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Taxation *in* Australia

Private wealth
The Tax Institute

Five ways that tax litigation is different
Angela Wood, CTA, and Andy Bubb, CTA

Section 100A and tax purpose
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Contents

Cover article

689
Private wealth
The Tax Institute

Feature articles

696
Five ways that tax litigation is different
Angela Wood, CTA, Partner, Tax, and Andy Bubb, CTA, Special Counsel, Tax, Clayton Utz

701
Section 100A and tax purpose
Mark West, CTA, Principal, West Garbutt

Invitation to write

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

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Insights from the Institute

668 President's Report
669 CEO's Report
671 Associate's Report

Regular columns

667 Tax News – at a glance
672 Tax News – the details
677 Tax Tips
683 Mid Market Focus
686 Higher Education
688 Member Spotlight
715 A Matter of Trusts
719 Superannuation
722 Alternative Assets Insights
727 Events Calendar
728 Cumulative Index

Tax News – at a glance

by TaxCounsel Pty Ltd

May – what happened in tax?

The following points highlight important federal tax developments that occurred during May 2022. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 672 (at the item number indicated).

Cash flow boost: scheme provisions

The AAT has held that a private company was entitled to a cash flow boost payment for the March 2020 quarter but was not entitled to a payment for the June 2020 quarter because of the operation of the scheme provision in the cash flow boost legislation (*Twin Rivers Developments Pty Ltd and FCT* [2022] AATA 887). **See item 1.**

Work-related expenses

The AAT has recently considered the deductibility of a range of work-related expenses claimed by a corrective services dog handler (*London and FCT* [2022] AATA 644). **See item 2.**

Penalties: breaches of foreign investment rules

The Federal Court (Beach J) has ruled on the penalties to be imposed in respect of four admitted contraventions of s 94 and two admitted contraventions of s 95 of the *Foreign Acquisitions and Takeovers Act 1975* (Cth) which establishes a regime to control investment by foreign persons in certain Australian assets (*FCT v Balasubramaniyan* [2022] FCA 374). **See item 3.**

Tax agent services: unregistered entity

In proceedings brought by the Tax Practitioners Board, the Federal Court (Banks-Smith J) has made a declaration that the respondent contravened s 50-5(1) of the *Tax Agent Services Act 2009* (Cth) on 531 occasions (between 1 July 2020 and 15 August 2021) by preparing and lodging income tax returns for taxpayers for a fee or other reward while not a registered tax agent, and has granted an injunction that the respondent be permanently restrained from providing tax agent services for a fee or other reward while not a registered tax agent (*Tax Practitioners Board v Stroe* [2022] FCA 482). **See item 4.**

Tax debts

The ATO has recently issued a statement dealing with its debt collection activities.

Some points to note are:

- the ATO remains committed to engaging with taxpayers about unpaid debts as the economy emerges from the COVID-19 pandemic and is offering tailored support and assistance to taxpayers with overdue debts;
- what is critical is that taxpayers or their representatives talk to the ATO and respond to its calls;
- where taxpayers do not engage, the ATO is taking firmer actions, including garnishees, recovery of director penalties, disclosure of business tax debts, and legal actions including summons, creditor's petition, wind-up and insolvency action;
- the ATO debt collection activities prioritise those taxpayers representing higher risks and refusing to engage;
- taxpayers with superannuation guarantee debts may be prioritised irrespective of their debt value;
- with regard to disclosure of business tax debts, the ATO has issued nearly 300 intent to disclose notices and has commenced disclosing some of these to credit reporting bureaus Equifax and Creditor Watch; and
- with regard to companies with outstanding obligations, the ATO is currently issuing 30 to 40 director penalty notices each day and expects that to increase.

President's Report

by Jerome Tse, CTA

Tax time and the rest of 2022

President Jerome Tse reflects on the federal election, EOFY and what's coming up.

As you know, the big news recently has been the federal election that was held on 21 May. The ALP has already flagged changes for multinationals in respect of interest deductions and intellectual property, and has confirmed that stage 3 tax cuts for individuals look set to remain.

As part of our advocacy work, the Institute will soon release a report titled *Incoming government brief* which highlights our opinion on what should be the key tax priorities for the new government. We are committed to working with government on these measures as they are developed and progressed. Throughout this work, we will continue to provide updates, seek your feedback, and keep you informed on what developments mean for you and your clients.

We are also continuing to produce resources that assist you in your day-to-day practice, including our *State of tax policy report*, released last month by our Tax Policy and Advocacy Team.

Federal election aside, the EOFY always means a heavy workload for tax and accounting professionals, and this year will be no different. This year, you'll no doubt be tackling at least some tricky topics in your client work, such as temporary full expensing, loss carry-back, professional practice profits, Div 7A and s 100A. Remember that the Institute has a wealth of resources on these topics and many others available. I encourage you to make use of them to save yourself time and effort during a busy period.

CPD in the second half of 2022

As always, our CPD calendar is full of opportunities for you to develop your knowledge, skills and networks. Our series of state Tax Forum events concluded last month. These events are some of my favourites in our CPD calendar, combining an impressive breadth of knowledge and valuable opportunities to connect with your fellow tax practitioners. This year, a renewed focus on local speakers and insights really made these events unmissable opportunities to increase your understanding and network. Members of our Tax Policy and Advocacy team were also able to travel and attend these events in person, which was a welcome chance to reconnect with our members.

In the second half of the year, we look forward to welcoming you to a number of other wonderful events, including the Tax Summit. As part of our recent Member Appreciation Week, we gave you a $200 credit to use towards registration at some of our key CPD events – I encourage you to take advantage of this before the end of June to attend an event that interests you, or to tune in online if travel isn't feasible. Many of you share my preference for attending these events in person, but I am also thrilled that we can extend our reach to those members who aren't able to travel as readily or as often. Our virtual capability also means that missing the live event doesn't mean missing out on great content. If you've missed an event that interests you, don't forget you can usually access that content on demand after the fact.

Maintaining a connection with your Institute

As I am sure you're aware by now, our renewals window is open and we are inviting all members to renew their membership. Continuing and growing the diversity of our membership is a key focus of mine this year, and each and every one of our members has a part to play in achieving that goal.

Your unique perspective and experience, along with your support and time, are key to making the Institute the influential organisation it is. Diversity of thought and opinion makes us better in all respects, from our advocacy work to our education programs.

I look forward to having you with us as a member for another year, during which there is much work to be done and much to be learnt.

CEO's Report

by Giles Hurst

A busy time in tax

CEO Giles Hurst on the busy end of financial year and what's coming up for the Institute.

The end of this financial year is fast-approaching, and I know that you are probably already busy ensuring that you and your clients are ready for it. I know that things are certainly not slowing down for our team at the Institute.

Added to the EOFY workload this year is consideration of the recent federal election and what a Labor Government means for our profession. A federal election always brings with it a level of uncertainty, regardless of the political outcome. Although a single election won't change the tax system at its fundamentals – the only certainties in life are death and taxes, after all – changing policy and legislation can have a major impact on your work and your clients.

We are sensitive to the fact that you may now be dealing with this uncertainty and client questions about the election's outcome at an already busy time of year. Our team is poised to continue its support by keeping you up to date on developing policy and advocating for outcomes that make sense. Our advocacy is concerned with not only a fair and efficient tax system, but also with one that allows you to work to the best of your abilities, without putting undue strain on the tax professionals who make the system work.

Keep your eyes peeled for news, resources and CPD events delving into new developments, and please remember that we are here to help. We are always keen to hear from members on new ways that we can better offer support.

A new digital home for the Institute

In recent Institute news, I am thrilled that our new website went live at the end of May. This is an updated, modern space for us to continue our work as the home of tax. I'm immensely proud of what our team has achieved.

I hope the improvements we've made enable you to better access the resources you know and love. This, like so many projects in a digital world, is an ongoing and evolving piece of work. We'll be rolling improvements out in stages, ensuring that you are kept abreast of changes. Thank you in advance for your patience as we do so, and as you get acclimatised to the new website.

Our community in the next year

Last, but certainly not least, a reminder that the membership renewal window is now open. Your support as a member allows us to continue our work in supporting the profession and advocating for much-needed change in our taxation system. Being part of our community also allows you to access the best resources for your career in tax.

Over the next 12 months, we'll be focusing on ensuring that this community remains vibrant and engaged. We'll continue to guide you through emerging legislation and amplify your voice on issues that matter. And as always, we will be providing opportunities to learn and grow your career, through CPD events, structured education and leading resources.

We look forward to having you with us for another year.

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Associate's Report

by Abhishek Shekhawat, ATI

FBT on car parking: stuck in reverse

The government's proposed consultation on FBT on car parking represents an opportunity to undertake much-needed holistic reform.

On 29 March 2022, the Hon. Michael Sukkar MP announced that the Morrison Government would consult on the application of FBT on car parking. The consultation would seek to make a minor modification to the current rules. However, it presents an opportunity for us to engage in a broader, more meaningful discussion regarding the need for holistic reform for FBT on car parking, and FBT more generally.

What sparked the consultation?

FBT on car parking is an unnecessarily complex area of tax legislation. Two of the numerous requirements for the provision of a car parking benefit for the purposes of FBT include:

- the existence of a "commercial parking station" within a 1km radius of the employee's place of employment;[1] and
- the "lowest representative fee" charged by any commercial parking station within a 1km radius needs to exceed the car parking threshold.[2]

Historically, it was understood that a car parking facility which charged a penalty rate significantly higher than the rates charged at commercial all-day parking facilities was not considered by the ATO to be a "commercial parking station" for the purposes of s 39A(1)(a)(ii) FBTAA.[3] However, recent court cases[4] overturned this approach and ruled that car parking facilities which charged a penalty rate should be considered to be a commercial parking station. The ATO will apply this view from 1 April 2022.[5]

The practical outcome of the case law and subsequent change in ATO approach is that a greater number of employers may be subject to FBT on car parking as they will be treated as being within a 1 km radius of a commercial parking station that charges a fee above the threshold.

The current scope of the consultation is to identify modifications to the definition of "commercial parking station" with a view to restoring the previously understood interpretation. However, we need to ask if this is enough.

A glance in the rear-view mirror

FBT on car parking is a complex and convoluted area of the tax legislation. Broadly, a car parking benefit arises when, in addition to the requirements noted above:[6]

- the car (which is leased or otherwise under the control of the employee) is parked at premises owned or leased by, or otherwise under the control of, the employer for more than four hours between 7am and 7pm;
- the car is parked at or near the employee's primary place of employment on that day and the parking is provided in respect of the employee's employment; and
- the car is used by the employee to travel between home and work (or work and home) at least once on that day.

In practice, these requirements mean that employers are legally required to keep extensive tabs on when their employees enter and leave the employer's car parking facility, where the employee is coming from/going to, and how long the employee parks there. Employers also have to understand the business model and pricing structure of all car parking facilities within a 1km radius (as travelled by road) to determine if these are commercial parking stations and charge above the car parking threshold.

If these requirements are met, the employer is required to calculate the number of car parking benefits provided, for which there are three methods, and the amount of FBT payable on the benefits provided, for which there are another three methods.[7] Each of the valuation methods have their own evidentiary requirements.

