments for the last option. It aligns the timing of gains and losses and minimises any tax-driven bias of capital gains over recurrent investment income. However, it may lead to unproductive tax structuring as it may encourage people to hold investments through entity types that have more favourable tax treatment across different types of savings.[83]

Any changes should apply to all types of passive investments so that the tax system does not create bias towards certain classes of assets. Removal of tax incentives for investments should lead investors to shift towards income-producing assets and has the potential to increase income tax collection. There is also the alternate view that less revenue may be collected if some investment properties are replaced by owner-occupier properties.

International comparisons. Australia's tax treatment of property investment losses is more generous than most comparable countries, with most enacting measures to quarantine and limit deductions from investments against salary and wage income.[84] As mentioned above, the negative gearing rules in the UK are limited — losses from investment income are quarantined to the same asset class, with excess losses carried forward. The main advantage under this system is that government revenue is not lost; however, there are some disadvantages such as the reduced tax value of losses in the event that the marginal tax rates decrease when applied and potentially increased compliance costs.[85]

From a tax policy perspective, the quarantining of losses from the negative gearing of investment assets should be considered in the wider context of the CGT regime. As a model basis, consideration may also be given to the design of the CGT regime which restricts the offset of capital losses only against capital gains.[86] Similar arguments apply to the quarantining of interest deductions on investment assets and the concessional CGT treatment in Australia. Additionally, the transfer system has an existing negative gearing rule requiring investment losses to be added back for income testing entitlement to benefits.

Options. A more consistent and principled approach could reasonably be taken across all types of investments to require the apportionment of interest expenditure between income production (deductible to the extent that income is produced) and capital (included in the cost base for CGT purposes). In the short term, the existing regime relating to investment assets can be reformed. Quarantining provisions could be introduced which are similar to the UK model and in consideration of the CGT regime.

Over the longer term, a more fundamental rethink of the taxation of savings income may be appropriate. The Henry

review's proposal to align the tax treatment of savings, including interest income, net rental income, capital gains and interest expenses, would provide a more consistent treatment of household savings and remains a worthy longer-term policy goal subject to being satisfied that the financial environment for such treatment remains valid.[87]

Individual tax residency and source

With regard to the current context of a post-COVID-19 era, a rapidly evolving modern economy and a trend in an increasingly mobile international workforce (disregarding travel restrictions and limitations imposed by COVID-19),[88] The Tax Institute considers it timely to continue the discussion on whether Australia's individual income tax residency rules are appropriate and adequately address the policy objectives of simplicity, equity, efficiency and integrity. It is noted that in the 2021–22 Federal Budget, the government has endorsed the principles for a revised individual residency test as proposed by the Board of Taxation in its report of 2019.[89]

Improved certainty, reduced compliance costs and making Australia more attractive as a destination for inbound taxpayers should be a priority in reforming the residency rules. Furthermore, we should not be creating barriers for those Australians seeking to gain valuable experience overseas that the economy should benefit from on their return.

Exemption of certain income earned by Australians working overseas

The Tax Institute is supportive of reform for a more flexible taxing arrangement for those individuals who pay tax in other jurisdictions on income earned offshore. Alternatively, reform by way of a broader application of the qualifying period under s 23AG ITAA36 could be considered. A more lenient and global workforce-friendly approach would be to apply the foreign earnings exemption for temporary residents where the taxpayer has a period of more than 90 days offshore in a tax year without the need for those days to be continuous.

Personal services income

The Tax Institute encourages the government to consider a revised regime in line with the recommendations canvassed and areas of concern identified by the Board of Taxation, the Henry review and the Black Economy Taskforce. Recommendation 10 of the Henry review outlined a revised regime to prevent the alienation of PSI. However, no reforms to the PSI rules emerged and the concerns raised by the Board of Taxation in 2009 remain valid today. The Board's review suggested that non-compliance was an issue, with 83.5% of a high-risk sample found to be non-compliant.[90]

It is time to evolve the tax system to be in step with wider economic, technological and social changes.

The following options are put forth for consideration:[91]

- amend the existing Pt 2-42 ITAA97 so that, where the PSI rules result in income remaining otherwise unattributed to the test individual, rather than rely on Pt IVA, any PSI left in the interposed entity is attributed to that test individual (or, where income splitting occurs, adjustments are made so that the PSI is attributed to the relevant individual). This would simplify the existing regime and render the existing PSB tests redundant. Alternatively, amendment by the direct attribution of PSI to the relevant individual in all cases would be preferable (or deeming dividends to the relevant individual). This could be done in conjunction with indexing the marginal tax thresholds to further reduce underlying key incentives for income splitting; or
- alternatively, a system similar to the NZ system could be adopted where the PSI regime (or a modified version of it) would only apply where an individual's net PSI is greater than the threshold where the 40% tax rate applies. This would simplify the self-assessment process for many individuals. However, this would not address the underlying incentives driving the splitting of income, such as the lower tax rates and multiple tax-free thresholds.

Meanwhile, ongoing and further consultation by professional bodies with the ATO can support the process of reform and ensure that changes to the compliance system and the practical implications are appropriately communicated to individual taxpayers. Furthermore, the overlap between the tax system and the social security system must be considered and may create difficulties in the implementation of any options for reform.

Options for reform

- Increase transparency of the marginal tax rate system and how it applies to individual taxpayers.
- In the short term, introduce a standard deduction for work-related expenses, with the option to claim actual expenses properly substantiated for employees with expenses above an agreed threshold value.
- Introduce quarantining of losses provisions to the negative gearing regime to streamline the tax treatment of investment properties.
- Improve tax and transfer system interactions, for example, addressing existing workforce participation experience by secondary workers (either by expansion of the subsidy or the introduction of universal free childcare).
- Base joint tax returns on the family unit.
- Modernise the individual tax residency rules and make rules appropriate for today's contemporary working environment. Address existing difficulties in the current residency rules for Australian expatriates and inbound workers.
- Address the ongoing practice of income splitting by revision of the PSI regime in line with the recommendations canvassed and areas of concern identified by the Board of Taxation, the Black Economy Taskforce and the Henry review.

Conclusion

As can be observed, the individual tax and transfer system is perhaps more in need of reform than any other part of the system. Even so, it would be a mistake to do this in isolation of the many other changes that are necessary to the whole system as any subsequent reform would still need to consider interactions across different parts of the system. The failure to undertake the necessary tax reform that has been exposed in this series of articles and *The Case for Change* will continue to condemn Australians to poorer lifestyles, business to lower profitability, and Australia to lower productivity through poorer investment and jobs outcomes.

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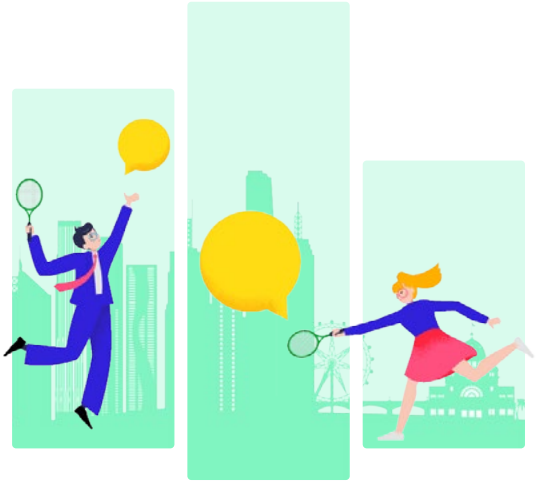

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Allocation of professional firm profits: part 2

by David Montani, CTA, National Tax Director, Nexia Australia

Part 1 of this article was prefaced with the longstanding dichotomy between income derived from property and income derived from an individual's personal services. This formed the background leading to the Commissioner of Taxation issuing PCG 2021/4, concerned with professional firm profits possibly being insufficiently attributed to practitioners whose personal efforts contributed to the derivation of the profit. Part 1 went on to cover when an affected taxpayer qualifies to rely on PCG 2021/4, and their situation when they don't. In part 2, we move on to PCG 2021/4's risk assessment framework, the scoring system, and the transitional arrangements with suspended guidelines from 2015. All of this leads into how we can assist clients in the applicable industries (and ourselves) to make key decisions that will determine whether they will be in the crosshairs of this targeting system for ATO compliance reviews.

Recap of part 1

Part 1 of this article set out a brief background on the history of the tax technical matters underlying PCG 2021/4. This included the concept of a business structure, income derived from which has generally not been regarded as attributable to anyone's personal services. However, the Commissioner states in PCG 2021/4 that, even where a business structure exists, some of a firm's profit may still reflect one or more individuals' personal services. It follows that redirecting income away from those individuals might still offend Pt IVA of the *Income Tax Assessment Act 1936* (Cth) (ITAA36).

PCG 2021/4 is concerned only with professional firms, which includes, but is not limited to, accounting, architecture, engineering, financial services, law, medicine and management consulting.

PCG 2021/4 is primarily a targeting system. It sets out a risk assessment framework by which the Commissioner will judge who within the applicable industries will likely be subject to further analysis and possibly audit, and who will not. Part 1 then covered the qualifying criteria that must be satisfied in order to rely on PCG 2021/4's risk assessment framework, and what happens when they are not satisfied.

Part 2 moves on to the risk assessment framework, and applying it to clients.

Risk assessment framework

Where an individual professional practitioner (IPP) qualifies to apply PCG 2021/4, it sets out a risk rating system based around the allocation of an IPP's share of firm profit between the IPP and associated entities. The rating system produces a score for the particular income year, which places an IPP into a green, amber or red zone. Green is a low risk rating, amber is moderate, and red is high risk.

The Commissioner considers the arrangements for IPPs in the amber or red zones to be at risk of giving rise to inappropriate tax outcomes.[1] As noted in part 1, this does not necessarily mean that Pt IVA applies — it is merely a mechanism for choosing taxpayers for a closer look. However, para 68 of PCG 2021/4 lists a number of other risk issues that the Commissioner might address, including s 100A and Div 7A ITAA36.

The risk rating is based on three risk assessment factors (RAFs), set out in Table 1.[2] IPPs have the option of determining their score from combining RAF 1 and RAF 2 only, or all three. The reason for allowing the choice is that RAF 3 can be difficult to determine accurately.

The only relevant associated entities of an IPP are those to whom some firm profit has found its way. An associated entity with no income originating from the firm is not relevant for this process.

Risk assessment process

Paragraphs 70 to 105 of PCG 2021/4 set out how to risk assess an IPP's arrangements for an income year. However, different terms are used across the three RAFs in relation to a firm's profit or income entitlement, such as "remuneration", "profit entitlement from whole of firm group", and "firm-related amounts". These terms are not defined in PCG 2021/4.

Paragraph 72 of PCG 2021/4 makes a general statement that all components of remuneration are to be included in an IPP's risk assessment. This includes cash, superannuation, fringe benefits, and other non-cash benefits. However, particular RAFs are not specified, implying that these are components of all three RAFs. Yet, RAF 1 makes no mention of remuneration, only "profit entitlement", and RAF 2 measures tax payable on "firm-related amounts" but does not specify what that means, only that it includes "income and associated deductions".[3]

Putting aside the inconsistent wording and undefined terms, the author has confirmed with the ATO that the calculations for all three RAFs incorporate the IPP's profit entitlement,

salary, superannuation and fringe benefits. This provides for a logical consistency.

Factors may exist pertaining to individual arrangements that affect an IPP's self-assessed risk rating. These may include things like retention of income within a firm, instant asset write-off or full expensing, or other extraordinary business factors. Where extraordinary factors exist, taxpayers can engage with the ATO to discuss.[4]

Applying the RAFs in Table 1 to a year of income will place an IPP into one of the three zones as set out in Table 2. Again, IPPs have the choice of an aggregate score based on only RAF 1 and RAF 2, or all three RAFs. It will become apparent that allocating a greater share of the IPP's profit entitlement to the IPP personally can shift to a lower score bracket for RAF 1 and RAF 3. In most cases, that will probably also increase the total effective tax rate, which can shift the RAF 2 score to a lower bracket as well. The 3 to 4 score brackets are somewhat of a "sweet spot" for placing in the green zone.