An opportunity to drive meaningful reform

As noted in the Case for Change, FBT is an inefficient, complex and onerous regime that places disproportionally high compliance costs on impacted taxpayers. Even if the announced consultation and the subsequent change to the law are effective in achieving their goal, the compliance burdens on employers when determining FBT on car parking benefits will remain.

Government has an opportunity to broaden the scope of the announced consultation and consider holistic changes to our FBT regime or, at the very least, an overhaul of the current approach to FBT on car parking. Replacing the existing rules for FBT on car parking with simpler requirements and fewer calculation methodologies will significantly reduce the complexity and compliance costs for impacted employers. Let us know in The Tax Institute's Community what you think the ideal reform options are for FBT on car parking.

References

1 S 39A(1)(a)(ii) of the *Fringe Benefit Tax Assessment Act 1986* (FBTAA).

2 S 39A(1)(a)(iii) FBTAA.

3 Para 81 of TR 96/26.

4 See *FCT v Qantas Airways Ltd* [2014] FCAFC 168 and *Qantas Airways Ltd and FCT* [2014] AATA 316.

5 Para 56 of TR 2021/2.

6 S 39A FBTAA.

7 See Subdivs B, C and D of Div 10A FBTAA, and ch 16.2 of Fringe benefits tax – a guide for employers.

Tax News – the details

by TaxCounsel Pty Ltd

May – what happened in tax?

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

Recent case decisions

1. Cash flow boost: scheme provisions

The AAT has held that a private company was entitled to a cash flow boost (CFB) payment for the March 2020 quarter but was not entitled to a payment for the June 2020 quarter because of the operation of the scheme provision in the cash flow boost legislation (*Twin Rivers Developments Pty Ltd and FCT*[1]).

A Mr Gregory Cahill was the sole director of the applicant company and he and his wife were equal shareholders of the company.

For some five years, the company (Twin Rivers Developments Pty Ltd (TRD)), which was engaged in the property development industry, had paid no wages to Mr or Mrs Cahill or any other employee. Then, after the announcement of the CFB measure, it disclosed wages said to have been paid to Mr and Mrs Cahill in the aggregate amounts of $130,000 for the March 2020 quarter and $54,000 for the June 2020 quarter, and deducted and paid pay as you go withholding (PAYGW) amounts. TRD did not disclose any wages paid in the quarterly periods following June 2020. If TRD paid the wages said to have been paid in the March and June 2020 quarters, it would, subject to the scheme provision mentioned below, be entitled to CFB payments.

The AAT said that, "[n]ot surprisingly", the timing of the startling departure from the history of no wages being paid by TRD attracted the attention of the Commissioner's officers. The Commissioner took the view that, in fact, no wages were paid by TRD in the two relevant quarterly tax periods. Alternatively, the Commissioner submitted that TRD was disqualified from entitlement to the CFB payments because it entered into a scheme for the sole or dominant purpose of obtaining or increasing the CFBs.

Having regard to the relevant evidence, the AAT accepted that wages were in fact paid in the March 2020 quarter. Despite its stark appearance at first glance, the AAT also accepted Mr Cahill's explanation of the timing of the wages paid in the March 2020 quarter, mainly because they commenced well before the CFB measure was announced.

However, the AAT was not persuaded that the scheme provisions did not apply in respect of the June 2020 quarter in which the purported wages comprised a single payment of $27,000 to each of Mr Cahill and Mrs Cahill on 10 June 2020.

The eligibility requirements for CFBs are provided for in the *Boosting Cash Flow for Employers (Coronavirus Economic Response Package) Act 2020* (Cth) (BCF Act). Those requirements tied eligibility for, and the amount of, CFBs to an entity's obligation to deduct PAYGW from wages paid in specified periods – in this case, the March 2020 and June 2020 quarterly tax periods (s 5(1)(a)(i) BCF Act).

The scheme provision (s 5(1)(g) BCF Act) required that:

> "neither the entity [that is, TRD] nor any associate or agent of the entity has entered into or carried out a scheme or part of a scheme for the sole or dominant purpose of achieving any of the following:
>
> (i) making the entity entitled to the cash flow boost for the period;
>
> (ii) increasing the amount of the cash flow boost to which the entity is entitled (disregarding this paragraph) for the period."

The AAT noted various aspects of s 5(1)(g) that were significant to the resolution of whether TRD had proved that this provision did not apply, including the following points:

- s 5(1)(g) refers to whether TRD or any associate or agent of TRD entered into a scheme (as broadly defined) or part of a scheme with the sole or dominant purpose of obtaining or increasing a CFB. The case was conducted on the basis that this required inquiry into the purpose of Mr Cahill as the sole director and controlling mind of TRD. There was no suggestion that the purpose of any other associate or agent of TRD was relevant;
- unlike general anti-avoidance provisions in other taxation laws, s 5(1)(g) requires an inquiry into whether the entity (or an associate or agent of the entity) had the sole or dominant purpose of obtaining or increasing a CFB entitlement rather than merely whether, on an objective inquiry, it would be concluded that an entity had the disqualifying purpose. Accordingly, the evidence of Mr Cahill as to his actual intention was relevant. However, evidence relating to the timing of the wage payments and other circumstances was also relevant to the determination of whether TRD had proved that the disqualifying sole or dominant purpose was not present; and
- if s 5(1)(g) applies, there is no entitlement to any CFB for the particular period. Again, unlike general anti-avoidance provisions in other taxation laws, there is no power to reconstruct what would have been the position had the scheme not been entered into. Neither the Commissioner nor the AAT has any power or discretion to assess a lower level of CFB on the footing that the scheme had not been entered into.

The AAT noted that, although not a matter discussed specifically in written submissions or at the hearing, the

scheme issue was generally approached by the parties in a global fashion, that is, in relation to the March 2020 and June 2020 tax periods being considered together. However, the AAT took the view that it was necessary to consider each tax period separately. In many cases, the result may be the same, but in this matter, the AAT reached a different conclusion in respect of the March 2020 and June 2020 quarters.

The AAT agreed that the source of funds for a payment may be irrelevant to the character of the payment. However, when (as here, in the June 2020 quarter) the funds for a payment included undoubtedly circular transactions, that may be relevant to whether the payment formed part of a scheme to obtain or increase the CFB payment. The evidence indicated that Mr Cahill was unwilling or unable to provide a full explanation of the background to certain entries in the company's bank statements. Whatever the explanation, on the material and explanations before it, the AAT was not able to be satisfied that the relevant transactions were not part of such a scheme and indicative of a dominant purpose of obtaining or increasing a CFB entitlement.

The AAT said that it may be that, when deciding to make the contested payments, Mr Cahill was not solely motivated by CFB considerations. But "common-sense dictates" that he must have been aware of the effect they would have on TRD's CFB entitlement.

The factual matrix for the contested payments on 10 June 2020 differed from the March quarter payments. Unlike the March quarter payments, the wages purportedly paid on 10 June 2020 were said to be part of larger amounts transferred to Mr and Mrs Cahill on that day, in each case, by way of a transfer of a single sum in excess of the amount of the purported wages.

2. Work-related expenses

The AAT has recently considered the deductibility of a range of work-related expenses claimed by a corrective services dog handler (*London and FCT*[2]).

The taxpayer was a dog handler in the so-called "Special Operations Unit" of the South Australian Department of Correctional Services. In the 2017–18 income year, he was responsible for training and maintaining two dogs which he supervised closely in relation to their deployment within the prison system. He was required to house and maintain the dogs at his home after working hours. A purpose-built enclosure had been erected on a concrete slab in the taxpayer's back yard for this purpose. While the dogs were at his home, the taxpayer was responsible for their welfare, that is, he had to feed, exercise and groom them, and keep their enclosure clean.

The taxpayer was required to be available to assist in emergencies that might arise. An emergency might involve, for example, a prison disturbance or the escape of a prisoner from custody. These emergencies arose rarely, but it was fair to say that the taxpayer had to be prepared for the possibility of an emergency arising at any time. He was also required to regularly train one of his dogs (a German shepherd) for this purpose. In connection with his work, but more particularly his work involving the German shepherd, it was clear from the evidence that the taxpayer was required to maintain a high degree of anaerobic fitness (that is, a degree of muscle strength sufficient to control a large German shepherd on a lead in a volatile situation) and a high degree of aerobic fitness (that is, a degree of speed and agility sufficient to enable him to move effectively with, and control and direct, his dog in an emergency). He also had to be prepared to restrain prisoners himself.

In his return for the 2017–18 income year, the taxpayer claimed a number of what may be called work-related expenses. Of those expenses that were still in dispute before the AAT, the following may be noted.

Clothing expenses

In relation to the taxpayer's claims for certain clothing expenses, the Commissioner submitted that no deduction was allowable because:

1. the particular items of clothing were normal items of clothing or apparel for which no deduction could be claimed; and
2. the items of clothing were not items of clothing or apparel prescribed or recommended by the employer as a necessary or reasonably appropriate employee purchase.

As to the Commissioner's second submission (ie (2) above), the AAT rejected it at least as a general proposition. The prime question that the Commissioner's officers must ask in connection with a voluntary expenditure by an employee is whether the employee in question has bona fide purchased the clothing, apparel or equipment in question for use in the course of their employment. This question may often, but not always, be answered by an examination of the facts without a consideration of the taxpayer's state of mind.

The Commissioner's officers do not usually need to ask whether the purchase in question was, by some objective measure, a necessary or reasonably appropriate one for the employee to make. Of course, the fact that, objectively, a particular item of clothing, apparel or equipment may be judged to be quite unnecessary may lead one to query the bona fides of the purchase in question for work purposes, that is, the voluntary purchase in question, while ostensibly for use in a work setting, may in fact be better explained as one for a private or domestic purpose. But, leaving this situation aside, the AAT said that there is a separate question requiring that the necessity or reasonable appropriateness of a purchase be examined when deductibility is being assessed by the Commissioner's officers.

The AAT gave as a simple illustration a tradesperson who may purchase steel-capped boots that they find more appropriate or convenient for use on work-sites than the steel-capped boots supplied by their employer. The employee may, in this circumstance, claim the full cost of the boots as they have been purchased for exclusive use at work. When assessing the claimed deduction, the

Commissioner does not have to decide in law whether the purchase was, objectively, a necessary or reasonably appropriate purchase for the employee to make in light of the comfort and functionality of the boots supplied by the employer.

Again, if the employer declined to supply steel-capped boots to its employees because the risk of toe-injury was judged to be minor, an employee, bona fide purchasing such boots as a protective measure against such a risk at work, would be entitled to a deduction, notwithstanding any view held by the employer of the lack of any real need for such protective clothing. The Commissioner's officers would not be required, as a general rule, to assess the reasonableness of the employee's choice in this regard when assessing deductibility, although an apparent lack of reasonableness may bear on the question of the bona fides of the purchase for work purposes.

The AAT did, however, accept the Commissioner's first submission (ie (1) above) that a broad distinction has emerged in the case law between, on the one hand, items of clothing/apparel that may be said to constitute ordinary or normal items (the cost of which is not deductible) and, on the other hand, items that may be said to be unusual (the cost of which is deductible). So far as the first category is concerned, it does not matter that the item in question may have been purchased solely for use at work. The cost of an ordinary business suit that is purchased for work and stays at the workplace and is only ever worn in the workplace is not, for example, a deductible purchase as a general rule. While the dividing line between the two categories is not clear, a useful practical test to apply in this case was to ask whether the item of clothing or apparel in question might be worn on other than work occasions or whether it is so unusual or distinctive that it can be said, practically speaking, to have a use limited to the workplace.