Profits retained in firm company

Where a professional firm is operated through a company, there is the matter of after-tax profits retained in that company. PCG 2021/4 illustrates in case studies 10 and 11 that, under this structure, the RAFs are concerned only with entitlements that the IPP and associated entities actually receive, that is, salary, superannuation, fringe benefits and dividends.

For example, in case study 10, the IPP's total entitlement is a stated $400,000, for which it is then revealed comprises a salary of $200,000 and a fully franked dividend of $200,000 ($140,000 in cash and $60,000 in franking credits). It is not stated whether the dividend represents profits earned that year or in an earlier year, and no mention is made of any profits earned that year but retained in the company. These matters appear to be irrelevant, and all that does matter as relates to measuring the IPP's share of the company's profits is dividends actually paid during an income year.

Based on the above, profits earned in a particular income year, but retained in the company, simply do not feature in this process. This would seem to be the case even where an IPP accesses funds representing those retained profits during the year by non-dividend means, such as by way of a loan.

Table 2. Risk zones

Risk zone	Risk level	Aggregate score: RAF 1 and RAF 2	Aggregate score: All three RAFs (optional)
Green	Low	≤ 7	≤ 10
Amber	Moderate	8	11 & 12
Red	High	≥ 9	≥ 13

Skewed outcomes can arise where the company retains profits and then pays them out as dividends in a subsequent year. Where there is a commercial reason for this, the Commissioner recognises that this can affect an IPP's risk rating.[4]

Unpaid present entitlement versus cash drawn

Where a professional firm is operated through a trust, a similar issue arises when applying PCG 2021/4 in relation to income entitlements. For example, a firm is operated through a unit trust, and an equity holder IPP's profit entitlement on their unitholding for an income year is $400,000. However, the IPP draws only $380,000 in cash during the year, leaving an unpaid present entitlement of $20,000 owing at 30 June.

In the above example, the question arises as to whether $400,000 or $380,000 is the IPP's profit entitlement from the trust, to be used when calculating each of the three RAFs. PCG 2021/4 does not specifically address this matter, nor is the answer definitively ascertainable from any of the examples or case studies. Example 4 is the most comprehensive of the examples, but is structure-neutral. It thus refers only to the IPP and associated entities receiving amounts of firm income, with nothing more specific. Case study 12 illustrates a firm operated through a trust. However, it refers to the IPP's "profit entitlement from the firm" of $600,000, again not addressing this specific issue.

RAF 2 is the one of particular contemplation here. It is easy to foresee the myriad of complexities that would arise in trying to calculate the effective tax rate on $380,000, when $400,000 is the amount that has been appointed and assessed to beneficiaries. This is exacerbated in the next income year, when perhaps that remaining $20,000 unpaid

Table 1. Risk assessment factors

Risk assessment factor	Score brackets					
	1	2	3	4	5	6
RAF 1: Proportion of profit entitlement from the whole of firm group returned in the hands of the IPP	> 90%	> 75% to ≤ 90%	> 60% to ≤ 75%	≥ 50% to ≤ 60%	> 25% to < 50%	≤ 25%
RAF 2: Total effective tax rate for income received from the firm by the IPP and associated entities[5]	> 40%	> 35% to ≤ 40%	≥ 30% to ≤ 35%	> 25% to < 30%	> 20% to ≤ 25%	≤ 20%
RAF 3: Remuneration returned in the hands of the IPP as a percentage of the commercial benchmark for the services provided to the firm	> 200%	> 150% to ≤ 200%	> 100% to ≤ 150%	> 90% to ≤ 100%	> 70% to ≤ 90%	≤ 70%

present entitlement is drawn in addition to that year's assessable profit entitlement.

The author has confirmed with the ATO that, in the above example, $400,000 is the appropriate figure to use. This might seem inconsistent with a company structure as discussed above, but it reflects the differing taxing mechanisms. The IPP would typically hold their units in the unit trust through a discretionary trust. Irrespective of how much cash is drawn, the discretionary trust is assessable on $400,000. Accordingly, the IPP through their discretionary trust must deal with the full $400,000 in that income year, and has control over the taxing outcomes in relation to that amount, not just the amount drawn in cash. Therefore, the logical conclusion is that the full entitlement to the unit trust's income is the appropriate amount to use when calculating the RAFs, irrespective of the amount of cash drawn.

We now consider each of the three RAFs.

RAF 1: proportion of profit entitlement

RAF 1 produces a score based on the proportion of profit entitlement included in the IPP's assessable income to the total amount of income to which the IPP and associated entities are collectively entitled (directly or indirectly) from the whole of firm group. The profit entitlement from the whole of firm group includes all entitlements in the manner discussed above, including profit share (whether a partnership share, appointed trust income or dividend), as well as salary, superannuation and fringe benefits. It also includes income from a service entity.

The greater proportion assessed to the IPP, the lower the score bracket. There is only a limited discussion of this, in paras 82 and 83 of PCG 2021/4. However, the ATO has clarified some matters of uncertainty as discussed above.

Where 100% of the whole of firm group income is assessed to the IPP, there is no requirement to do anything further. The arrangement is automatically low risk, as none of the income is diverted to other entities.[6]

RAF 2: effective tax rate

RAF 2 measures the "total effective tax rate" on income received from the firm by the IPP and associated entities. Despite being income tax by another name, the Medicare levy is excluded from the calculation of tax.[5]

Paragraph 85 of PCG 2021/4 requires calculating two amounts of tax for the IPP and each associated entity respectively — the para 85(a) and para 85(b) tax amounts. For each person/entity, select the larger of the two tax amounts. Those selected larger amounts are then added together, and the total divided by the total firm income collectively received. The higher the resulting percentage, the lower the score bracket.

"Total tax paid" is calculated on "firm-related amounts". PCG 2021/4 does not explain in any detail what firm-related amounts means, other than to say it includes income and associated deductions. However, again as noted above, it has been confirmed that it includes all forms of income entitlements. Further, when calculating the total tax payable:

- deductible contributions to superannuation (whether paid by the firm or IPP) are included as part of the income (denominator), with 15% tax recognised as paid (numerator);[7]
- example 6 in PCG 2021/4 (paras 98 to 99) confirms that salary paid to an IPP is included in the calculation of effective tax rate; and
- para 73 of PCG 2021/4 makes the general statement that fringe benefits are included in an IPP's risk assessment where they form part of overall remuneration. Where FBT is paid by the firm, it is included when calculating the risk assessment factor (relevant only for RAF 2).[8]

As noted above, we are required to calculate two tax amounts for the IPP and each relevant associated entity. The higher one for each person/entity is then used in the calculation of effective tax rate. These two alternative tax amounts are explained below.

> "How much additional tax are you prepared to pay to put yourself in the green zone?"

Paragraph 85(a) tax amount

Individually for the IPP and associated entities, the para 85(a) tax amount is the tax that would be payable on firm-related amounts, assuming there are no other sources of income or deductions. In other words, ignore all income and deductions that are unrelated to the firm, and calculate the tax as if the firm-related amounts were the person/entity's only income/deductions.

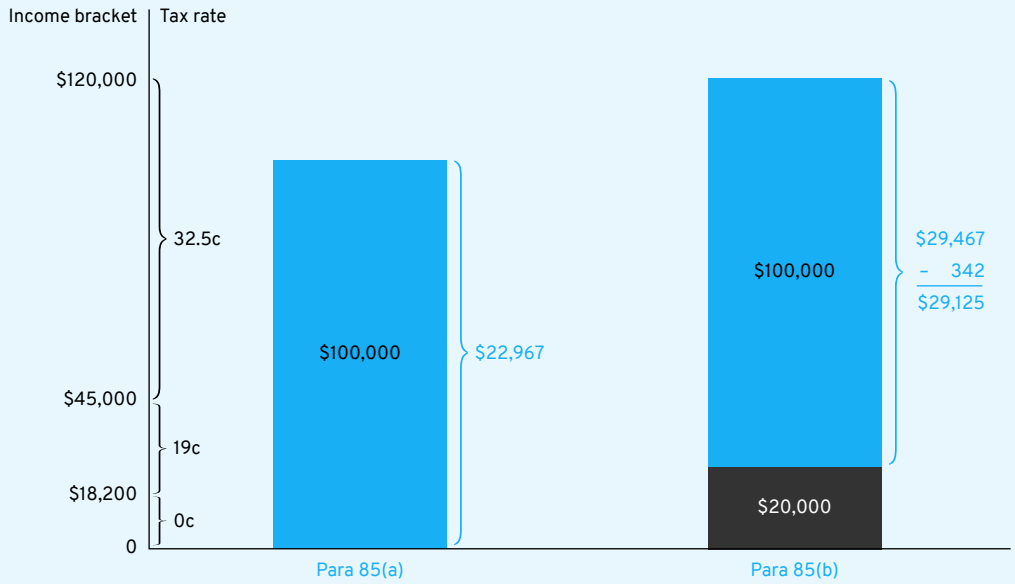
Case studies 10 and 11 in PCG 2021/4 make it clear that, where any income amounts are a franked divided, the franking rate is irrelevant. For example, case study 10 features a fully franked dividend of $200,000, comprising $140,000 cash with a $60,000 franking credit attached. The fact that this dividend is franked at 30% is irrelevant, as the tax amounts are calculated by reference to the grossed-up amount of $200,000.

Paragraph 85(b) tax amount

The para 85(b) tax amount is the income tax paid for the year factoring in all income and deductions from all sources, less the tax that would be payable on non-firm-related amounts. This is essentially placing firm-related amounts on top of non-firm-related amounts, with the resulting tax calculated from the higher tax brackets. The same approach applies with franked dividends as noted above.

Examples 1 and 2 below illustrate how these amounts are calculated.

Diagram 1. Illustration of example 1 tax amounts



Example 1. RAF 2: other net income

An IPP's total firm-related income and deductions amount to $100,000. The IPP also has other income and deductions, unrelated to the firm, netting to $20,000 income. Diagram 1 illustrates how the para 85(a) and para 85(b) tax amounts are calculated.

The para 85(a) tax amount is simply the tax on the total firm-related amount of $100,000, as if that were the only income for the year. This starts with the tax-free threshold, and so on in the usual way. This amounts to $22,967.

The para 85(b) tax amount is the tax on the IPP's total taxable income of $120,000 ($29,467), less the tax on $20,000 ($342). $29,467 minus $342 equals $29,125. It is effectively the tax on the $100,000 of firm-related income at the tax rates applying above an income of $20,000. Accordingly, this pushes the $100,000 up the tax scale, with no tax-free threshold, and more of it taxed at higher rates.

The para 85(b) tax amount of $29,125 is larger than the para 85(a) tax amount of $22,967, and so $29,125 is the amount used. The process is repeated for associated entities with firm-related amounts, and the combined tax amounts are divided by the total firm income collectively received.

Example 2. RAF 2: other net deduction

The spouse of the IPP in example 1 receives firm income of $100,000. They also have other income and deductions, unrelated to the firm, totalling to a net *deduction* of $40,000.[9] Diagram 2 illustrates how the para 85(a) and para 85(b) tax amounts are calculated.

Example 2 (cont)

The para 85(a) tax amount again is simply the tax on the total firm-related amount of $100,000, as if that were the only income for the year ($22,967). The para 85(b) tax amount is the tax on the total taxable income ($60,000), less the tax on non-firm-related amounts. Tax on $60,000 is $9,967. As non-firm-related amounts is a $40,000 loss, the tax on that is nil. Accordingly, the para 85(b) tax amount is $9,967 minus nil, which equals $9,967.

In this case, the para 85(a) tax amount of $22,967 is larger than the para 85(b) tax amount of $9,967, and so $22,967 is the amount used.

Example 1/2 effective tax rate

On the basis that the IPP and spouse were all of the relevant parties for that IPP, the effective tax rate would be:

$$\frac{\$29,125 + \$22,967}{\$100,000 + \$100,000} = 26.05\%$$

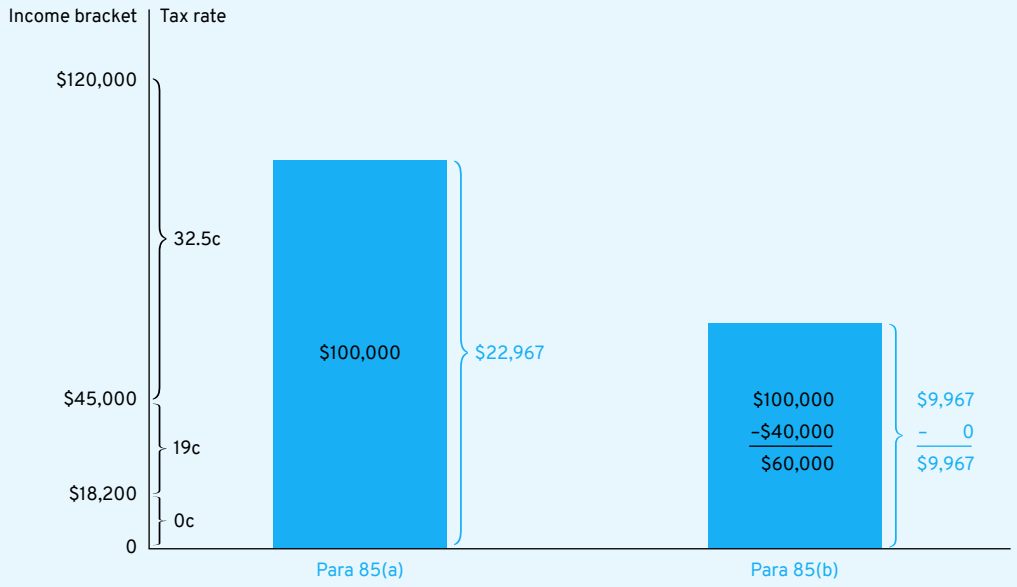
As this is greater than 25%, but less than 30%, this produces an RAF 2 score of 4 per Table 1.

Stage 3 tax cuts, company tax rate

The stage 3 tax cuts legislated to come into effect from 1 July 2024 would obviously have a downward impact on the effective tax rate percentage. It would be appropriate for the Commissioner to adjust the RAF 2 percentage bands in due course to reflect that.

Further, PCG 2021/4 uses a 26% company tax rate in the applicable case studies for firm profits appointed to a

Diagram 2. Illustration of example 2 tax amounts



corporate beneficiary — implying that that rate contributed to determining the percentage bands. However, the vast majority of private companies are subject to a 25% rate. Nonetheless, the calculations for the para 85(a) and para 85(b) tax amounts for corporate beneficiaries simply apply the company tax rate to appointed income. No account is taken of any top-up tax liability or franking credit refund that might arise in a future year.

RAF 3: appropriate remuneration

The third RAF is discussed in paras 100 to 105 of PCG 2021/4. It is the remuneration returned in the hands of the IPP as a percentage of a commercial benchmark for the services that the IPP provides to the firm. Its purpose is to gauge the extent to which an IPP receives an appropriate return for the services they provide to the firm. The higher the resulting percentage, the lower the score bracket.

All components of the IPP's remuneration are included, such as cash, superannuation, fringe benefits and any other non-cash benefits, in addition to the IPP's allocated profit entitlement. A number of factors are canvassed when establishing an appropriate benchmark, and it should be reviewed annually.

In recognition that it can be difficult to establish an appropriate benchmark, using RAF 3 is optional. That is why the scoring table in para 78 of PCG 2021/4 (Table 2 above) has two sets of scoring results — when using the aggregate score for RAF 1 and RAF 2 only, and when using all three (provided support is documented for the RAF 3 benchmark).

It is worth repeating at this point that the purpose of PCG 2021/4 is to risk assess IPPs in relation to possible alienation of income that reflects their contribution of personal effort or skills. It is therefore bewildering that an IPP returning firm income of around 100% of the benchmark is regarded as moderate risk, producing an RAF 3 score of 3 or 4. One would think it wholly reasonable for the scoring brackets to be set such that this were regarded as low risk, with a 1 to 2 score.

ATO's compliance approach

Paragraphs 106 to 111 of PCG 2021/4 set out the Commissioner's approach when applying the above risk assessment framework and evidencing taxpayers' self-assessment. IPPs who have self-assessed as falling into the green zone (presumably on an ongoing year-by-year basis) will be subject to further scrutiny in only exceptional circumstances. Otherwise, where selected for review under PCG 2021/4, they will generally only be required to confirm that they satisfy the qualifying criteria to apply PCG 2021/4, and confirm the calculations putting them in the green zone.

Where an IPP falls into the amber zone (presumably for any year), the ATO is likely to conduct further analysis. Where an IPP falls into the red zone (again, presumably for any year), the ATO firmly states that it will conduct further analysis. However, that merely may proceed to audit. IPPs must document support for their self-assessment of profit allocation and resulting zone outcome each year. If an IPP considers that the risk rating outcome does not reflect their underlying risk, the ATO encourages engaging with them.

Interestingly, the ATO comments (in para 107 of PCG 2021/4) on arrangements that "drift" over time to the outer limit of the green zone "without commercial drivers". Despite the IPP's arrangements remaining low risk, the ATO might still engage to determine the rationale for the change.

Pragmatic approach

Having considered all three RAFs and the ATO's compliance approach, we can now bring everything together into a process for helping clients. PCG 2021/4 is a reality, and so we must deal with it. No one likes the thought of being subjected to a review by the ATO, even where one considers that their affairs contain no inappropriate tax outcomes.

In view of this, one approach clients can take is to address this pragmatic question: how much additional tax are you prepared to pay to put yourself in the green zone?

Being in the green zone gives peace of mind that the ATO is unlikely to conduct any further scrutiny. However, that may well come at a cost. In order for a client to make profit allocation decisions, we need to quantify that cost. The case study below illustrates a process for doing that for a client.

Case study: risk assessment framework

This case study illustrates a process for assessing a client's risk assessment score and, if they fall into the amber or red zones, quantifying the cost of moving to the green zone. For the purposes of the case study, it is assumed that the qualifying criteria for applying PCG 2021/4 discussed in part 1 of this article are satisfied.

Superstruct Consulting Engineers operates through a unit trust. It has five equal equity holders as set out in Diagram 3, and 40 professional staff. It is currently June 2023, and you are assisting your client, Mary Sharp, with year-end tax planning. Mary is a director of the trustee company, and works full-time in the business, along with her four fellow directors. Her family trust owns 20% of Superstruct Unit Trust, and holds an interest in a service trust.

Based on the interim financial statements for the business to 31 May 2023, the predicted outcomes for the 2022–23 income year are as follows:

- Superstruct Unit Trust's taxable income/profit: $2,000,000;
  - Sharp Family Trust's 20% share: $400,000;
- Sharp Family Trust also has a profit entitlement of $10,000 from the service trust;
- superannuation paid by Superstruct Unit Trust on Mary's behalf: $27,500;
- grossed-up taxable value of fringe benefits provided directly to Mary: $5,000; and
- Mary's salary: $6,000.

In addition, Mary earns $40,000 per year from several non-executive board positions, and typically incurs about $5,000 of work-related deductions each year. Mary's husband John is a full-time homemaker, and for whom they paid $27,500 of concessional superannuation contributions, funded from their share of the business's profit. Mary and John have four children as follows:

- Alex is 22 years old and in his second year as a teacher, earning a salary of $50,000;
- Charlotte is 19 years old and a university student, earning $10,000 from a casual job; and
- twins Chloe and Kiera are 15 years old and in school.

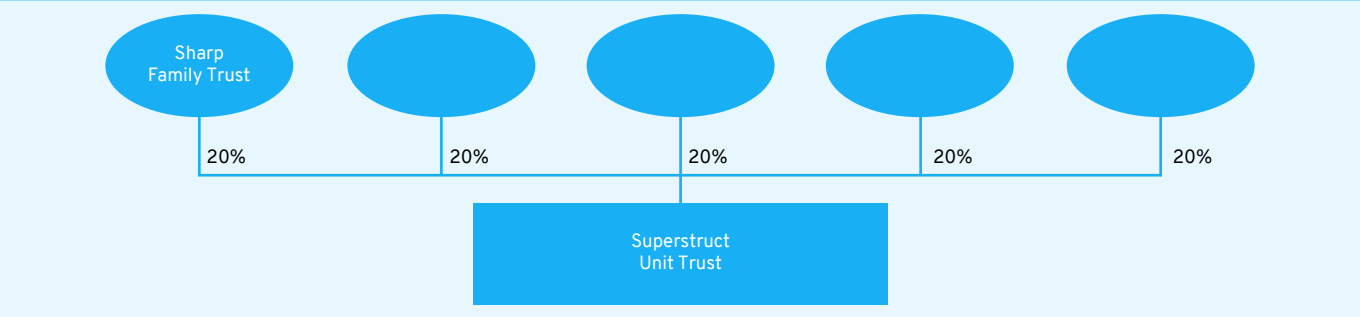
Optimum profit allocation

First, we determine the optimum appointment of the Sharp Family Trust's predicted 2022–23 net income of about $410,000. This is the trust's net income entitlement on its units in Superstruct Unit Trust and service trust per above. This is set out in Table 3.

Table 3. Optimum profit allocation

Beneficiary	$	Reason
Mary	200,000	Matches funds drawn for private consumption and John's superannuation contribution
John	75,000	
Alex	Nil	Already into 32.5c bracket on his own income
Charlotte	35,000	Make use of the remainder of the 19c bracket
Chloe and Kiera	832	Tax-free limit for minors ($416 each)
Corporate beneficiary	100,000	Remainder
Total	**410,832**[10]	

Diagram 3. Superstruct Consulting Engineers



The income appointed to Mary and John is "optimum" in the sense that, by matching the amount of funds drawn, certain integrity and anti-avoidance rules do not come into play.[11] The last piece of information is a commercial benchmark value for Mary's services to the firm, which is determined to be $250,000.

Table 4 sets out all of the relevant information drawn from the above for calculating the three RAFs.[12] The currently legislated income tax rates for the 2022–23 income year are used to calculate the various tax amounts. Table 5 summarises the components of each RAF calculation.

Mary's para 85(a) and para 85(b) tax amounts for RAF 2 are calculated by applying the 2022–23 income tax rates to the net total of her profit allocation, firm salary and related deductions (but not superannuation). This reflects example 5 in para 94 of PCG 2021/4. Her tax amounts are then completed by applying a 15% tax rate to her superannuation contribution, and the FBT actually paid (in this case, 47%) on the fringe benefits provided as part of her remuneration.

It can be seen that, if Sharp Family Trust's 2022–23 net income were appointed as per Table 3, Table 4 shows that Mary would be in the amber zone on both aggregate score options. This means that the ATO will likely analyse Mary's tax arrangements. Note that her RAF 1 + RAF 2 score is 8, and thus requires only a one-point reduction in either RAF to move into the green zone.