Gym membership expenses

In relation to certain gym membership expenses claimed by the taxpayer, the AAT said that there was a plausible and demonstrable link between the gym regimes and the taxpayer's desire to maintain himself in peak physical condition as a member of an Emergency Response Group. The AAT considered that it ought to apply TR 95/13 which permits a deduction for a police officer's fitness expenses if the officer's income-earning activities "involve strenuous physical activities on a regular basis". The ruling goes on to state that "members of special emergency squads, diving squads, and police officers who work regularly with police dogs and train them, may be able to demonstrate that their income-producing activities demand a high level of physical fitness".

In the AAT's view, there was no reason why the same logic should not be applied to those correctional services officers who are members of Emergency Response Groups and train and control dogs. When participating in emergency situations involving prisoners, correctional services officers perform what is, in effect, a policing role. That TR 95/13 covers only police officers who work with and train dogs was not a reason for not applying it to correctional services officers who work with and train dogs.

While accepting that TR 95/13 refers to "strenuous physical activities" on a "regular basis" (which was in fact the reason given for rejecting the taxpayer's claims), the AAT did not believe this paragraph in the ruling was intended to exclude a deduction for police officers who may very rarely be called on to exert themselves strenuously in an emergency, but who are nevertheless required to train dogs for such an emergency and be ready themselves to respond to any emergency that may eventuate. The taxpayer fell into this category. The deductibility of the fitness expenses made possible under TR 95/13 could not logically depend on how frequently in actual fact such an employee is called on to respond. If it is part of an employee's duties to serve as a responder whenever emergencies arise, any fitness expenses they incur bona fide to maintain fitness on an ongoing basis must be, in principle, either deductible or not. The taxpayer was entitled to a deduction for the gym membership fees. The evidence did not establish a basis for apportionment between a work and private use.

However, the AAT held that the taxpayer was not entitled to deductions in respect of the purchase of gym clothing (which was not in any way particularly distinctive or unusual) or of vitamin or other supplements.

3. Penalties: breaches of foreign investment rules

The Federal Court (Beach J) has ruled on the penalties to be imposed in respect of four admitted contraventions of s 94 and two admitted contraventions of s 95 of the *Foreign Acquisitions and Takeovers Act 1975* (Cth) (FATA) which establishes a regime to control investment by foreign persons in certain Australian assets (*FCT v Balasubramaniyan*[3]).

Section 94(1) FATA provided at the relevant time that a foreign person who proposed to take a notifiable action that is a residential land acquisition must not take the action if the foreign person has not given a notice relating to the action under s 81 FATA. Section 95(1) FATA provided at the relevant time that a foreign person who was a temporary resident must not hold an interest in more than one established dwelling at the same time.

The respondent, who was a temporary resident but relevantly a foreign person, acquired interests in four Victorian properties during the period July 2016 to February 2018, without giving notice to the Treasurer as required under s 81 FATA (contraventions 1 to 4). By his contravening conduct, the respondent made gross capital gains amounting to $710,300, although the net and ultimate gains to him were much less.

The respondent also contravened s 95(1) FATA in several respects because he held an interest in two established dwellings at the same time (contravention 5). This contravention began on 9 November 2016 and ended on 30 April 2021 when one of the properties was transferred to a third party purchaser. And for the period August 2017 to

October 2019, the respondent also held an interest in a third established dwelling (contravention 6).

The aggregate of the maximum penalty for each contravention was $1.0045m. The Commissioner sought a pecuniary penalty in the aggregate of $425,000, while the respondent contended that the aggregate pecuniary penalty should be $34,200. Beach J held that an aggregate penalty of $250,000 was appropriate.

In the course of his judgment, Beach J said:

> "65 … I should note that the paramount objective of a pecuniary penalty is deterrence, which has the two dimensions of general deterrence and specific deterrence …
>
> 66 Now where regulation of economic activity is involved, it is deterrence with a view to putting a price on the contravention(s) that is sufficiently high to deter repetition by the contravener and by others who might be tempted to contravene the Act that is the guiding theme. Moreover, the overarching requirement for a penalty which achieves general deterrence will frequently limit the weight that can properly be given to a contravener's financial position."

His Honour said that he accepted that the requirement to secure deterrence must not result in a penalty that is so high as to be oppressive, but this required only that the penalty be no higher than that required to achieve general deterrence. It did not require that the proper amount necessary to achieve general deterrence be unduly mitigated by reference to notions of financial hardship by the contravener in question. The contravener's financial position was a relevant consideration when determining whether a penalty would achieve specific deterrence.

But a formula for setting a maximum penalty which increases commensurate with the value of an economic transaction at the centre of the proscribed conduct can be seen as having a slightly different dimension. It is intended to enable the court to fix penalties at levels that are sufficient to create a genuine commercial disincentive to contravening conduct. Its function in fixing penalties may be seen more as giving the court headroom, and less as a yardstick.

In the present case, the maximum penalty formulae took the greatest of alternative amounts, calculated in specified ways. The amounts so calculated may render a maximum less directly linked to notions of gravity of the contravening conduct. The formulae reflected the fact that economic considerations inform both the contraventions and the way they are to be deterred. They signal that general deterrence is to be achieved by ensuring that contravening conduct is not profitable.

Beach J also noted that, when setting a penalty, it was relevant to have regard to the purpose of the FATA and any underlying policy considerations that its provisions were intended to reflect and promote. Also, the mandatory and non-mandatory considerations prescribed by the legislation as being relevant to setting a penalty were considered by Beach J.

Making various deductions, the Commissioner concluded that the respondent's net gain may be calculated at approximately $425,000. Beach J said that he was satisfied that a figure of around $250,000 represented no less than the respondent's net gain and said that he proposed to wipe this out by the total penalty that should be imposed. It was necessary to do so in order to achieve the principal objective of general deterrence. Indeed, the sum of $250,000 was considerably more than the respondent's own calculation of the net gain.

Beach J said that he had taken into account the fact that the respondent had disposed of the properties, denying himself income from rent and further capital appreciation, and suffering transaction costs in the process. These economic losses were a direct result of the contraventions. His Honour also took into account that the respondent had, to a significant extent, been cooperative with the Commissioner in the Commissioner's investigations, had admitted the contraventions, and had disposed of each of the properties.

In a media release, the Commissioner pointed out that this case was the first in which the penalty regime for breaches of Australia's foreign investment rules had been considered. The ATO had identified the purchases involved using its extensive data sources as part of a multi-faceted compliance approach to detect foreign investors in breach of the FATA.

4. Tax agent services: unregistered entity

In proceedings brought by the Tax Practitioners Board, the Federal Court (Banks-Smith J) has made a declaration that the respondent contravened s 50-5(1) of the *Tax Agent Services Act 2009* (Cth) (TASA) on 531 occasions (between 1 July 2020 and 15 August 2021) by preparing and lodging income tax returns for taxpayers for a fee or other reward while not a registered tax agent, and has granted an injunction that the respondent be permanently restrained from providing tax agent services for a fee or other reward while not a registered tax agent (*Tax Practitioners Board v Stroe*[4]).

The Board's application before the court was for default judgment, a declaration, a permanent injunction, and pecuniary penalties. Banks-Smith J granted the relief sought except in relation to penalties which her Honour deferred.

Banks-Smith J held that, in the circumstances, the Board was entitled to default judgment. Her Honour was satisfied that the respondent was personally served, in accordance with the *Federal Court Rules 2011*, with the originating process and affidavits in support. The respondent was obliged to file a notice of address for service and failed to do so, despite the Board informing her of her obligation, and the respondent was in continuing default. Her Honour was also satisfied that the respondent was on notice of each of the dates for the first return of the originating application on 23 August 2021 and of the case management hearings on 1 November 2021 and 17 March 2022. The respondent failed to attend the hearings and was accordingly in default.

Additionally, order 4 of the orders made on 1 November 2021 required the respondent to file a defence which she had not done and, accordingly, she was in default for this reason also.

Given those defaults, the court was empowered to make orders pursuant to r 5.23(2)(c) of the Federal Court Rules, but there remained a discretion as to whether or not that power should be exercised. While noting that default judgment should not be entered lightly, in the circumstances of the case, Banks-Smith J was satisfied that it was appropriate to enter judgment in default.

By her failure to file a defence, and pursuant to the relevant principles, the respondent was taken to have admitted the facts pleaded against her in the statement of claim, but not the entitlement to relief flowing from those facts. Accordingly, the respondent was taken to have admitted that she provided tax agent services within the meaning of the legislation on 531 occasions for fee or reward while not a registered tax agent. She was also taken to have admitted that, on each occasion when she provided those services, she knew or ought to have known that they bore the characteristics of tax agent services as defined. It followed that the Board had established the respondent's contraventions. Banks-Smith J considered that the discretion of the court in relation to declaratory relief should be exercised to make the declaration sought by the Board.

Further, having regard to the terms of s 70-5(1) TASA, the respondent had contravened a civil penalty provision (being s 50-5(1) TASA), and having regard to the repetitive nature of the conduct, it was appropriate that an interim injunction that had been granted earlier be made permanent. In coming to this view, Banks-Smith J said that she had taken into account the potential prejudice to the respondent, but noted that the terms of the injunction provided a mechanism for her to provide tax agent services in the future if she becomes a registered tax agent.

Banks-Smith J said that there would be a separate hearing in due course to address the pecuniary penalties sought by the Board.

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References

1 [2022] AATA 887.

2 [2022] AATA 644.

3 [2022] FCA 374.

4 [2022] FCA 482.

Tax Tips

by TaxCounsel Pty Ltd

Statement penalty safe harbour

A recent decision of the AAT has considered several issues in relation to the false or misleading statement penalty provisions, including the operation of the penalty safe harbour.

Background

When the present tax agent registration regime was introduced by the *Tax Agent Services Act 2009* (Cth) (TASA09), a related amending Act[1] introduced safe harbours for clients of registered tax agents or business activity statement agents (BAS agents) in certain circumstances. In particular, safe harbours were enacted in relation to the false or misleading statement penalty and the late lodgment penalty. The safe harbours apply where certain conditions are met and neither recklessness as to the operation of a taxation law nor intentional disregard of a taxation law are involved on the part of the agent.

The relevant explanatory memorandum[2] explained that, in the absence of recklessness and intentional disregard of the requirements of the taxation law, taxpayers should not be subject to administrative penalty as a result of the actions (or omissions) of their agents. The explanatory memorandum went on to state that this approach was possible because of the regulatory framework in the TASA09 which allows effective action to be taken to improve the performance of tax agents or BAS agents where necessary.

Aspects of the provision that defines the operation of the false or misleading statement penalty (including the operation of the safe harbour) were recently considered by the AAT (constituted by Thawley J) in *Automotive Invest Pty Ltd and FCT*.[3] In that case, the operation of the false or misleading statement penalty provisions became a live issue once Thawley J (in his capacity as a judge of the Federal Court) effectively dismissed the taxpayer's appeals from adverse objection decisions that were made by the Commissioner in relation to what may be referred to as "the primary tax issues" and which related to luxury car tax (LCT) and GST (*Automotive Invest Pty Ltd v FCT (Gosford Classic Car Museum)*.[4]

This article discusses the decision of Thawley J in the *Automotive Invest (penalty issue)* case and also notes some other points in relation to the operation of the false or misleading statement penalty safe harbour. The discussion does not recite the facts of the case in detail but seeks to bring out the underlying principles on which Thawley J proceeded.

The penalty provisions

The statement penalty provisions are provided for in s 284-75 of Sch 1 to the *Taxation Administration Act 1953* (Cth) (TAA53)[5] and, so far as is relevant for present purposes, that section provides as follows:

> "**284-75 Liability to penalty**
>
> (1) You are liable to an administrative penalty if:
>
> (a) you make a statement to the Commissioner or to an entity that is exercising powers or performing functions under a taxation law (other than the Excise Acts); and
>
> (b) the statement is false or misleading in a material particular, whether because of things in it or omitted from it.
>
> Note: This section applies to a statement made by your agent as if it had been made by you: see section 284-25.
>
> (2) You are liable to an administrative penalty if:
>
> (a) you make a statement to the Commissioner or to an entity that is exercising powers or performing functions under an income tax law or the petroleum resource rent tax law; and
>
> (b) in the statement, you treated an income tax law, or the petroleum resource rent tax law, as applying to a matter or identical matters in a particular way that was not reasonably arguable; and
>
> (d) item 4, 5 or 6 of the table in subsection 284-90(1) applies to you.
>
> (3) …
>
> (4) You are liable to an administrative penalty if:
>
> (a) you make a statement to an entity other than:
>
> (i) the Commissioner; and
>
> (ii) an entity exercising powers or performing functions under a taxation law (other than the Excise Acts); and
>
> (b) the statement is, or purports to be one that:
>
> (i) is required or permitted by a taxation law (other than the Excise Acts); or
>
> (ii) might reasonably be expected to be used, by an entity in determining, for the purposes of the GST law, whether you are an Australian consumer (within the meaning of the GST Act); or
>
> (iii) might reasonably be expected to be used, by an entity in determining, for the purposes of the GST law, whether a supply made to you is connected with the indirect tax zone

(within the meaning of that Act) because of Subdivision 84-C of that Act; and

(c) the statement is false or misleading in a material particular, whether because of things in it or omitted from it.

Exceptions to subsections (1) and (4)

(5) You are not liable to an administrative penalty under subsection (1) or (4) for a statement that is false or misleading in a material particular if you, and your agent (if relevant), took reasonable care in connection with the making of the statement.

(6) You are not liable to an administrative penalty under subsection (1) or (4) if:

(a) you engage a registered tax agent or BAS agent; and

(b) you give the registered tax agent or BAS agent all relevant taxation information; and

(c) the registered tax agent or BAS agent makes the statement; and

(d) the false or misleading nature of the statement did not result from:

(i) intentional disregard by the registered tax agent or BAS agent of a taxation law (other than the Excise Acts); or

(ii) recklessness by the agent as to the operation of a taxation law (other than the Excise Acts).

(7) If you wish to rely on subsection (6), you bear an evidential burden in relation to paragraph (6)(b).

…"

How the penalty issue arose

The taxpayer company in the *Automotive Invest* cases owned and operated the "Gosford Classic Car Museum" which opened on 28 May 2016 in West Gosford. The taxpayer company had been established by a Mr Anthony Denny in early 2015 and the underlying issue concerned the taxpayer's liability to LCT and GST for confined tax periods from June 2016 to November 2017. The two underlying issues in dispute were whether:

1. the taxpayer company had "increasing luxury car tax adjustments" under ss 15-30 and 15-35 of the *A New Tax System (Luxury Car Tax) Act 1999* (Cth) (LCT Act); and
2. the input tax credits which the taxpayer company could claim were limited by s 69-10[6] of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth).

Although the LCT question concerned actual use and the GST question concerned intended future use, the parties were agreed that, on the facts of the case, the LCT and GST questions would be answered in the same way. It followed that the central question could be summarised as whether the taxpayer company used or intended to use each car for the purpose of holding the car as trading stock and for no other purpose.

Taking the LCT issue, if under the LCT Act an entity can "quote" its ABN when acquiring or importing a car, it will not be subject to LCT. The system of quoting is designed to prevent LCT becoming payable until the car is imported or sold at the retail level.

Where an entity is supplied with, or imported, a luxury car and no LCT was payable because the entity quoted for the supply, the entity will have an "increasing luxury car tax adjustment" if it later "use[s] the car for a purpose other than a quotable purpose": s 15-30(3) (supply), s 15-35(3) (importation) LCT Act. The term "quotable purpose" is defined to mean "a use of a car for which you may quote under section 9-5": s 27-1 LCT Act. Section 9-5(1) LCT Act provides for the circumstances in which an entity is entitled to quote:

> "You are entitled to quote your ABN in relation to a supply of a luxury car or an importation of a luxury car if, at the time of quoting, you have the intention of using the car for one of the following purposes, and for no other purpose:
>
> (a) holding the car as trading stock, other than holding it for hire or lease; or …"

With one exception, the Commissioner did not dispute that the taxpayer company was entitled to quote at the time of importation or acquisition for those cars imported or acquired by the taxpayer company before the museum commenced operations on 28 May 2016. The issue in respect of those cars was whether the taxpayer company had an increasing adjustment on the basis that, once the cars were placed in the "museum", the taxpayer company started to "use the car[s] for a purpose other than a quotable purpose": ss 15-30(3) and s 15-35(3) LCT Act. In the *Automotive Invest (substantive liability)* case, Thawley J held that the Commissioner's view that there was an increasing adjustment was correct.

In relation to GST, by reason of s 69-10 GSTA99, if a taxpayer acquires or imports a car, the value of which exceeds the "car limit", and the taxpayer was not entitled to quote under the LCT Act, the input tax credit to which it is entitled is limited to 1/11 of the "car limit".

The Commissioner contended that this limitation on claiming input tax credits applied in relation to each car acquired or imported by the taxpayer company after 28 May 2016 in the relevant tax periods. The principal issue in relation to these cars was whether, when the taxpayer company imported or acquired the relevant car, it had the intention of using the car for the purpose of holding it as trading stock "and for no other purpose". In the *Automotive Invest (substantive liability)* case, Thawley J upheld the Commissioner's contention.

Penalties

Penalties were assessed by the Commissioner under s 284-75(1) Sch 1 TAA53 on the basis that the taxpayer

company had made false or misleading statements by understating its net amount in 11 of its business activity statements for various tax periods from June 2016 to November 2017. Penalties were assessed on the basis that the base penalty rate was 25% of which the Commissioner, in the exercise of his discretion in that regard, remitted 50%.

The taxpayer company's case concerning penalties was as follows:

- that it was not liable to a penalty because it and its agent took reasonable care in connection with making the statements such that the exception in s 284-75(5) was engaged; and
- that, in relation to four tax periods in which its registered tax agent lodged its business activity statements, it gave its registered tax agent all relevant taxation information and the false or misleading nature of the statements did not result from intentional disregard or recklessness by the registered tax agent such that the safe harbour provision in s 284-75(6) was engaged.

The Commissioner contended that neither s 284-75(5) nor s 284-75(6) applied and that there was no basis warranting further remission.

The taxpayer company's advisers

The taxpayer company sought and obtained advice from external advisers, Fortunity Group Pty Ltd (Fortunity) and PricewaterhouseCoopers (PwC) on its LCT obligations. Mr Denny engaged Fortunity and PwC in January 2015 before the taxpayer company was incorporated. Mr Denny engaged with Mr Ryan Smith from PwC in November 2014 and met with Mr Paul Bolton from Fortunity in November 2014.

Mr Denny informed Fortunity and PwC of what he called the "museum concept" before the "Gosford Classic Car Museum" opened on 28 May 2016. Mr Denny gave evidence that he discussed the fact that admission fees would be charged with both Mr Bolton and Mr Smith. Mr Bolton gave evidence that he was told about the proposed charging of admission fees, although, in cross-examination, he could not be sure about whether he was told that before he provided his advice on 30 June 2015. No person from PwC was called to give evidence.

The Commissioner submitted that Mr Denny's and Mr Bolton's evidence in this respect should not be accepted. Thawley J then said that there was contemporaneous documentary evidence that Fortunity knew in January 2016 that admission fees would be charged. Indeed, it advised the ATO of this fact. His Honour then said that it was likely that PwC was also aware of this fact at least before the museum opened and probably at the time it gave its advice on 19 November 2015. There was no good reason why Mr Denny would inform Fortunity about the proposal to charge admission fees, but not inform PwC.

The taxpayer company received written advice from Fortunity on 30 June 2015, which stated that there was no taxable importation if "the importer quotes its ABN, for example, where a registered dealer imports a car that it uses as trading stock". The advice concluded: "Therefore no LCT will need to be paid on importations if they are to be trading stock." Mr Bolton accepted that he did not, at that time, consider the possibility that the use of the cars in the museum might constitute a use for a purpose other than or additional to a use of the cars as trading stock. Thawley J accepted this evidence.

PwC also gave the taxpayer company written advice on LCT. Its advice, entitled "Luxury Car Tax" and dated 19 November 2015, stated that, where the taxpayer company purchased a luxury car in Australia or imported a luxury car, LCT would not be paid "on the basis your ABN is quoted (provided) and [the] car will be held as trading stock". The advice included the comment:[7]

> "Where an ABN is quoted on the purchase or import of a luxury car, the payment of the LCT can be deferred until the sale of the car or until the car comes to be used for a quotable purpose. The vehicle stops being used for a quotable purpose should it become a capital asset of the business (eg not for sale) or you start using the vehicle for private purposes."

The advice also included PwC's explanation of LCT adjustments, including that increasing adjustments could result from a change in use. The advice contained no active consideration about whether the museum activities in which the taxpayer company proposed to engage would mean that existing cars might cease to be held only for the purpose of holding them as trading stock or whether cars to be purchased in the future might be purchased for a purpose which included something other than a purpose of holding the cars as trading stock. A number of PwC employees were involved in giving the advice. Thawley J said that he thought it unlikely that it did not occur to anyone at PwC at the time that the use of the cars in the proposed museum might constitute a use of the cars for a purpose other than trading stock within the meaning of s 9-5(1) of the LCT Act. His Honour said that this was perhaps particularly so given the conclusion he had reached that the taxpayer company informed PwC that admission fees would be charged.

On 22 January 2016, some months before the Gosford Classic Car Museum opened, Ms Turner of Fortunity emailed Ms Carter of the taxpayer company stating:[8]

> **"LCT**
>
> As discussed, I believe the only situation in which Auto Invest might be liable for LCT will be where they import a vehicle and then sell it within two years of import to a private buyer (who does not quote an ABN). Another situation is where Auto Invest does not import the car themselves but they purchase it from a registered business who has imported the car within two years of Auto Invest selling it to a private buyer. These situations may not occur frequently …"

Fortunity lodged the taxpayer company's business activity statement for the period 1 April 2016 to 30 June 2016 on 1 September 2016. PwC lodged the taxpayer company's

business activity statement for 1 November 2016 to 30 November 2016 on 21 December 2016.