The choice as to appointment of Sharp Family Trust's 2022–23 income among beneficiaries is the lone variable, as everything else is essentially fixed. Accordingly, the next step is to alter the possible appointment choices in ways that will move at least one of the aggregate scores into the green zone.

Get to green: option 1

We can start by focusing on RAF 1, in which the profit allocation per Table 3 will give Mary a score of 4. Appointing a greater share of income to Mary such that she exceeds 60% of the whole-of-firm amounts collectively entitled will nudge the score down to 3. Table 6 sets out this alternative appointment choice.

The only change compared to the optimum profit allocation in Table 4 is that an additional $34,000 is appointed to Mary (ie $200,000 increased to $234,000), with a corresponding reduction in income appointed to the corporate beneficiary ($100,000 decreased to $66,000). Mary's RAF 1 score is reduced from 4 to 3, and the RAF 3 score also falls by one, putting her in the green zone on both aggregate score options. As we are working with estimated outcomes for the income year, it may be prudent to shift a little more income, to allow some buffer for landing in the green zone.

As covered before, the first step when calculating each person/entity's para 85(b) tax amount is calculating the tax on the entirety of the taxable income for the year. This is shown in column D in Tables 4, 6 and 7. This conveniently reveals the change in the year's overall tax impost on changing the profit allocation.[13]

From column D in Table 6, it can be seen that this option to move Mary into the green zone will cost about an extra $7,500 in tax (including Medicare levy). This simply reflects the 22c gap between the company tax rate of 25% and Mary's marginal rate (including Medicare levy) of 47% on that $34,000 of profit shifted to her. That is, 22c × $34,000 = $7,480 per column D in Table 6.

Get to green: option 2

An alternative is to focus on reducing the RAF 2 score by one, which would also move Mary into the green zone. This requires increasing the total effective tax rate to 30% or more. Table 7 sets out one way of achieving this.

Again comparing to the optimum profit allocation in Table 4, an additional $75,000 is appointed to John (ie $75,000 increased to $150,000), with a corresponding reduction in income appointed to the corporate beneficiary ($100,000 decreased to $25,000). This causes the effective tax rate to increase beyond 30%. Mary's RAF 2 score is thus reduced from 4 to 3, putting her in the green zone on the RAF 1 + RAF 2 aggregate score. The aggregate score based on all three RAFs remains in amber, but that is okay, as we need to move only one aggregate score option to green.

From column D in Table 7, it can be seen that this alternative to move Mary into the green zone will cost about an extra $7,200 in tax (including Medicare levy). Similar to option 1, this reflects the $75,000 shifted away from the corporate beneficiary to John, and taxed at his marginal rates, which are higher than the 25% company tax rate.

Information to answer the question

Now we have the required information to present to Mary and John that will enable them to make an informed decision by 30 June as to the appointment of Sharp Family Trust's 2022–23 net income. Their situation can be summarised as follows:

- the optimum scenario will place Mary in the amber zone. This means that, if selected for review, the ATO would likely conduct further analysis into Mary and John's tax arrangements. This will invariably cost time and money; and
- for an additional tax cost of around $7,500, Mary can instead be in the green zone. If selected for a review, all that would likely be required is to show that Mary satisfies the qualifying criteria to rely on PCG 2021/4, and that the Table 6 or 7 (whichever is chosen) calculations are in accordance with PCG 2021/4. Circumstances will differ from year to year, but undertaking this exercise each June will quantify the approximate cost each year.

Mary and John now have the information they need to make an informed choice. They might take the view that the additional tax cost each year is worth the peace of mind that, should the ATO conduct a review, it will most likely be the minimal exercise set out above, and with no further investigation.

Table 4. Optimum profit allocation

IPP and associated entities	A	B	C	Para 85(a) tax amount	D	E	Para 85(b) tax amount		Aggregate score and risk zone
	Firm-related amounts	Net other income/ deduction from non-firm sources	Total taxable income/ remuneration (A+B)	Tax on firm-related amounts only (ie A)	Tax on total taxable income/ remuneration (ie C)	Tax on B, if were only income for year	D minus E	Total effective tax (larger of para 85(a) and para 85(b))	
IPP – Mary's:									
Profit share	200,000								
Salary	6,000								
Related deductions (except concessional superannuation contributions)	(5,000)								
Total overall entitlement	201,000	40,000	241,000	61,117	79,117	4,142			$ 233,500 / 444,332 = 52.55% — Total net firm income and remuneration / Total whole-of-firm amounts collectively entitled
Concessional superannuation contributions	27,500	N/A	27,500	4,125	4,125	N/A			
Fringe benefits (grossed up taxable value)	5,000	N/A	5,000	2,350	2,350	N/A			
Total net firm income and remuneration	233,500			67,592	85,592	4,142	81,450	81,450	4 *RAF 1*
Associated entities									
John	75,000	(27,500)	47,500	14,842	5,905	–	5,905	14,842	
Alex	–	50,000	50,000	–	6,717	6,717	–	–	
Charlotte	35,000	10,000	45,000	3,192	5,092	–	5,092	5,092	
Chloe and Kiera (no tax)	832	N/A	832	–	–	–	–	–	
Corporate beneficiary (25% rate)	100,000	–	100,000	25,000	25,000	–	25,000	25,000	
Total whole-of-firm amounts collectively entitled	444,332				121,831			126,384	
						Total effective tax rate:		28.44%	4 *RAF 2*
						Commercial benchmark for IPP services:		250,000	8 **Aggregate score (RAF 1 and RAF 2)**
						Percentage:		93.40%	4 *RAF 3*
									12 **Aggregate score (all three RAFs)**

Legend

- Share of firm profit
- IPP's other firm-related amounts
- Non-firm-related amounts
- Benchmark remuneration

Table 5. RAF calculations

RAF	Calculation		How amount determined	
RAF 1	Numerator	$233,500	IPP's:	$
			Profit allocation	200,000
			Salary	6,000
			Related deductions	(5,000)
			Superannuation	27,500
			Fringe benefits	5,000
			Total	233,500
	Denominator	$444,332		$
			Total firm profit share[10]	410,832
			IPP's:	
			Salary	6,000
			Related deductions	(5,000)
			Superannuation	27,500
			Fringe benefits	5,000
			Whole-of-firm amount	444,332
	Result	52.55%	Score: 4	
RAF 2	Numerator	$126,384	Total of the larger of each person/entity's respective para 85(a) or para 85(b) tax amount.	
	Denominator	$444,332	Same as RAF 1 denominator	
	Result	28.44%	Score: 4	
RAF 3	Numerator	$233,500	Same as RAF 1 numerator	
	Denominator	$250,000	Commercial benchmark for IPP services	
	Result	93.4%	Score: 4	

Alternatively, they might prefer to go with the optimum scenario and keep that approximate $7,500 in their pocket. It's difficult to predict the chances of being reviewed, but, if that were to happen, they may well be happy to argue the case that there is no cause for Pt IVA to apply to their arrangements (with the understanding that there can be no guarantee that the ATO would ultimately accept that and close the review). The cost of that exercise might amount to a few years' worth of tax savings (and some of their time), but that might well still leave them better off overall in the medium-to-longer term. This comparison exercise can be undertaken each June to at least ensure that they remain in the amber zone and do not venture into the red zone.

Only Mary and John can make the choice between the optimum profit allocation and the alternative options, placing Mary in either the amber or green zones, respectively. Once they have made their decision, they can then resolve the appointment of the trust's 2022–23 net income accordingly. However, the key is that providing the estimated difference in tax cost is essential to making that choice on an informed basis.

Permanent versus timing tax cost

The additional estimated tax cost for Mary and John to move to the green zone is not necessarily a permanent cost, and might in fact be merely a timing difference. This will be determined by the timing of extracting the $100,000 of trust income appointed to the corporate beneficiary in the optimum scenario, and Mary and John's wider circumstances.

Imagine Mary intended to retire within a couple of years, and that the $100,000 appointed to the corporate beneficiary in the optimum scenario would be extracted after Mary and John transitioned to lower incomes. There may well be no top-up tax on the dividends, thus capping the tax impost on the income appointed to the corporate beneficiary to 25%. In this case, the additional tax cost to move to the green zone is a permanent cost.

On the other hand, imagine Mary's retirement is still a number of years away, and the income appointed to the corporate beneficiary will be extracted over the next few years while Mary and John are still on higher incomes. In this case, at least some top-up tax will likely be payable. To that extent, it is merely a timing difference, bringing that tax impost forward to the 2022–23 income year through appointing additional trust income to Mary or John (and commensurately less to the corporate beneficiary).

In summary, the additional tax impost arising from moving to the green zone will be either a permanent cost or a full or partial timing difference. Each client's individual circumstances and future intentions will determine which one it is for them. That is a crucial part of the conversation in leading to a client making an informed decision.

Table 6. Get to green: option 1

IPP and associated entities	Para 85(a) tax amount					Para 85(b) tax amount			Aggregate score and risk zone
	A	B	C		D	E			
	Firm-related amounts	Net other income/ deduction from non-firm sources	Total taxable income/ remuneration (A+B)	Tax on firm-related amounts only (ie A)	Tax on total taxable income/ remuneration (ie C)	Tax on B, if were only income for year	D minus E	Total effective tax (larger of para 85(a) and para 85(b))	
IPP – Mary's:									
Profit share	234,000								
Salary	6,000								
Related deductions (except concessional superannuation contributions)	(5,000)								
Total overall entitlement	235,000	40,000	275,000	76,417	94,417	4,142			$ 267,500 / 444,332 = 60.20% Total net firm income and remuneration / Total whole-of-firm amounts collectively entitled
Concessional superannuation contributions	27,500	N/A	27,500	4,125	4,125	N/A			
Fringe benefits (grossed up taxable value)	5,000	N/A	5,000	2,350	2,350	N/A			
Total net firm income and remuneration	267,500			82,892	100,892	4,142	96,750	96,750	3 *RAF 1*
Associated entities									
John	75,000	(27,500)	47,500	14,842	5,905	–	5,905	14,842	
Alex	–	50,000	50,000	–	6,717	6,717	–	–	
Charlotte	35,000	10,000	45,000	3,192	5,092	–	5,092	5,092	
Chloe and Kiera (no tax)	832	N/A	832	–	–	–	–	–	
Corporate beneficiary (25% rate)	66,000	–	66,000	16,500	16,500	–	16,500	16,500	
Total whole-of-firm amounts collectively entitled	444,332				128,631			133,184	
			Total tax in optimum scenario (Table 5):		121,831	Total effective tax rate:		29.97%	4 *RAF 2*
				Additional tax:	6,800				7 **Aggregate score (RAF 1 and RAF 2)**
				Medicare levy	680	Commercial benchmark for IPP services:		250,000	
				Total additional tax cost:	***7,480***	Percentage:		107.00%	3 *RAF 3*
									10 **Aggregate score (all three RAFs)**

Legend

- Share of firm profit
- IPP's other firm-related amounts
- Non-firm-related amounts
- Benchmark remuneration

Table 7. Get to green: option 2

IPP and associated entities	Para 85(a) tax amount				Para 85(b) tax amount				Aggregate score and risk zone
	A	B	C		D	E			
	Firm-related amounts	Net other income/ deduction from non-firm sources	Total taxable income/ remuneration (A+B)	Tax on firm-related amounts only (ie A)	Tax on total taxable income/ remuneration (ie C)	Tax on B, if were only income for year	D minus E	Total effective tax (larger of para 85(a) and para 85(b))	
IPP – Mary's:									
Profit share	200,000								
Salary	6,000								
Related deductions (except concessional superannuation contributions)	(5,000)								
Total overall entitlement	201,000	40,000	241,000	61,117	79,117	4,142			$ 233,500 / 444,332 = 52.55% Total net firm income and remuneration / Total whole-of-firm amounts collectively entitled
Concessional superannuation contributions	27,500	N/A	27,500	4,125	4,125	N/A			
Fringe benefits (grossed up taxable value)	5,000	N/A	5,000	2,350	2,350	N/A			
Total net firm income and remuneration	233,500			67,592	85,592	4,142	81,450	81,450	4 *RAF 1*
Associated entities									
John	150,000	(27,500)	122,500	40,567	30,392	–	30,392	40,567	
Alex	–	50,000	50,000	–	6,717	6,717	–	–	
Charlotte	35,000	10,000	45,000	3,192	5,092	–	5,092	5,092	
Chloe and Kiera (no tax)	832	N/A	832	–	–	–	–	–	
Corporate beneficiary (25% rate)	25,000	–	25,000	6,250	6,250	–	6,250	6,250	
Total whole-of-firm amounts collectively entitled	444,332				127,568			133,359	
			Total tax in optimum scenario (Table 5):		121,831	Total effective tax rate:		30.01%	3 *RAF 2*
				Additional tax:	5,738				7 **Aggregate score (RAF 1 and RAF 2)**
				Medicare levy	1,500	Commercial benchmark for IPP services:		250,000	
				Total additional tax cost:	***7,238***	Percentage:		93.40%	4 *RAF 3*
									11 **Aggregate score (all three RAFs)**

Legend

- Share of firm profit
- IPP's other firm-related amounts
- Non-firm-related amounts
- Benchmark remuneration

If client chooses to go to green, which option?