On 1 March 2017, Mr Russell of PwC sent an email to Ms Evans (the finance manager of the taxpayer company), copied to Mr Barry, Mr Smith and Mr Dever of PwC. He stated that "the [ATO] concern regarding museum vehicles having a dual use is somewhat surprising". The concern raised by the ATO was raised in an email from Mr John Noonan of the ATO to Ms Evans sent on 28 February 2017. Thawley J said that, in the absence of evidence from PwC, he was not prepared to conclude from this email that no person at PwC was aware of the "dual use" issue. Such a conclusion was unlikely given that PwC representatives had visited the museum on 16 June 2016 and had previously given advice on LCT, and that Mr Denny kept an LCT defence file. Given that Mr Denny considered that LCT might be "potentially contentious", the probabilities favoured that he consulted PwC on the topic and PwC gave advice. It was not known what the advice was.

The business activity statement for the period 1 February 2016 to 28 February 2017 was lodged by PwC on 22 March 2017.

Reasonable care: s 284-75(5) Sch 1 TAA53

In relation to the operation of the reasonable care exclusion from the false or misleading statement penalty, Thawley J held that the exclusion was not engaged with respect to any of the business activity statements.

So far as concerned the taxpayer company, Thawley J said that he had concluded that it knew there was a potential issue and that the probabilities favoured that it obtained advice on the issue from PwC. The "issue" was the question of whether the use or intended use of the cars in the museum might have the consequence that the cars were not being held only as trading stock. His Honour then said:[9]

> "The issue was so obvious it was unlikely to have been missed by each of the PwC advisers and the probabilities favour that the issue was discussed by them with the taxpayer company. In reaching that conclusion, I am conscious of the fact that the issues have now been the subject of detailed evidence and argument and that hindsight can, if not consciously corrected, distort an assessment of the events at the relevant time. Without proper evidence from PwC on the topic, it is not possible to reach a positive persuasion that PwC gave advice that the [taxpayer company's] position was reasonable or arguable or that the better characterisation of the [taxpayer company's] activities was that the cars were being held only as trading stock and for no other purpose. Whilst there will be cases where the failure to call the adviser will not result in a failure to discharge the onus, … there will be cases where the failure does have that consequence … In my view, the present case is in the latter category for the reasons given."

So far as concerned PwC, and although not strictly necessary for him to reach a conclusion on the point, Thawley J said that the taxpayer company had failed to discharge its onus of establishing that PwC took reasonable care in respect of the business activity statements that it lodged. Thawley J said that it may be accepted that the "dual use" issue was one which required characterisation of the taxpayer company's purpose or purposes and that minds often differ in relation to such questions. The difficulty was that one does not know what PwC considered or advised the taxpayer company or the reasons why. In the circumstances of the case, one could not properly infer these matters from the arguments which PwC put to the ATO in the context of the dispute and audit. These were arguments advocating the taxpayer company's case as well as PwC could, and it was not possible in the circumstances of the case to infer from the arguments that they also expressed PwC's view about the correct answer.

Thawley J went on to say:[10]

> "Relevantly to whether the [taxpayer company] took reasonable care, it is not possible to infer that the arguments put to the ATO were part of advice given earlier to the [taxpayer company]. For all the Tribunal knows, PwC might have advised the [taxpayer company] that its position was highly unlikely to succeed if the ATO took issue with it or that it gave such advice once the ATO had taken issue with it. It should be recalled that, at the relevant times, PwC was proceeding on an understanding that the relevant test was, in substance, a sole purpose test."

Thawley J said that it was not necessary to reach a concluded view about whether Fortunity took reasonable care in connection with the statements that it made in the business activity statement it lodged because he had concluded that the taxpayer company had failed to establish that it took reasonable care in that regard.

Client safe harbour: s 284-75(6) Sch 1 TAA53

The taxpayer company contended that the client safe harbour from the false or misleading statement penalty provided for by s 284-75(6) Sch 1 TAA53 applied such that it was not liable to an administrative penalty in respect of the following business activity statement periods:

- 1 April 2016 to 30 June 2016, lodged by Fortunity on 1 September 2016;
- 1 November 2016 to 30 November 2016, lodged by PwC on 21 December 2016; and
- 1 February 2017 to 28 February 2017, lodged by PwC on 22 March 2017.

Thawley J said that Mr Bolton gave evidence, consistently with what he otherwise would have inferred, to the effect that Fortunity was the local adviser, and that it had a subsidiary advising role to that of PwC. Mr Bolton gave evidence that he would consider that the cars were used only for a trading stock purpose despite the use of the cars in the museum. His Honour inferred that this was Mr Bolton's view at the time of lodging the business activity

statement. In the *Automotive Invest (substantive liability)* case, the Federal Court, having the benefit of detailed evidence and argument on the issue, had concluded that that view was not the better view. Mr Bolton's view, however, was one which was principally based on a characterisation of the taxpayer company's activities, about which minds often differ. Thawley J did not consider that either Mr Bolton or Fortunity was reckless or acted with intentional disregard in connection with any statement in the business activity statement lodged by Fortunity. Therefore, s 284-75(6) Sch 1 TAA53 applied to the business activity statement for the 1 April 2016 to 30 June 2016 tax period.

In relation to the business activity statement lodged by PwC, the taxpayer company submitted that "PwC was … intimately involved in the [taxpayer company's] business". Ms Evans' evidence included that PwC had access to the taxpayer company's documents and accounting system. Thawley J said that he inferred that PwC was aware of the full extent of the museum operations at the time it lodged the two relevant business activity statements and had effectively been given all relevant taxation information (s 284-75(6)(b) Sch 1 TAA53). The taxpayer company submitted that PwC was not reckless and that it did not act with intentional disregard in making the statements.

Thawley J went on:[11]

> "I have earlier concluded that PwC was aware that there was an issue created by the use of the cars in the museum and that it is likely to have advised in relation to that issue before 28 February 2017, indeed before the museum opened. If it had not advised on the issue earlier, it is even more likely that it would have advised on the issue after 28 February 2017. What view PwC took is not revealed by the evidence. In the circumstances of this case, one cannot properly infer these matters from the arguments which PwC put to the ATO in the context of the dispute and audit. The [taxpayer company] has failed to discharge its onus of establishing that PwC was not reckless. I would emphasise that this conclusion is not a conclusion that PwC acted recklessly; rather – as I have said – it is simply a conclusion that the [taxpayer company] has failed to prove that PwC did not act recklessly.
>
> Section 284-75(6) does not apply to the Business Activity Statements lodged by PwC."

Meaning of agent: s 284-75(6) Sch 1 TAA53

In the *Automotive Invest (penalty issue)* case, Thawley J considered the meaning of the word "agent" in s 284-75(6) Sch 1 TAA53. His Honour said that this reference to "agent" was likely to be a reference to a common law agent (including but not limited to a tax agent), given that subs (6) refers to a "registered tax agent or BAS agent".

The Commissioner had submitted that, in so far as subs (5) required reasonable care on the part of agents, in the circumstances of the case, it was only directed to reasonable care in connection with the business activity statements lodged by those agents and not to the question of whether the agents took reasonable care in the advice that they gave to the taxpayer company in respect of the business activity statements lodged by the taxpayer company. The taxpayer company accepted that proposition and Thawley J proceeded on that basis.

Observations

It will be noted that the false or misleading statement penalty provisions that provide the safe harbour expressly provide that the taxpayer bears an evidential burden in relation to the question of whether the taxpayer gave the registered tax agent or BAS agent all relevant taxation information (s 284-75(6) Sch 1 TAA53). This provision would seem to state what would be the case in any event. In this regard, it may be noted that in the *Automotive Invest (penalty issue)* case, Thawley J held that the taxpayer company had failed to discharge its onus of establishing that PwC was not reckless in relation to its preparation of a business activity statement.

In PS LA 2012/5, it is pointed out that:

- where the penalty safe harbour applies, the penalty is not transferred to the tax agent; and
- whether or not all relevant taxation information was provided needs to be considered objectively. It does not matter if the entity genuinely believed that they provided all relevant information. The safe harbour will not apply if the entity omitted or did not supply any part of the relevant information, or gave incorrect or conflicting information.

A point to note is that, where there is a possibility that a registered tax agent or BAS agent was reckless and, as a result, an administrative penalty is imposed on a client, it would be in the client's best interests to do everything possible to help the agent refute the allegation of recklessness. If the client and agent can convince the Commissioner that the agent has only made a mistake, the client will not be liable to the penalty and the agent will potentially face lower sanctions. It is unlikely that this was the intention of the legislation but it is an unavoidable outcome of it.

The test is whether all relevant taxation information has been given by the taxpayer. If the tax agent fails to ask for further details (even if a prudent tax agent would have done so) and, as a result, takes an erroneous view when preparing the statement on the basis of the information given, that would not, it is submitted, excuse the taxpayer from penalty.

Of course, if a registered tax agent or BAS agent does not request further details, this may constitute a failure by the agent to comply with the Code of Professional Conduct in the TASA09 and, in particular, with the principle that an agent must take reasonable care in ascertaining a client's state of affairs. However, it is submitted that the fact that an agent may have breached this principle of the Code could not affect the construction of s 284-75(6) Sch 1 TAA53.

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References

1 The *Tax Agent Services (Transitional Provisions and Consequential Amendments) Act 2009.*

2 To the Tax Agent Services (Transitional Provisions and Consequential Amendments) Bill 2009 at para 2.12.

3 [2022] AATA 673. This case is, for convenience, referred to as the *Automotive Invest (penalty issue)* case.

4 [2022] FCA 281. This case is, for convenience, referred to as the *Automotive Invest (substantive liability)* case. The taxpayer company has appealed to the Full Federal Court from the decision of Thawley J in this case.

5 Note that subs (6) and (7) were enacted by the *Tax Laws Amendment (2010 Measures No. 1) Act 2010.*

6 This section is headed "Amounts of input tax credits for creditable acquisitions or creditable importations of certain cars".

7 [2022] AATA 673 at [12].

8 [2022] AATA 673 at [14].

9 [2022] AATA 673 at [40].

10 [2022] AATA 673 at [42]. In relation to business activity statements lodged after 6 April 2017 Thawley J noted that the taxpayer company had received comments from a Mr Cavasini who apparently had some expertise in LCT.

11 [2022] AATA 673 at [55] and [56].

Mid Market Focus

by Guy Brandon, CTA, HLB Mann Judd

Employee share schemes – another instalment

A review of some situations that have been observed during the past year and comments on the recent changes to Div 83A ITAA97.

Introduction[1]

Employee share schemes (ESSs), as assessed under Div 83A of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) (and the respective state and territory payroll tax Acts), continue to cause difficulties for companies and ESS interest recipients.[2]

Recent changes to Div 83A ITAA97

Since the author's last article on ESSs,[3] the House of Representatives Standing Committee on Tax and Revenue has released the report *Owning a share of your work: tax treatment of employee share schemes.*[4]

Thus far, the following changes have been enacted/proposed.

Enacted

The cessation of employment has been removed as a deferred taxing point for an ESS interest from 1 July 2022.[5]

Proposed[6,7]

Where employers make larger offers in connection with ESSs in unlisted companies, participants can invest up to:

- $30,000 per participant per year, accruable for unexercised options for up to five years, plus 70% of dividends and cash bonuses; or
- any amount, if it would allow the participants to immediately take advantage of a planned sale or listing of the company to sell their purchased interests at a profit.

The government will also remove regulatory requirements for offers to independent contractors where they do not have to pay for interests.

Payroll tax

When ESS interests are proposed, consideration (hopefully) is given to the federal tax liability under Div 83A ITAA97 and the accounting implications.[8] In the author's experience, less thought is given to the potential payroll tax liability that the granting of ESS interests may cause.

Critically:

- When should the value of the ESS interests be determined (and the timing of any liability)?
- What method should be used to value the ESS interests?

Notwithstanding that there may be a value for the ESS interests calculated, whether there is a payroll tax liability will also be contingent on the tax-free threshold allowable to the company, which is dependent on:

- the level of other taxable wages of the company;
- whether the company is grouped with other entities;[9] and
- whether the company (or other grouped entities) operates in more than one state or territory, and where they may be.

Respective states/territories[10]

All states and territories treat ESS interests as being included in taxable wages. For ease of review, the following links are provided:

- Australian Capital Territory: www.revenue.act.gov.au/payroll-tax?result_1060955_result_page=1;[11]
- New South Wales: www.revenue.nsw.gov.au/taxes-duties-levies-royalties/payroll-tax/wages/shares-options;[12]
- Northern Territory: https://view.officeapps.live.com/op/view.aspx?src=https%3A%2F%2Ftreasury.nt.gov.au%2F__data%2Fassets%2Fword_doc%2F0010%2F593578%2FI-PRT-001.docx&wdOrigin=BROWSELINK;[13]
- Queensland: www.business.qld.gov.au/running-business/employing/payroll-tax/taxable-wages/shares-options;[14]
- South Australia: www.revenuesa.sa.gov.au/payrolltax/wages;[15]
- Tasmania: www.sro.tas.gov.au/payroll-tax/taxable-exempt-wages/shares-options;
- Victoria: www.sro.vic.gov.au/shares-and-options;[16] and
- Western Australia: www.wa.gov.au/government/multi-step-guides/payroll-tax-employer-guide/wages-payroll-tax-employer-guide/taxable-wages-payroll-tax-employer-guide/employee-share-acquisitions-payroll-tax-employer-guide.[17]

Table 1 sets out the critical dates to be considered to determine the value of taxable wages attributable to ESS interests.[18]

Foreign aspects of ESSs

The application of Div 83A ITAA97 to circumstances having a foreign aspect require consideration of the residency of the individual, what role the ESS interests are related to, and the source of that income.

Temporary residents[19]

Div 83A ITAA97 will apply to ESS interests relating to employment in Australia (although not to services provided outside of Australia).[20]

Table 1. Definitions of critical dates

Liability date	The "relevant day", being either: • the date that the share or option is granted to the employee; or • the vesting date of the share or option. The default is the vesting date. If the share or option has a nil value, the grant has been deemed to have been paid or payable on the grant day of the ESS interest.
Vesting date	For shares, the earlier of: • when any conditions (eg performance criteria) attached to the grant of the share have been met and the employee's legal or beneficial right in the share cannot be rescinded; or • seven years after the day the share is granted to the employee. For options, the earliest of: • the day the share that the option relates to is granted to the employee; • the day the employee exercises their right under the option to have the relevant share transferred, allotted or vested; or • seven years after the day the option is granted to the employee.
Valuation of the ESS interest	Referable to Div 83A-315 ITAA97.

Australian (non-temporary) residents with foreign service income

In the absence of a double tax treaty that provides concessional treatment, Australian (non-temporary) residents will be assessed on discounts received on ESS interests relating to foreign service under Div 83A ITAA97.

Foreign residents being directors of Australian resident companies

While COVID-19 may have increased the number of foreign resident directors of Australian resident companies due to geographical constraints, there were foreign resident directors previously due to Australian resident companies holding foreign assets directly or via foreign subsidiaries.

Commentary on para 2.1 of art 15 (concerning the taxation of income from employment) in the *OECD Model Tax Convention on Income and on Capital*[21] states:

> "Member countries have generally understood the term 'salaries, wages and other similar remuneration' to include benefits in kind received in respect of an employment (e.g. stock-options …)."

Commentary on para 1 of art 16 (concerning the taxation of directors' fees) in the *OECD Model Tax Convention on Income and on Capital* states:

> "This Article relates to remuneration received by a resident of a Contracting State, whether an individual or a legal person, in the capacity of a member of a board of directors of a company which is a resident of the other Contracting State. Since it might sometimes be difficult to ascertain where the services are performed, the provision treats the services as performed in the State of residence of the company."

Therefore, caution should be had by foreign resident directors of Australian resident companies when determining the tax treatment of ESS interests received. Although the foreign resident director may not be in Australia, they still may be assessed under Div 83A ITAA97. That is, s 83A-25(2) may not be applicable as the employment may be deemed not to be outside Australia. Whether the foreign resident director is receiving the ESS interests in their capacity as a director or in another capacity (eg as an in-country operations manager) may have differing Australian tax implications.[22]

Cessation of employment

The enacting of the *Corporate Collective Investment Vehicle Framework and Other Measures Act 2022* on 22 February 2022 removes the deferred taxing point for shares and rights from 1 July 2022 for future, and current, ESS interests.

Although this welcome change has been enacted, caution still must be had for individuals who are unaware of the delayed commencement of the amendments and that a cessation of employment is still a deferred taxing point for ESS interests until 30 June 2022.

Notably, cessation of employment still has relevance in the application of an ESS interest's minimum holding period[23] as it relates to the start-up concession[24] and the taxed-upfront scheme – $1,000 reduction.[25]

Salary sacrifice/preserving cash

Recently (particularly in the uncertain times at the start of COVID-19), more consideration has been given to providing ESS interests, not just as bonuses but in substitution for cash salaries and wages.

Notably, s 83A-105(4) ITAA97 provides concessions for salary sacrifice arrangements that satisfy that provision. In the author's experience, there has been little appetite in this area as it does not relate to rights (options), it limits the amount that can be sacrificed, it is a "deferral" concession, and it may be difficult for the company to administer.

More evident is the issuing of ESS interests in lieu of net salary (or wages). That is, the company has already calculated and paid/will pay PAYG withholding and superannuation contributions on the gross salary.

This can be problematical when:

- issuing shares is commensurate with the net salary foregone calculated at a discount to market (which would in an ESS discount and possibly an unfunded tax liability); and
- the pay period has since passed and the issuing of the ESS interest is at a later time (possibly in a subsequent income year), ie at what time is the ESS interest value

calculated,[26] and is it different to the net salary foregone (noting again that this may result in an ESS discount and unfunded tax liability)?[27]

ASX and ZEPOs/performance rights

When planning for an initial public offering (IPO) or a re-compliance listing, companies may be planning to issue zero priced options (ZEPOs) or performance rights.[28]

Inevitably, as part of that planning, consideration must be had for the tax outcomes for the individuals to receive such ESS interests (if not just for calculating a payroll tax liability for the company).

There have been situations where what has been initially proposed as part of the IPO or re-compliance has had to be altered on review by the ASX.[29] Care must be taken to assess the tax implications as they may materially change depending on the alterations required for the ESS interests to satisfy the ASX listing rules. This is particularly important given the proliferation of ZEPOs over performance rights.

How the ESS interests are documented will ultimately determine whether they are ZEPOs or performance rights. There have been times when what was thought to be the form of the ESS interest has been the opposite on a review of the documentation. At first instance, they may appear to be the same (ie no additional amount is payable by the ESS interest holder to acquire the underlying share), but the main difference is that, on vesting of the performance right, the underlying share is automatically issued (subject to administrative constraints).

Notwithstanding that a ZEPO may have vested, the underlying share will not be issued to the holder until the ZEPO has been exercised. The view is that this "manual interrupt" of a ZEPO allows for a later "deferred taxing point" for ESS interests that Subdiv 83A-C ITAA97 applies to. In particular (assuming that, at the time when the ESS interest was acquired, the scheme genuinely restricted the immediate disposing of the ESS interest and the scheme no longer so restricts[30]), the third possible taxing point is delayed until s 83A-120(7) ITAA97 is satisfied.[31]

In summary

Employee share schemes/share based payments are common but, unless the federal/state/territory taxes, accounting treatment and the ASX listing rules have been fully factored in, there may be significant delays to, or costs from, a potential transaction.

As with all transactions, the constituent documentation must accurately reflect, in all aspects, what is required by the parties to the ESS interests. A failure to accurately document may result in a tax liability at an unexpected time and/or an unexpected quantum.

Guy Brandon, CTA
Tax Consulting Partner
HLB Mann Judd WA

References

1 This article is written on the basis of an ESS interest being acquired on or after 1 July 2009.

2 Difficulties with ESS interests have been around since 1974 when s 26AAC of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) was enacted, followed by Div 13A ITAA36 from 1995 to the various iterations of Div 83A ITAA97 commencing with effect from 1 July 2009.

3 G Brandon, "Division 83A: employee share schemes", (2021) 55(10) *Taxation in Australia* 519.

4 Available at www.aph.gov.au/Parliamentary_Business/Committees/House/Tax_and_Revenue/EmployeeShareSchemes/Report.

5 See below under the heading "Cessation of employment" for further commentary.

6 See "Employee share schemes – expanding access and further reducing red tape" on p 19 of *Budget Paper No.2 2022–23*. Available at https://budget.gov.au/2022-23/content/bp2/download/bp2_2022-23.pdf.

7 With the proroguing of the 46th parliament, and the federal election to be held on 21 May 2022, it is yet to be seen how many of the proposed changes, and others announced in the 2021–22 Budget (see "Employee share schemes – removing cessation of employment as a taxing point and reducing red tape" on p 16 of *Budget Paper No.2 2021–22*; available at https://archive.budget.gov.au/2021-22/bp2/download/bp2_2021-22.pdf) will ultimately be enacted.

8 See Australian Accounting Standards Board AASB 2 Share-based payment.

9 Not necessarily other companies.

10 Even though *A protocol for payroll tax harmonisation between jurisdictions* was signed on 28 July 2010 (available at www.payrolltax.gov.au/harmonisation/2010-harmonisation-joint-protocol) has assisted in cross-border operations, there are still some differences between states/territories, as well as different tax-free thresholds.

11 Div 3.4 of Pt 3 of the *Payroll Tax Act 2011* (ACT).

12 Div 4 of Pt 3 of the *Payroll Tax Act 2007* (NSW).

13 Div 4 of Pt 3 of the *Payroll Tax Act 2009* (NT).

14 Div 1C of Pt 2 of the *Payroll Tax Act 1971* (Qld).

15 Div 4 of Pt 3 of the *Payroll Tax Act 2009* (SA).

16 Div 4 of Pt 3 of the *Payroll Tax Act 2007* (Vic).

17 Subdiv 4 of Div 2A of Pt 2 of the *Pay-roll Tax Assessment Act 2002* (WA).

18 Care should be given to the potential payroll tax consequences of a subsequent recission/cancellation of an ESS interest.