If Mary and John were to choose to move Mary into the green zone, which of the two options to get there would be preferred? Although the additional tax cost under each one is about the same, the key difference is the amount of appointed income shifted away from the corporate beneficiary to Mary/John. Under option 1 (Table 6), $34,000 is shifted (to Mary), whereas under option 2 (Table 7), $75,000 is shifted (to John). Being spouses, it doesn't matter to whom the income is shifted insofar as relates to accessing it. The reason is that, once extracted from the trust, it essentially forms part of intermingled marital funds.

Based on the above, option 2 in Table 7 would be preferred. Although the additional tax cost is about the same, Mary and John (via John) will have an additional $41,000 (ie $75,000 compared to $34,000) in present entitlement owing to them. The overall additional $75,000 entitlement owing to John will have no further tax impost on extraction from the trust to Mary and John. This is reflected in the trust's entitlement owing to the corporate beneficiary being $75,000 less (ie $25,000 instead of $100,000) compared to the optimum scenario. That is, that $75,000 will not need to be extracted through the corporate beneficiary, and thus top-up tax is not an issue.

Annual service offering

The above exercise can be repeated each year in June, ahead of the client making their trust income appointment decision.

Transitional arrangements

In 2015, the Commissioner issued guidelines on the allocation of professional firm profits, but these were suspended in 2017. PCG 2021/4 is a much more detailed set of guidance, and addresses a number of gaps in the suspended guidelines. Paragraphs 112 to 119 of PCG 2021/4 set out the transitional arrangements.

Under para 113 of PCG 2021/4, IPPs with pre-existing arrangements can continue to rely on the suspended guidelines until 30 June 2022, provided their arrangement:

- complies with the suspended guidelines;
- is commercially driven; and
- does not exhibit any of the high-risk features outlined in para 47 of PCG 2021/4.

Under para 114 of PCG 2021/4, a further concession is granted in recognition that some IPPs' arrangements are low risk under the suspended guidelines, but those same arrangements might have a higher risk rating under PCG 2021/4. IPPs in that situation are permitted to continue applying the suspended guidelines to their arrangements until 30 June 2024.

IPPs must satisfy the para 113 transitional rule in order to apply the further transitional rule in para 114. In other words, if an IPP fails to qualify to apply the para 113 transitional rule, they cannot apply the additional para 114 transitional rule.

For new equity-holding IPPs, from 1 July 2022, the suspended guidelines have no application.

Engaging with the ATO

The ATO has a dedicated team responsible for the oversight and management of profit allocation arrangement risks, and encourages engagement with the ATO through a dedicated email address.[14]

Conclusion

The Commissioner's framework for allocating compliance resources to conduct vaguely worded reviews on matters for which there is no authoritative benchmark metric against which to conduct such reviews has been challenging to absorb and process. Establishing some judicial guidance on the extent to which, if any, income derived through a business structure can be regarded as attributable to an individual's personal services would be a welcome improvement in taxpayer certainty.

If the Commissioner's intent behind PCG 2021/4 includes identifying a suitable test case in circumstances where an IPP qualifies to rely on it, it would be helpful to be open about that. In the meantime, we can offer a structured process to clients that will give them clarity on where they stand, and enable them to make informed decisions.

David Montani, CTA
National Tax Director
Nexia Australia

References

1 PCG 2021/4, para 67.

2 PCG 2021/4, para 76.

3 PCG 2021/4, para 85.

4 PCG 2021/4, paras 74 and 75.

5 Does not include any levy based on taxable income, such as Medicare levy and Medicare levy surcharge (PCG 2021/4, p 14, fn 6). Also, from 1 July 2022, the low and middle income tax offset will cease, and so does not feature in the calculation of total effective tax rate.

6 PCG 2021/4, para 81.

7 PCG 2021/4, paras 95 and 96. The guideline does not mention Div 293 of the *Income Tax Assessment Act 1997* (Cth) tax, being the additional 15% where a person's adjusted income for the year exceeds $250,000. None of the examples or case studies feature superannuation, and so it can be inferred that any Div 293 tax is excluded from the calculation of effective tax rate.

8 PCG 2021/4, para 97.

9 This could comprise deductible donations, salary from unrelated employment, work-related expenses, tax losses carried forward, negatively geared investments etc.

10 As the numbers are based on only an estimate of the profit share for the year, to show round numbers for everyone else, the $832 for Chloe and Kiera is simply added to the $410,000.

11 If the income appointed fell short of their drawn funds, a debit loan to Mary and John would arise in Sharp Family Trust, certainly invoking the need for Div 7A compliance, and possibly the attention of s 100A ITAA36.

12 Alex does not need to be there, as no firm profit is allocated to him. However, it can be seen that he has no impact on the RAF outcomes in any case. Including him may simply be convenient for when considering alternative profit allocation options.

13 Changing the profit allocation will not alter the set tax amount on superannuation and fringe benefits. Therefore, the marginal change in the total of column D in Tables 4, 6 and 7 properly reflects the change in overall tax impost.

14 PCG 2021/4, para 121.

Trust disclaimers: FCT v Carter

by Philip Bender, ATI, Barrister, Victorian Bar

Disclaimers of rights under a trust by a beneficiary have previously been seen as a possible mechanism for retrospectively avoiding a present entitlement and an income tax liability in respect of trust income under the provisions for trust taxation. The High Court has now swept away that possibility in its recent decision in *FCT v Carter*. Now, any disclaimer made after the end of the income year will not be effective to remove a beneficiary's present entitlement and tax liability in respect of trust income under s 97 of the *Income Tax Assessment Act 1936*. This article explores the High Court's reasoning and the reasoning of the decision-makers in the Administrative Appeals Tribunal and the Full Federal Court.

Introduction

The High Court has recently, in *FCT v Carter*,[1] made an important decision regarding the tax effect of a disclaimer of trust income by a beneficiary of a trust. The High Court decided that a disclaimer of trust income after the end of an income year cannot retrospectively affect a beneficiary's present entitlement to trust income and their tax liability under the trust taxation provisions in s 97 of the *Income Tax Assessment Act 1936* (Cth) (ITAA36). This article will examine the decisions of the Administrative Appeals Tribunal,[2] the Full Federal Court[3] and the High Court in *Carter's* case and the implications of the High Court's decision.

Background facts

Carter's case involved a patriarch of a family and his four daughters and minor son, who were the taxpayers. The matter concerned a family discretionary trust (the family trust) whose beneficiaries included the patriarch and his children. The trust deed named the patriarch and one daughter as joint guardians of the family trust.

The trust deed contained a discretionary power to distribute or accumulate income each financial year. There was a clause that provided for default distributions of income to go to the children if the trustee did not exercise its discretion to distribute or accumulate income in any particular year. Certain powers under the trust deed could not be exercised without consent of the guardian, including the power to distribute income in favour of particular entities.

There was also a company, MNWA, of which the patriarch was a director. The trustee of the family trust (the trustee) entered into an option agreement to purchase some land (the land) in 2005. The trustee executed a deed in 2007 indicating it would acquire the land and hold it for the benefit of MNWA (the MNWA deed). The financial records of MNWA, however, disclosed that MNWA loaned funds to the trustee but did not record that MNWA held the land as an asset.

There were purported minutes of meetings of the trustee for the 30 June 2011 to 2014 years that purported to record resolutions to distribute income from the family trust in favour of particular entities (who were not the children). There was no evidence that all of the joint guardians had consented to these distributions.

After an audit, the Commissioner of Taxation concluded that there were no beneficiaries presently entitled to the family trust's income for the 2011 to 2014 years under s 97 ITAA36. As a consequence, the default income distribution clause applied to treat the children of the patriarch as default beneficiaries of the income. They were, therefore, presently entitled to the trust income for those years and would be taxable on their share of the trust's net (taxable) income, save for some disclaimers that they executed after the audit had commenced. The Commissioner accepted that there were valid disclaimers in place for the 2011 to 2013 years for the adult children and so withdrew assessments that he had initially issued to them for those years. The trustee was then assessed under s 99A ITAA36 on the basis that no one was presently entitled to the relevant income of the family trust for the 2011 to 2013 years. Alternative assessments were issued to MNWA on the basis that it might be the beneficial owner of the land (and income) if a valid trust arose over the land under the MNWA deed.

The Commissioner assessed the children as default beneficiaries for the 2014 financial year. In that year (as opposed to the 2011 to 2013 years), the Commissioner did not accept that the disclaimers that had been made were effective. Although there were minutes of meetings purportedly recording income distribution resolutions for each year in favour of certain beneficiaries (not the children), the Commissioner had enquired of the controllers of those beneficiaries and there was no one who knew about those purported distributions.

Based on legal advice, a series of three types of disclaimers were executed by the children as a consequence of the audit.

First disclaimers

The operative part of the first disclaimers read as follows:

"1. I hereby disclaim absolutely and irrevocably any and all of my right title and interest to or in the income,

or any part of the income, of the Trust for each of the years ending 30 June 2011 to 30 June 2013.

2. Without limiting the generality of the disclaimer in paragraph 1, I disclaim any entitlement to any income which might otherwise have accrued under clause 3.7 of the Trust Deed."

Second disclaimers

The operative part of the second disclaimers read as follows:

"1. I hereby disclaim absolutely and irrevocably any and all of my right title and interest to or in the income, or any part of the income, of the Trust tor the year ending 30 June 2014.

2. Without limiting the generality of the disclaimer in paragraph 1, I disclaim any entitlement to any income which might otherwise have accrued under clause 3.7 of the Trust Deed.

3. My disclaimer is intended to take effect on and from 30 June 2013."

Third disclaimers

In 2016, after objection decisions had been made by the Commissioner, the children executed the third disclaimers. These were in much wider terms than the first and second disclaimers and disclaimed all right title and interest under the family trust, any income for earlier years, and all right title and interest conferred by the default distribution clause.

Administrative Appeals Tribunal Decision

The trustee and children sought a review of the Commissioner's assessments in the Administrative Appeals Tribunal (the tribunal).[2] The taxpayers asserted that:

1. the land was beneficially owned for MNWA, such that MNWA was entitled to the trust income and it should be assessed on it (or the trustee should be so assessed on the basis that its income was subject to an equitable charge over the land in favour of MNWA until the debt owing to MNWA was repaid);

2. alternatively, distributions of trust income for the 2011 to 2014 years were made to the beneficiaries named in the purported minutes of meetings, such that the default beneficiaries could not be assessed as they were not entitled to the trust income;

3. alternatively, if the children were entitled to the trust income, the disclaimers were effective; and

4. as the Commissioner had accepted that the disclaimers for the 2011 to 2013 years were effective, he was obliged to accept the disclaimers for the 2014 year as effective.

MNWA deed

The tribunal did not accept that the land was beneficially owned for MNWA because, other than the MNWA deed, there was no evidence of the trustee holding the land on trust for MNWA. The patriarch of the family had given evidence that the income of the family trust was distributed pursuant to its trust deed, and the financial records showed that MNWA was not the owner of the land. The tribunal also did not accept that, as a creditor of the family trust, MNWA was entitled to all of the cash from the land, such that the children could not be entitled to the income of the family trust.

2011 to 2013 year distributions and disclaimers

The tribunal did not accept that the purported resolutions to distribute income for the 2011 to 2013 years were effective for the following reasons:

1. there was insufficient evidence that the procedures in the constitution of the trustee had been followed when holding the meetings and making the resolutions;

2. the tribunal was not satisfied that the meetings for which minutes existed at which the resolutions had been purportedly made actually took place. There were inconsistencies in the evidence about the purported meetings and a lack of evidence from some of the directors of the trustee; and

3. the trust deed required the guardians to consent to any distribution of income, but there was no evidence of such consent. The taxpayers contended that the daughter of the family patriarch was not a guardian because she never knew about and accepted the office of guardian. Accordingly, as the patriarch was the sole guardian, he could be taken to have consented to the distributions. The tribunal did not accept these assertions. There was a requirement for the joint guardians to consent and they had not done so. That meant the purported distributions were void.

As the purported distributions were void and the Commissioner had accepted that the disclaimers for the 2011 to 2013 years were effective, that meant the trustee was properly assessed on the trust's net income under s 99A. The Commissioner's position was that he had mistakenly decided that the disclaimers for the 2011 to 2013 years were effective. That mistaken opinion did not otherwise affect the result of the review before the tribunal, including the Commissioner's argument that the 2014 year disclaimers were not effective.

Effectiveness of disclaimers for the 2014 year

For the 2014 year, the tribunal also found that the purported distribution of income was void for the reasons already given. The key remaining issue was whether either the second disclaimers or the third disclaimers were effective such that the children would not be presently entitled to the trust income for the 2014 year and so could not be assessed for that year.

The tribunal found that:

1. under the terms of the second disclaimers, the children failed to disclaim all of their entitlements under the

default beneficiary clause (only their entitlements to annual income were disclaimed);

2. the third disclaimers were probably wide enough on their terms to have been effective, but they were not effective because:

   a. there had already been implicit acceptance of the gift of income under the default beneficiary clause by a failure to disclaim the gift in its entirety under the second disclaimers. Once there was such acceptance of the gift, there could not be a later effective disclaimer; and

   b. there had been a delay from the time the children became aware of their entitlement to trust income that prevented the third disclaimers operating effectively.

As there had not been disclaimers of all of the interests of the children under the default beneficiary clause, there had not been effective disclaimers. Those children were still presently entitled to the trust income for the 2014 year as default beneficiaries and were liable to be taxed on their share of the family trust's net income under s 97 ITAA36.

Full Federal Court Appeal

Some of the taxpayers successfully appealed part of the tribunal's decision to the Full Federal Court.[3] Only the 2014 assessments were challenged on appeal, but not the assessments for the other years. The appeal dealt with three key issues:

1. the taxpayers argued that 100% of the trust income had been appointed to another trust for the 2014 year, so the default beneficiary clause had no operation. This meant that the individual taxpayers could not be presently entitled to any of the trust income and so could not be assessed on the trust's net income;

2. alternatively, the taxpayers argued that, if the default beneficiary clause did operate (ie if the taxpayers were presently entitled to trust income for the 2014 year), the second and third disclaimers were effective; and

3. finally, the Commissioner asserted that, if the second and third disclaimers were effective, they could not operate retrospectively for tax purposes. That is, the Commissioner argued that any disclaimer could not affect the operation of s 97(1) ITAA36. Once s 97(1) had included a share of the trust's net income in a beneficiary's assessable income based on a present entitlement to trust income, it was not possible to change the operation of the legislation.

First appeal issue: appointment of trust income to another trust

The taxpayers argued that there were errors in the tribunal's conclusion that income had not been appointed to another trust based on:

1. a lack of satisfaction that the purported meeting whereby there was a resolution to appoint 100% of the trust income for 2014 to another trust had actually taken place; and

2. even if the meeting to pass the resolution had occurred, it was not valid because the trust deed required the consent of the guardian and there had been no such consent of the two jointly appointed guardians.

The taxpayers attacked the tribunal's findings about the purported meeting taking place on the following grounds:

1. there was a lack of procedural fairness because the patriarch of the family had not been cross-examined about the alleged meeting in 2014; and[4]

2. the tribunal failed to apply s 1305 of the *Corporations Act 2001* (Cth) which provides that a book kept by a company under that Act is prima facie evidence of any matter stated or recorded in the book. The taxpayers argued that the tribunal had failed to treat the minutes as prima facie evidence of the matters recorded in the document.

> "A disclaimer of trust income after the end of an income year cannot retrospectively affect a beneficiary's present entitlement."

The Full Court rejected both of these arguments as follows:

1. there was no lack of procedural fairness because it was clear from the Commissioner's statement of facts, issues and contentions filed in the tribunal that the Commissioner did not accept that the meeting in 2014 occurred or that the resolution in 2014 had been made; and

2. the Full Court doubted whether the tribunal was bound to apply s 1305, particularly because the section had not been directly raised as an issue. It did not matter, however, because even if the section did apply, it was only prima facie evidence and the tribunal referred to other circumstances which led it to conclude that it was not satisfied that the meeting had occurred.

The Full Court also found that, even if the meeting had taken place and the resolution had been made, the tribunal was correct that the resolution would have been invalid because the trustee could not make a distribution without guardian consent. The court held that the daughter was validly appointed as joint guardian with her father such that both their consent was required for a valid distribution of income.

Second appeal issue: effectiveness of disclaimers

The second issue was whether any of the disclaimers were effective in respect of the 2014 year. The Full Court

accepted that the third disclaimers were wide enough, if they were effective, to disclaim the entirety of the taxpayers' interest under the default beneficiary clause.

The Full Court found that the tribunal fell into error in finding that the default gift of income to the taxpayers had been effective based purely on its finding that the third disclaimers were ineffective. In particular, just because the first and second disclaimers did not reject the entirety of the gift under the default beneficiary clause, did not necessarily mean that the gift under that clause was accepted by the children. Where there had not been an express acceptance of that gift of income under the default beneficiary clause, it was necessary to examine the circumstances to determine whether it could be inferred that there had been an acceptance of the gift by the children. The tribunal had not undertaken that exercise and had just assumed that because there had been ineffective first and second disclaimers that meant the children had accepted the gift of income.

The Full Court found that the children's evidence of their understanding that the first and second disclaimers were fully effective was inconsistent with an intention to accept the gift of income. Further, the tribunal's finding that the delay in executing the third disclaimers meant that they were not effective should not be accepted. As soon as the Commissioner rejected the second disclaimers, the taxpayers executed the third disclaimers. The Full Court found that the gift of income had not been accepted and that the third disclaimers were effective.

Third appeal issue: can a disclaimer affect a beneficiary's present entitlement under s 97(1)?

Under s 97(1), a beneficiary of a trust who is not under a legal disability can be assessed where the beneficiary is presently entitled to a share of the income of the trust estate. A beneficiary is only assessed on that share of the trust's net (taxable) income as is attributable to when the beneficiary was a resident, or to sources in Australia when they were not a resident).

The Commissioner argued on appeal that a disclaimer could not retrospectively affect a taxpayer's present entitlement under s 97(1), so even if the disclaimers were effective, the children would still be assessed as default beneficiaries.

The Full Court found that disclaimers *could* operate retrospectively to prevent the taxpayers from being assessed under s 97(1) for the following reasons:

1. "present entitlement" under s 97(1) has a general trust law meaning;
2. a beneficiary is taxed on a proportionate share of trust net income only if that beneficiary has a present entitlement pursuant to *FCT v Bamford*;[5]
3. at general law, an effective disclaimer of a present entitlement to a distribution of income results in the rejection of that entitlement;
4. the consequence of an entitlement being disclaimed is that s 97 is not engaged because that section only applies where a beneficiary is presently entitled to trust income. Disclaimer would result, at general law, in an extinguishment of an entitlement to trust income from when it arose such that there would be no present entitlement in the income year in which the beneficiary would otherwise have been taxed based on the present entitlement; and
5. there was nothing in the legislative scheme to suggest that a beneficiary's liability to taxation under s 97 was determined once and for all by reference to legal relationships in existence in the relevant income year. A disclaimer did not alter the operation of s 97, rather the tax consequences of disclaimer under s 97 were determined by reference to general law concepts of disclaimer and present entitlement.

Accordingly, the disclaimers were effective and prevented the taxpayers from being assessed under s 97(1) ITAA36 for the 2014 year. The appeal by the taxpayers was successful.

High Court Appeal

The Commissioner appealed to the High Court on a single issue: whether events after the end of an income year (ie disclaimer) can affect a beneficiary's present entitlement to trust income under s 97(1) ITAA36.[1] In other words, whether a beneficiary's disclaimer of a trust interest after an income year has ended can prevent that beneficiary from being assessed on a trust's net income where they were presently entitled to trust income in a previous income year.

The plurality

The plurality (Gageler, Gordon, Steward and Gleeson JJ) held that, once a beneficiary is presently entitled to trust income at the end of an income year, disclaimer by the beneficiary after the end of the income year cannot affect that present entitlement under s 97(1). That means the beneficiary will still be assessed on their share of the net income of the trust represented by the share of trust income to which they are presently entitled, even though they have disclaimed their interest in the trust income.

The reasoning of the plurality is not complicated:

- s 97(1) uses the phrase "*is* presently entitled to a share of the income of the trust estate". That is, the phrase is expressed in the present tense and is directed towards the beneficiaries who have a present legal right to demand and receive payment of trust income immediately before the end of the income year;
- the concept of present entitlement is based on a legal *right* to demand and receive payment of trust income, not the receipt of that income. That is also made clear by s 95A ITAA36 which ensures that a beneficiary is treated as still having a present entitlement to income even though they no longer have a right to demand and receive payment of the income because it has already been paid to them or applied for their benefit;

- the process in s 97 allows the beneficiaries who are to be assessed at the end of the income year to be identified; it then allows the net income of the trust to be determined; and then the amount of tax payable by the beneficiary can be calculated;
- s 97(1) also requires a beneficiary to be a resident and not under any legal disability. Those conditions support the view that a beneficiary's present entitlement is determined just before the end of the income year and those are conditions which cannot be altered by facts occurring after the end of the income year. In other words, whether a beneficiary is a tax resident or is under a legal disability (eg being a minor) just prior to the end of an income year is not going to be affected by later events (eg if they become an adult or leave Australia in a subsequent income year). The other trust assessment provisions (ss 98, 99 and 99A ITAA36) also operate by reference to events that exist at the end of the income year and cannot later be altered; and
- the taxpayer argued that, for a reasonable period after the end of the income year, subsequent events (eg disclaimer) could disentitle a beneficiary who had been presently entitled at the end of the income year. The plurality rejected this interpretation as it was contrary to the text of s 97(1) and the objects of the section set out above. Allowing a beneficiary's present entitlement to be affected for s 97(1) purposes in a subsequent income year would create uncertainties about who would be taxed and that would be not "fair, convenient or efficient" to the Commissioner, trustees and beneficiaries.