19 As defined in s 995-1 ITAA97.

20 Further consideration is required should the temporary resident continue employment in Australia in respect of ESS interests acquired while providing foreign service.

21 OECD, *Model Tax Convention on Income and on Capital*, November 2017. Available at http://dx.doi.org/10.1787/g2g972ee-en.

22 Paragraph 32 of art 13 (concerning the taxation of capital gains) in the *OECD Model Tax Convention on Income and on Capital* states: "There is a need to distinguish the capital gain that may be derived from the alienation of shares acquired upon the exercise of a stock-option granted to an employee or member of a board of directors from the benefit derived from the stock-option that is covered by Article 15 or 16."

23 S 83A-45(5) ITAA97.

24 S 83A-33 ITAA97.

25 S 83A-35 ITAA97.

26 Is it the time of the service provided, the time of the agreement to forgo cash net salary for an ESS interest, or on the issue of the ESS interest?

27 Not forgetting that in lieu of *gross* salary may result in as many, if not more, implications (than in lieu of net salary) including whether the contract or award that the proposed ESS recipient is subject to allows for such a substitution.

28 As well as shares and other options.

29 ZEPOs will not satisfy condition 12 of ASX Listing Rule 1.1.

30 S 83A-120(4)(c) ITAA97.

31 Assuming that it is not at the end of the 15-year period (s 83A-120(6) ITAA97). It should be noted that this relates to the deferred taxing points on or after 1 July 2022. See above under the heading "Cessation of employment" for commentary on ESS interests where employment ceases before 1 July 2022.

Higher Education

Having strong tax knowledge in your career

The dux of CommLaw 1 for Study Period 2 2021 discusses the importance of having strong tax knowledge for a career in finance.

Erin Clark
Regional Financial Controller — Asia Pacific — Lift Brands, Managing Director, ECF Consulting, Queensland

Please provide a brief background of your career in tax.

I have around 15 years of accounting experience across a wide range of disciplines, mostly working in roles across South-East Queensland. I have achieved a Bachelor of Business (Accountancy) Degree, Chartered Accountant qualification, Certificate of Public Practice, and I am also a Certified Chair.

I started my career in corporate recovery and bankruptcy, and then moved into commercial accounting working for a variety of industries and business types, including not-for-profits, SMEs and ASX-listed. Earlier in my career, I worked for 12 months at a small tax accounting practice in Mackay where I obtained the fundamentals across personal and corporate tax, as well as SMSFs. Tax has never been the primary focus in my career, but having worked in senior finance roles for the last 8 to 10 years has resulted in working closely with external accounting firms. My various roles have also pushed me to focus on internal tax services, such as preparing depreciation schedules/fixed asset registers, corresponding with the ATO, reconciling and preparing activity statements, ascertaining withholding obligations, and preparing and supervising payroll.

Why did you choose to study the CommLaw 1 subject?

The CommLaw 1 subject is the first of the three commercial law subjects that I will be studying to become a Registered Tax Agent.

What have you learned from the subject, and have you applied this to your role?

I now have increased knowledge of the Australian legal system, torts, contracts, and remedies to contracts.

The contracts module was of particular importance as it forms such a large part of operating a business – knowing my rights and the other party's rights in a contract is pertinent.

How did you juggle study, work and other commitments?

Juggling was not easy and, if I am being honest, I went into the exam thinking I hadn't studied enough. However, during the weeks leading up to the exam, I spent a significant amount of time completing the practice exam and questions, and I believe this helped me to pass.

In preparation for the exam, I made sure that I had both paper notes and electronic notes. I saved my electronic notes into one file so that I could quickly search if I was unable to find the paper bookmark. I also provided as much relevant information as possible to achieve part marks when answering questions.

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

I need to undertake a review of my relevant work experience in tax to identify any key gaps in knowledge. My aim is to register as a tax agent soon.

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

It is never too late to study. It is never too late to realise the importance of having strong tax knowledge in your career, especially for senior finance professionals working in the commercial space.

National GST Conference

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22-024EVT_05/22

Member since:	**2006**
Member level:	**CTA**
Current role:	**Cooper Grace Ward Lawyers, Queensland**

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

Before becoming a lawyer, I worked as an accountant for 18 years, specialising predominantly in tax. I really enjoyed dealing with both the commercial and taxation aspects for clients when they either restructured or exited their businesses. The major reason that I changed my career path to law was to provide clients with great outcomes from both a commercial and taxation aspect. As a major component of my work involves dealing with taxation issues, it makes sense for me to be a member of The Tax Institute which has a strong "tax" focus.

How is your membership beneficial to your practice and clients?

The Tax Institute provides members with valuable resources and the opportunity to attend excellent seminars and conferences. Members are provided with the unique opportunity to obtain insights from the ATO, network with colleagues, and access presenters who are specialists in their areas. It is always an honour to be asked to speak at seminars as it provides a fantastic opportunity to share technical issues and practical solutions with others.

What is your most memorable career achievement to date?

Becoming a partner at Cooper Grace Ward Lawyers was a career highlight for me. After practising as an accountant for 18 years, my first 12 months in law was extremely challenging (the accountant pretending to be a lawyer). But the past 15 years have been extremely rewarding and I keep pinching myself that I am part of such an incredible team.

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

The impact of COVID-19 has not only impacted clients' businesses, but also practitioners' own practices – in particular, managing staffing and workflow issues. The major challenge (on top of keeping up to date with changes in the law) is trying to figure out what works for their practices, including dealing with clients' and team members' expectations in a "COVID-19 world".

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

Effective leaders need so many skills! In the tax profession, the pressure to keep up to date in an ever-changing environment puts a responsibility on us to share our knowledge and develop our teams. This requires a commitment to professional development not just for us, but also for our teams. And all in a COVID-19 world where we are finding new ways to do training and development effectively.

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

It is important to have strong technical skills, but you also need to understand what outcomes are important to clients. It is vital that you ask the right questions of clients and listen to them so you make certain that you find practical solutions to their goals (not what you *think* their goals are).

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

I really love what I do so it can sometimes be difficult to put the work aside and remember to unwind. My partner and I dote on our two adorable Dobermans, so weekends are often spent on the farm where we live with the dogs. I also relax by going to the gym and we love to travel.

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

I have always been focused on achieving the best results for clients. Often this involves interpreting what they really want, which can be quite different to what they actually ask for. To be recognised for this is quite an honour.

Private wealth

by The Tax Institute

In this chapter of the *Case for Change* paper, we turn to the taxation of private wealth and the transfer of wealth following death. We consider how a well-designed tax law can improve equity in respect of the tax treatment of private wealth assets and whether more appropriate tax outcomes following the death of a taxpayer can be implemented. Private wealth clients face many of the same taxation issues as other individuals, and those general issues are covered in the chapters of the *Case for Change* paper related to both individuals and superannuation. One of the most significant issues in advising private wealth clients is succession planning. Succession planning can be a difficult and challenging area in which to advise clients as not only is it an emotional issue for all family members involved, but it also traverses a broad range of legal and financial issues of which tax is only one. While this impacts all individuals, the issues arising are more pronounced with private wealth individuals. The tax issues arising often involve CGT, superannuation, wealth extraction, which itself may include dividends, deemed dividends, loans and trust vesting issues, and tax administration issues on death.

Overarching principles

The overarching principles in tax include that income is taxable when it 'comes home' and capital gains are taxable on realisation of the underlying change in economic ownership. The taxation system needs to appropriately address and facilitate the access to, and taxation of, the profits and wealth accumulated over the years by privately wealthy individuals, with these profits and wealth being situated in personal, corporate, trust or superannuation environments.

In a properly designed system, the profits should be taxable when they are accessed by the respective individuals, and wealth should be taxable when realised or transferred (subject to specifically targeted roll-overs, deferrals or exemptions aimed at achieving a desired policy intent).

Issues

Access to corporate profits

The inappropriate access of corporate profits has always been a challenge for the tax laws. Predecessors to the current Div 7A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) were too easily manipulated and required determinations to be made by the Commissioner for the provisions to have effect, also being at direct odds with the principles otherwise associated with a self-assessment regime.

Div 7A has had application from 4 December 1997. The concept behind Div 7A in principle is simple – a self-operating provision ensuring profits extracted directly or indirectly from corporate entities without the intention to repay would be deemed as dividends and assessed in the hands of those who extracted such profits. This extraction of profit could be by way of loan, payment or the provision of, or access to the use of, an asset of the corporate entity. The actual operation and practical implications of Div 7A, on the other hand, are quite complex and onerous. The prescriptive rules have been amended on many occasions in an attempt to patch shortcomings and ease administrative burdens, on both taxpayers and the ATO.

Today, the provisions remain in a state of flux, with the ATO trying to fix technical deficiencies with administrative concessions and interpretative positions by way of rulings or other guidance materials, and the government struggling to achieve comfort in announced reforms which have now been pending for many years. Taxpayers are left to meet the significant compliance requirements imposed by the provisions to retain sufficient evidence to prevent these self-operative provisions applying in a self-assessment regime.

Division 7A therefore places an excessive burden on small businesses and family-owned enterprises for the simple behaviours it is otherwise intended to combat. The prescriptive design of the provisions places unreasonable restrictions on the flow of finance, resulting in the tax system overreaching what a properly designed tax law should otherwise do. Finally, private groups and their advisers are left managing information and records for different loans and unpaid present entitlements (UPEs), the implications of which are contingent on the timing of the loan or UPE and the direct/indirect manner in which the loan or UPE arose – all being unnecessary complexity.

Dealing with trust estates

The taxation of trusts has been clearly problematic for some decades. Many of the problems emerge from interactions with other parts of the tax law – in fact, most of the issues surrounding trusts have emerged because of changes to other parts of the tax law. In addition, to address perceived and actual avoidance, the ATO has often adopted positions that go beyond accepted principles of trust law, in the process creating even further issues.

A new approach is needed to address these various issues and reduce the complexity and compliance costs that arise not just from the fundamental problems that have been identified, but also from the additional reporting that has been placed on all trustees in an attempt to deal with some minority cases and issues.

The approach to the taxation of trusts has changed over the last 100 years or so. The first Commonwealth income tax laws approached the taxation of trustees of trust on the basis of the application of general rules of income and deduction, but effectively provided a deduction for distributions to beneficiaries.[1] By 1922, one could start to see the emergence of some concepts that are reflected in the current regime.[2] However, there was nothing contained in those provisions about the *nature* of the income of the trust.

The wide use of trusts in Australia is somewhat unique; other jurisdictions limit the use of trusts for the conduct of business either directly or through the tax regime itself. The use of trusts to conduct businesses can be easily observed in the conduct of the business of a deceased taxpayer where the trustee might continue to carry on the business for a considerable period for the benefit of income beneficiaries. To distinguish those cases (which, in some instances, continued for many decades) from an inter vivos trust created to carry on a business might be said to be difficult (although not impossible).

Trusts provide the flexibility of look-through taxation (generally), variable interests in the income (although this can also be addressed in the partnership and company context through differential shares or rights) commonly, and limited liability.