The plurality accepted that their construction could give rise to unfair results because a beneficiary could be unaware of a present entitlement and they could be taxed under s 97. Nonetheless, the plurality found that any unfairness was based on the drafting of s 97, ie a beneficiary is assessed based on present entitlement rather than receipt of income.

In addition, the taxpayers had put forward an argument based on a lack of assent by the beneficiaries (the children) to the gift of trust income. That is, the children argued that they did not assent to the gift so they could not be presently entitled to the trust income under s 97(1). It was argued that there was a rebuttable presumption that the beneficiaries had assented and the beneficiaries had rebutted this presumption based on the third disclaimers. The plurality rejected that argument.

The judgment of Edelman J

Edelman J, in a separate judgment, agreed with the construction of s 97(1) that the plurality had put forward. Edelman J, however, went on to make further comments about what his Honour said were errors in an assumption made by the Commissioner and the taxpayers about the nature of disclaimer in equity.

Edelman J commented that there was an incorrect assumption by the Commissioner and the taxpayers that a creation or an increase in value of equitable rights is not complete until affirmed by a beneficiary of a trust. For example, a declaration of trust would be made on the presumed assent of a beneficiary, but the creation of the rights under the trust would not be complete until there was assent by a beneficiary. Edelman J rejected this purported assumption of the Commissioner and the taxpayers. As a declaration of trust or an increase in the value of rights under a trust did not, sometimes, require a beneficiary to exist (eg a trust of a charitable purpose), it made no sense that there would be a requirement for a beneficiary to assent for there to be a valid declaration of trust if no such beneficiary existed.

Edelman J also criticised the purported assumption about the need for assent on the basis that there had been a mistaken understanding by the Commissioner and the taxpayers that a trust is the equitable equivalent of a common law gift. His Honour observed that this was incorrect, as a common law gift requires a transfer of rights, but a declaration of trust involves a creation of equitable rights and obligations, not a transfer of rights.

In summary, his Honour did not accept that there was any need for assent of a beneficiary, so the arguments of the taxpayers based on the need for assent were not valid ones.

Implications of the decision

The High Court's decision should send a frosty chill up the spine of many practitioners. It means that a beneficiary may be unaware of their present entitlement to trust income at the end of an income year, but may be powerless to prevent themself from being assessed on their share of the trust's net income, even if they disclaim after the end of the income year. Any disclaimer would have to happen prior to the end of the income year to be effective for tax purposes. This could have some particularly alarming and unfair consequences when a beneficiary was presently entitled to a particular amount of trust income, but their share of the trust's net income was much larger. In other words, a beneficiary might have a legal right to only call for an amount of trust income from the trust that was much smaller than the amount of tax which they would be liable to pay on the trust's net income.

Assume, for example, that a trust had trust income as defined in its trust deed of only $100, but net (taxable) income of $1,000,100 (due to a capital gain that the trust had made of $1m which was not part of the trust income because of the way the trust deed definition of "income" was drafted and in respect of which no beneficiary was specifically entitled). Assume that beneficiary A was presently entitled to 10% of the trust income as at 30 June 2022. Beneficiary A would therefore, under the principles in *Bamford's* case, be assessed on 10% of the trust's net (taxable) income (ie $100,010), but would have no right to call for that amount from the trust due to its present entitlement being confined to the $100 of trust income. Beneficiary A would be taxed on income that they had not received and could not receive. That is

plainly an unfair outcome and one that, given the High Court's judgment, may need to be addressed by law reform.

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References

1 [2022] HCA 10.
2 *The Trustee for the Whitby Trust and FCT* [2019] AATA 5637.
3 *Carter v FCT* [2020] FCAFC 150.
4 Based on the rule in *Browne v Dunn* (1893) 6 ER 67.
5 [2010] HCA 10.

A Matter of Trusts

by Lucy Liang, Sladen Legal

Taxation of employee remuneration trusts

This article discusses the potential tax consequences of using an employee remuneration trust as a vehicle to provide long-term incentives to the employees.

Employee remuneration trusts (ERTs) are popular for providing long-term incentives and rewards to employees. ERTs are generally used to provide remuneration structures that can meet the market for key employees, encourage and reward employees for high performance, and create a culture whereby employees share the success of the business.

An ERT arrangement involves a trust being established to facilitate the provision of payments and/or other benefits to employees of an employer. The trustees of the ERT provide the benefits to employees at the direction of the employer.[1]

The purpose of this article is to provide an overview of key employee remuneration trust tax rules that concern both employers and employees. The ATO released TR 2018/7 which sets out the Commissioner's view on how the taxation laws apply to an ERT arrangement that operates outside of the employee share scheme rules in Div 83A of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).

Are the contributions made by an employer to an ERT deductible?

TR 2018/7 provides that a contribution made by an employer to an ERT is deductible under s 8-1 ITAA97 if all of following conditions are met:[2]

- it is an irrevocable payment of cash made at a time when the employer carries on a business for the purpose of gaining or producing assessable income;
- it is made because the employer reasonably expects their business to benefit from the contribution via an improvement in employee performance, morale, efficiency or loyalty; and
- it is intended to be permanently and entirely dissipated in remunerating employees of that business within a relatively short period of the contribution being made (other than employees who are engaged in affairs of capital of the business).

The term "relatively short period" is not defined and depends on the facts and circumstances. However, the Commissioner provides guidance in TR 2018/7 and considers a period of no more than five years to be a relatively short period.[3]

It should be noted that, even if a contribution to an ERT meets all of the above conditions, it is not deductible if the contribution is applied for the benefit of the owners or shareholders of the business or is capital in nature.[4] There has to be a sufficient connection between a contribution and the benefit to the employer's business for the payment to an ERT to be deductible.[5]

The ATO has provided three relevant factors in determining whether a payment to an ERT is made for the benefit of the employer's business:[6]

- the nature and timing of the benefits to be derived by the employer and the employees;
- employee awareness of the scheme; and
- whether the scheme and the contribution address the business-related need, function or complaint.

Example 1 in TR 2018/7 provides that a contribution to an ERT made by a building company is considered to have a sufficient connection with the business. In this example, the building company employs construction managers who are essential to the effective and successful management of construction projects. The labour market is highly competitive, and the loss of construction managers is significantly detrimental to the business. Therefore, the building company sets up an ERT arrangement that delivers performance bonuses to its construction managers when they meet key performance indicators. The construction managers are fully aware of the operation of the ERT and their potential to benefit from it. The ATO views that the operation of the ERT will benefit the business by enhancing employee loyalty.

When is a contribution to an ERT a fringe benefit?

The payment made by an employer to an ERT, giving employees a contingent and deferred benefit, might have created a fringe benefits tax liability for the employer. A contribution is not a fringe benefit if it is a payment of salary or wages or if Div 7A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) applies.

When is a contribution to an ERT assessable to an employee?

TR 2018/7 notes that an employee can be taxable at the time the contribution is made to the ERT if the circumstances are such that it has the character of ordinary income, is applied or dealt with on the employee's behalf or as the employee directs, or is not excluded from the operation of s 6-5 ordinary income of the ITAA97. However, TR 2018/7 also indicates that an employee should be taxable when the payment from the ERT is ultimately received after service and/or performance conditions have been met. The examples in TR 2018/7 provide some guidance but otherwise the ruling only implies this view.

The key consideration is an employee's ability to direct the employer on what to do with the contribution made to the ERT. If an employee does not have a legal right or entitlement to enforce a direction to the employer, the contribution will not be assessable to the employee until they meet the performance criteria and become entitled to the payment from the ERT.

The question of whether an employee derives ordinary income is a complex fact exercise and much will depend on the terms of the agreements between the parties and whether an employee has the ability to direct the trustee of the ERT in respect of items of income.

Other issues that should be considered

Division 7A

Division 7A ITAA36 can apply where a private company is presently entitled to income of a trust and the trustee of the trust distributes the underlying benefit to a shareholder or an associate of the company.

If the trustee of an ERT is a shareholder of an employer company or an associate of a shareholder of the employer company, a contribution made by the employer to the ERT will be deemed to be a dividend and included in the income of the ERT.[7] "Associate" is widely defined under s 318 ITAA36. For individual shareholders, associate can include:

- a relative of the shareholder;
- a partner of the shareholder or a partnership in which the shareholder is a partner;
- a spouse or child of an individual partner;
- a trustee of a trust where the shareholder or associate benefits under the trust; and
- a company controlled by the shareholder or associate.

Reasonable care should be taken to avoid inadvertently triggering Div 7A dividends when making contributions to an ERT.

Distribution of contributions from an ERT to an associate of an employee

Some employers may consider distributing the contributions from an ERT to an employee's family trust instead of the employee personally. It should be noted that that kind of distribution is likely to generate alienation of income and Pt IVA ITAA36 concerns from the ATO. Paragraphs 92 and 93 of TR 2018/7 provide that:

> "92. Where one or more of the following factors is present in an ERT arrangement, the Commissioner will regard the arrangement as high risk and is likely to apply compliance resources to determine whether Part IVA of the ITAA 1936 should apply to a particular ERT:
>
> …
>
> - the provision of a benefit to an employee through the ERT results in the benefit being taxed in a manner that is inconsistent with it being remuneration, for example:
>   - distribution of amounts which have a different tax character, including franked dividends, discount capital gains or tax deferred distributions
>   - income splitting or alienation, which may result in amounts being assessed to persons other than the relevant employee, and
>   - the provision of a benefit in a non-taxable form (for example, through the use of uncommercial loans or finance facilities to an employee).
>
> 93. If you have entered into, or are contemplating entering into, an ERT arrangement that exhibits one or more of these features, we encourage you to engage with us early, or seek independent professional advice."

Deductibility of establishment and administration expenses for an ERT

The ATO recently published TD 2022/8 which provides guidance on determining when expenses incurred in establishing and administering an employee share scheme are deductible. The Commissioner considers that establishment and administration expenses are not deductible to the employer company under s 8-1 ITAA97 because they are capital in nature. An employee share scheme is established to deliver benefits to employees, and it adds to the business structure.

Although TD 2022/8 specifically considers the expenses incurred in establishing and administering an "employee share scheme", the establishment and administration expenses for an ERT are also unlikely to be deductible under s 8-1. However, ongoing maintenance and management fees should be deductible.

Conclusion

There has been an increasing use of employee remuneration trust arrangements as a key component of employers' remuneration and incentive arrangements for employees. The ATO previously published two draft rulings, TR 2014/D1 and TR 2017/D5, on the ERT arrangements and finalised its view in a 37-page guidance, indicating the complexity of the issues and the concerns that the ATO has with this kind of arrangement. The ATO also issued several taxpayer alerts on employee benefit arrangements. Care should be taken to check whether your employee benefit arrangement has features which are subject to a taxpayer alert.

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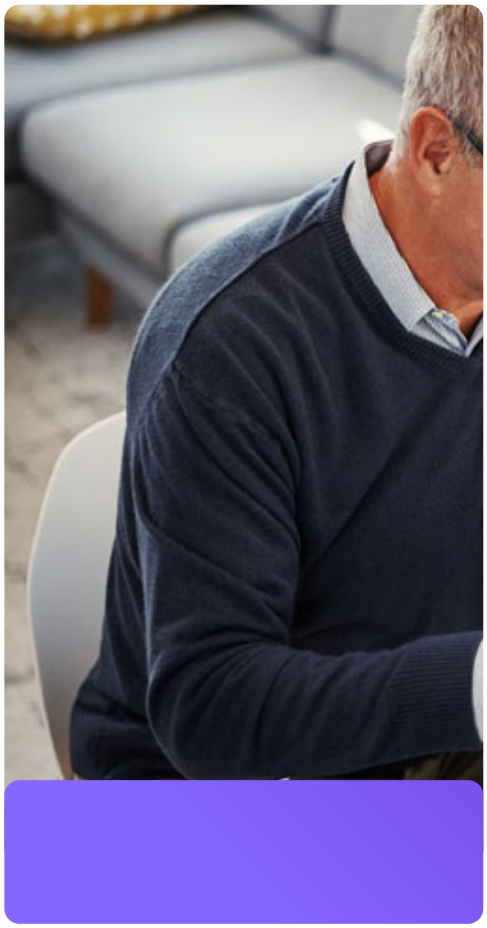
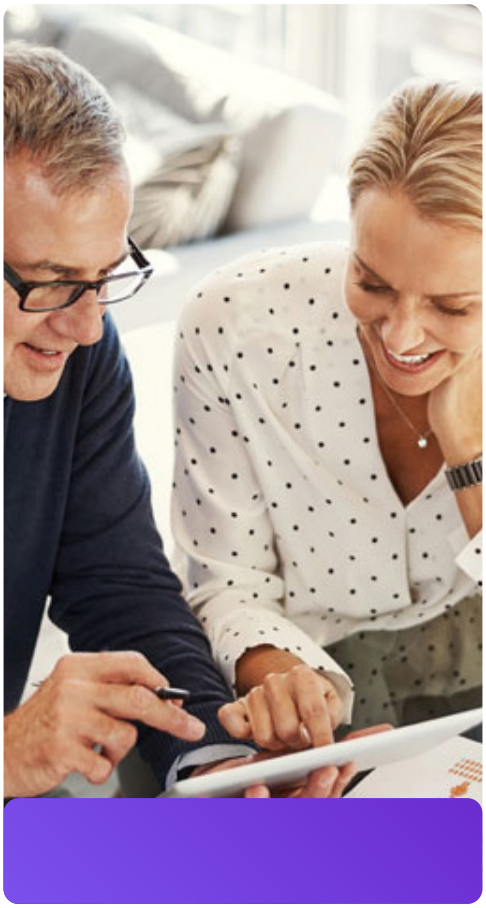
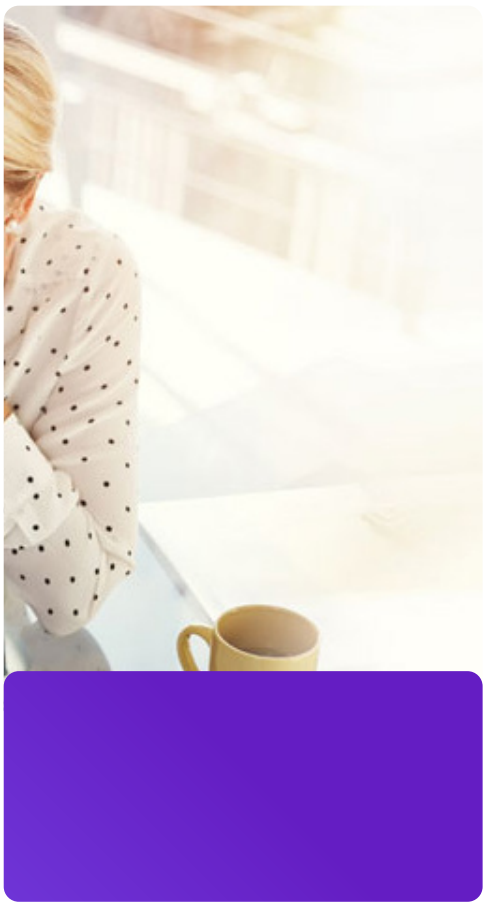
References

1 Para 8 of TR 2018/7.
2 Para 9 of TR 2018/7.
3 Para 89 of TR 2018/7.
4 Para 16 of TR 2018/7.
5 Para 10 of TR 2018/7.
6 Para 10 of TR 2018/7.
7 Paras 34 to 35 of TR 2018/7.







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Superannuation

by William Fettes and Daniel Butler, CTA, DBA Lawyers

A guide to SMSF succession planning: part 1

SMSF succession planning broadly aims to ensure that the right people receive the intended share of SMSF money and assets, and have control of the SMSF to ensure that benefits are paid as intended.

This is the first part of a two-part article on SMSF succession planning. In part 1, we examine key considerations that arise for SMSF members seeking to formulate a robust succession plan in relation to their SMSF benefits. We also focus on planning for control of a fund in different circumstances. In particular, we examine:

- the important role of an enduring power of attorney (EPoA) in addressing superannuation law compliance requirements and other risks associated with a fund member losing legal capacity;
- how the death of a fund member impacts control of an SMSF; and
- where a corporate trustee is in place, how succession to the control of the company's directorship is a critical issue that should be carefully considered.

What is SMSF succession planning?

Succession planning is a critically important aspect of successfully operating an SMSF, although it is often overlooked. Every SMSF member should develop a personal succession plan to ensure that there is appropriate planning in place to govern succession to the control of the fund and other succession arrangements that are appropriate for their individual circumstances.

SMSF succession planning broadly aims to accomplish the following outcomes:

- that the right people receive the intended share of SMSF money and assets; and
- that the right people have control of the SMSF to ensure that superannuation benefits are paid as intended.

An optimal SMSF succession plan should achieve these goals in a timely fashion, with minimal uncertainty and in the most tax efficient manner possible. However, it should also be recognised that trade-offs may need to be considered, as it would usually be considered preferable that the "right" people receive a benefit and pay tax, rather than the "wrong" people receive a benefit in a more tax efficient manner. Accordingly, there is no easy "one-size-fits-all solution" for SMSF succession. However, a well thought out SMSF succession plan should ideally address the following matters:

- determine the person(s) (or corporate entity) who will occupy the office of trustee on loss of capacity or death;
- in relation to a corporate trustee, determine who the directors of the SMSF trustee company will be (ie who will have control of the company) on loss of capacity or death of each director/member;
- ensure that the SMSF can continue to meet the definition of an SMSF under s 17A of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA93);
- determine what each member's wishes are for their superannuation benefits;
- determine to what extent each member's wishes should be "locked in" through the use of an automatically reversionary pension and/or a binding death benefit nomination (BDBN); and
- determine the tax profile of anticipated benefits payments.

Many people have no succession plan in place for their SMSF which may result in considerable uncertainty arising in the future with respect to the control of the fund and the ultimate fate of their member benefits.

Succession on loss of capacity: the role of an EPoA

With the passage of time, there is a significant risk that some SMSF members may lose capacity to administer their own affairs. In the absence of prior planning, this could result in major uncertainty and risk arising in relation to control of the SMSF. Having an EPoA in place can help overcome this problem, as an EPoA appointment is "enduring", enabling a trusted person (ie the member's attorney under an EPoA) to continue to run the SMSF as their legal personal representative (LPR) in the event of loss of capacity.

It is strongly recommended that every SMSF member implement an EPoA as part of their personal SMSF succession plan. It would not be an exaggeration to say that being a member of an SMSF without an EPoA is courting disaster.

Naturally, given the important responsibilities of the position, the member must trust their nominated attorney to do the right thing by them. Only a trusted person should be nominated, and insofar as the member retains capacity, the EPoA should be subject to ongoing review to ensure its ongoing appropriateness. Consideration should also be given as to whether scope of the appointment should be general in nature (ie a general financial power) or limited to the SMSF or to the trustee of the SMSF.

For example, if the member wishes to preclude their attorney from exercising certain rights in relation to, say, their member entitlements or confirming, making or revoking their BDBN, this should be expressly covered in their EPoA.

It should be noted that, by itself, an EPoA is not a mechanism by which an attorney can actually step into the role of trustee or director of a corporate trustee. An EPoA merely permits the member's attorney to occupy the office of trustee or director of the corporate trustee to help ensure that the SMSF can continue to operate in a fashion consistent with the member's wishes. This is because a member's attorney appointed under an EPoA is expressly recognised as satisfying the criteria relating to the trustee–member rules in s 17A SISA93. However, the attorney must still be appointed in the first place. The appointment mechanism which facilitates the LPR to step into the role of SMSF trustee or director of the corporate trustee is contained in the SMSF deed and the company's constitution. For example, in the context of a corporate trustee, in the absence of other appointment provisions in the constitution, generally the shareholders must exercise their voting rights to appoint a director.

Succession on death: the role of the executor as LPR

The death of a member is another situation where succession to control an SMSF should be carefully considered.

Section 17A(3)(a) SISA93 provides an exception to the trustee–member rules where a member has died. The exception in s 17A(3)(a) provides that a fund does not fail to satisfy the basic conditions of the trustee–member rules by reason only that:

> "(a) a member of the fund has died and the legal personal representative of the member is a trustee of the fund or a director of a body corporate that is the trustee of the fund, in place of the member, during the period:
>
> (i) beginning when the member of the fund died; and
>
> (ii) ending when death benefits commence to be payable in respect of the member of the fund;"

This exception permits an LPR of a deceased member (eg an executor of a deceased person's estate) to be an individual trustee or a director of a corporate trustee in place of a deceased member until the member's death benefits commence to be payable. However, it is important to understand that this provision does not require or create this state of affairs. For example, for s 17A(3)(a) to apply, an LPR must actually be appointed as either:

- a director of the corporate trustee of the fund pursuant to the constitution of the company; or
- an individual trustee of the fund pursuant to the governing rules of the fund.

The operation of the provision in this way has been confirmed in numerous cases, particularly in *Ioppolo v Conti*[1] and *Ioppolo v Conti*,[2] and implicitly in *Wooster v Morris*.[3] These cases underscore the fact that a deceased person's LPR (ie their executor) does not automatically step into the role of an SMSF trustee or director on a member's death. Broadly, it depends on the provisions of the SMSF deed (most SMSF deeds do not have a mechanism for this to occur) and whether there are other appropriate legal documents in place to ensure that this can occur.

Corporate trustees

Section 201F of the *Corporations Act 2001* (Cth) empowers the personal representatives of a sole director and sole shareholder in a private company to appoint new directors for the company on the death or loss of mental capacity of the principal (ie the sole director/shareholder). Thus, if an SMSF has a sole member who is also the sole director/shareholder of the corporate trustee, s 201F can assist in relation to the member's LPR exercising powers to take control of the SMSF trustee after their death (or loss of legal capacity).

However, it is important to understand the limitation of this provision. For instance, s 201F cannot assist where an SMSF member has died and the SMSF trustee company has more than one director or shareholder, or where the shareholder is a person other than the sole director who has died. Accordingly, relying on s 201F is not a sound strategy in many cases.

Successor directors

By ensuring that the company constitution of the SMSF trustee contains successor director provisions, it is possible to plan for succession to the role of a director in a variety of circumstances without the limitations of:

- appointing a new director via the usual rules in the corporate trustee's constitution (eg by majority shareholder vote); or
- the limited flexibility in s 201F of the *Corporations Act 2001*.

Making a successor director nomination allows a director (ie the principal director making a nomination in accordance with an appropriately drafted constitution) to nominate a person to automatically step into the shoes of the principal's directorship role immediately on loss of capacity, death or another specified event that occurs.

The successor director strategy is designed to work in conjunction with a member's overall estate and succession plan to enable an attorney appointed under an EPoA, or an executor of a deceased member's will, to be automatically appointed as a director without any further steps involved.

Naturally, a successor director strategy relies on the right paperwork being in place, including the right constitution and related successor director nomination form.

In part 2 of this article, we examine tax considerations on death, and planning for the timely payment of benefits before death.

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References

1 [2013] WASC 389.

2 [2015] WASCA 45.

3 [2013] VSC 594.

Events Calendar

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MAY
6
Fri

VIC

Women in Tax – Purposeful Pursuits – Melbourne

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Thu-Fri

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3
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