The use of trusts as investment vehicles has been common for centuries in the private or family context. Their use continues to be common for these purposes in family situations to protect against marriage breakdowns and 'spendthrift' children. The use of trusts as public investment vehicles most obviously emerged in their use by property trusts in the 1970s. This was perhaps because there was no other suitable vehicle that, at that time, did not result in either double taxation (companies) or the loss of tax concessions (such as depreciation and building allowances).

Over time, some of the alienation aspects have been addressed in the penal rates of taxation of minor beneficiaries (Div 6AA ITAA36).

As alluded to earlier, the plethora of deemed amounts of tax income and amounts that are not represented by cash has been at the base of differences arising between income of the trust and the 'taxable' income of the trust. These include franked dividend gross-up amounts, capital gains determined differently (both as to amount and timing) compared to the trust profit, attributable income from various regimes and exemptions provided for (e.g. foreign branch income).

Some of these issues only became apparent by the overlay of the 'proportional' approach to the taxation of beneficiaries. This means that a beneficiary is taxed on an amount of the trust's 'tax' income by reference to their share of the trust's income.

Further issues arose from a change of heart by the ATO of the approach to the treatment of different kinds of income in the hands of different beneficiaries. That is, the 'proportional' approach meant that there was no distinction between different kinds of tax income. That is, it was irrelevant, according to this view, that a beneficiary was only entitled to, say, rent from Blackacre; if the trust had other kinds of income, the beneficiary would be taxed on a portion of all of the different kinds of tax income (dividends, interest, rent, foreign income), having regard to their share of the total trust income.

In the period from around 2008–2013, there was a flurry of activity and several projects launched to address some of the issues that had become almost untenable in the uncertainty regarding the way trusts taxation should be approached and the way in which the taxation of trusts was being administered. It might be said that many of those projects were seeking to address symptoms rather than the underlying issues that gave rise to those symptoms.

The only real change from this period was the acknowledgment of streaming of franked dividends and capital gains. The method by which this was achieved was highly complicated and formulaic. That approach has produced its own problems.

Additionally, it is the rates of tax that can apply that encourage certain kinds of behaviour. For example, the high rates of tax applying to undistributed or accumulated income encourage the use of a company beneficiary to limit the tax to the corporate rate. The income is needed for working capital in the business conducted by the trust, which is why it isn't distributed in the first place. As it is needed for working capital, it is then lent back to the trust, giving rise to the attraction of the anti-avoidance rules in Div 7A.

Additionally, concerns over the potential undermining of the corporate tax base through the use of trusts by large businesses resulted in Div 6C ITAA36, which is designed to treat such a trust as a corporate entity and subject to corporate tax. The potential reach of those rules has given rise to another phenomenon — the stapled structure. Of course, this has then given rise to an ATO response and further amendments to the law. All this results in highly complicated rules.

Trusts are also subject to a range of specific CGT rules that are often complicated but, nonetheless, either give rise to inappropriate taxation or turn out to be not necessarily comprehensive.

Specific regimes have been developed for public investment trusts (managed investment trusts and attribution managed investment trusts (AMITs)) that add to the complication (although the underlying concept might reveal an option for reform).

That many of these specific rules exist at all may be the result of consistently narrow thinking that seeks to find solutions only in the trust regime itself. For example, as has been mentioned in chapter 3 of the *Case for Change* paper,[3] why is there differential taxation of business income based on the vehicle or structure chosen? Why are limited partnerships taxed as companies when they could provide

the perfect vehicle for small business to operate, giving flow-through treatment, flexibility and limited liability?

Dealing with deceased estates

A capital gain or loss made from a CGT event on death is generally disregarded.[4] Section 128-15 ITAA97 then sets out various cost base rules in circumstances where CGT assets devolve to a legal personal representative or pass to a beneficiary following the death of a taxpayer and are subsequently disposed of or sold.

The policy intent of this is clear. An estate should not be forced into the sale of an asset to simply fund a tax liability that would otherwise arise on the transfer of assets/wealth to the beneficiaries of a deceased.

However, these provisions, while on their face appear simple, give rise to unnecessary complexities when interposed with other provisions within the tax laws.

One example includes the application of the main residence exemption to assets passed to the taxpayer on the death of another.[5] The respective sections provide a full or partial CGT exemption to an individual who has taken ownership of, and subsequently disposes of, property acquired from a deceased estate (either where the ownership interest passes to a beneficiary in a deceased estate or is owned as the trustee of a deceased estate). These rules are overly complex and require the analysis of the deceased's use of the assets and retention of substantiation in relation to the same, which may not always be easily obtained.

Operation of the main residence exemption rules for deceased estates

Pursuant to s 128-15(4) ITAA97, where a dwelling that was a taxpayer's main residence devolves to a legal personal representative or passes to a beneficiary upon that taxpayer's death, the property's cost base is broadly determined according to the market value of the dwelling on the date of the taxpayer's death. This rule eliminates the need to determine and use the original cost base of the asset in CGT calculations and permits the cost base to be reset on the date of death. This rule is designed to reduce complexity and make it easier for those administering an estate or inheriting a property.

There are a number of problems with the operation of the cost base rule in s 128-15(4):

1. these cost base rules are complex and poorly understood. The interaction between the rules set out in s 128-15 compared to the full and partial exemption rules in s 118-195 and s 118-200 ITAA97 are difficult to navigate. This places a heavy burden on those who take possession of property via deceased estates in ensuring that they apply the correct tax treatment to that property;
2. the market value deeming rule in s 128-15(4) is limited in its application and inconsistent. In practice, this means that the market value rule in s 128-15(4) applies in a narrower set of circumstances than many taxpayers realise; and
3. the cost base rules are difficult to apply in practice. This is particularly the case for property that passes through a chain of deceased estates. Where the market value deeming rule in s 128-15(4) does not operate to shift the cost base calculation to the date of death, the compliance burden associated with determining the original cost base of property passing through multigenerational deceased estates is high and complicated. It requires those further down the chain of deceased estates to correctly characterise the use of the property at each stage of ownership through the chain.

Transfer of wealth from the superannuation system

As at 31 December 2020, there was over \$3tr[6] in superannuation assets in Australia. While chapter 10[7] of the *Case for Change* paper deals with superannuation more generally, for the purposes of considering superannuation and deceased estates, some issues will be noted here.

The operation of the transfer balance cap (TBC) limits the total amount of superannuation that an individual can transfer into retirement phase income streams, including most pensions and annuities. This is complicated when a person receives an income stream from a fund as a consequence of the death of the person whose superannuation benefit is the source of that income stream.

The ATO explains[8] the operation of the TBC on death benefit income streams as follows:

> "If you are receiving a death benefit income stream – either by itself or in combination with another super income stream – you need to ensure you don't exceed your personal balance cap.
>
> From 1 July 2017, death benefits can be rolled into another fund. However, the new fund must commence a death benefit income stream or pay the amount out of super as a lump sum (or a combination of these). The death benefit cannot be retained in accumulation phase."

Where an individual who has already maximised their TBC is the death benefits dependant of an individual who died, they will not be able to receive a death benefit income stream without exceeding their TBC. The death benefit cannot be retained in accumulation phase, so the amount will need to be cashed out or transferred in specie to the death benefits dependant as a death benefit lump sum.

This will result in assets (or cash equivalent where the assets were sold prior to transfer to facilitate the payment of the death benefit lump sum) leaving the concessional superannuation environment. Given the current contribution cap settings,[9] in the decades ahead, the value held in high balance superannuation funds[10] will be transferred out of superannuation and will not be able to be contributed back in. The substantial transfer of billions of dollars out of superannuation assets will pose inevitable questions as to where that wealth will rest.

Options

Division 7A

The government has acknowledged that the rules in Div 7A are in great need of reform. However, the passage of more than eight years since the post-implementation review of Div 7A by the Board of Taxation was commissioned in 2012 illustrates the enormous challenge in designing workable reforms.

It will be essential for the profession to constructively engage with the various stakeholders to ensure that the policy objective is reasonable and that the enacted provisions are workable, sensible and equitable.

Tax rate differential

The single most significant issue within our tax laws driving the behaviours which Div 7A is designed to combat is the variance in tax outcomes as between companies, trusts and individuals. A properly designed tax system addressing these differences and appropriately balancing the tax mix between income and consumption taxes would alleviate the need for such complex 'anti-avoidance'-type provisions such as Div 7A. These issues are discussed and addressed throughout the *Case for Change* paper.

Aligning the s 99A rate with the corporate tax rate would resolve most Div 7A issues

It is common in small to medium-sized enterprise groups for a company to lend funds (whether its own funds or funds borrowed as the financier within a business group) to a related trust. The funds are used by the trust to acquire the business premises or plant and equipment that is leased or made available to the company which carries on the business. This arrangement ensures that the business assets are sufficiently protected. However, the arrangement requires the trust to manage the loan according to Div 7A complying loan terms, or be exposed to being assessed on a deemed dividend generally equal to the amount of the loan funds. There is no mischief or private use of the funds.

As an alternative to the current approach to the taxation of trusts, if the rate applicable to funds retained by a trustee under s 99A ITAA36 is aligned with the business tax rate on a universal entity basis, there would be no difference between the corporate tax rate and the rate imposed under s 99A. This would allow an outcome similar to what currently happens when one company lends to another private company (i.e. the loan is excluded under s 109K ITAA36).

The alignment of the tax rates would also, in many cases, likely eliminate the incentive for taxpayers to establish corporate beneficiaries of trusts.

Allow an 'otherwise deductible rule' for loans made for a taxable purpose

Alternatively, there should be an 'otherwise deductible rule' (akin to the 'other deductible rule' in the FBT laws) which excludes a loan made by a private company to another related entity from being subject to Div 7A where the loan is:

- genuine;
- made in accordance with the powers of the trustee or the company constitution and does not contravene the relevant provisions of the *Corporations Act 2001* (Cth) (such as the provisions relating to directors' duties and trading while insolvent); and
- made for a taxable purpose (for example, to acquire a business, business premises or a rental property, or for working capital).

Introduce a self-correction mechanism

While the government announced on 3 May 2016 that a mechanism to allow taxpayers to self-correct breaches of Div 7A would be introduced with effect from 1 July 2016, the start date of the proposed reform has been deferred three times.

Where other reforms are not introduced eliminating the need for Div 7A, The Tax Institute supports the introduction of a self-correction mechanism as soon as possible. It should also be accompanied by a limited-period amnesty (akin to that offered by PS LA 2007/20 in 2007 and 2008) to allow taxpayers to address existing loans that don't comply with Div 7A.

Proposed reforms

Where other reforms are not introduced due to the passage of time since the original announcement of the reforms to Div 7A on 3 May 2016, the various transitional dates should be modified.

Consideration should also be given to:

- the introduction of equitable transitional rules for existing seven-year loans;
- providing workable safe harbours for the use of company assets;
- introducing more streamlined default loan terms;
- simplifying complying loan arrangements/agreements; and
- a one-off 'tick-the-box' election for exemption from Div 7A for loans to trusts (see below).

The Board of Taxation's 2014 *Post-implementation review of Division 7A of Part III of the Income Tax Assessment Act 1936*[11] recommended that there be a one-off, tick-the-box election for exemption from Div 7A whereby trusts could be eligible to make a 'once-and-for-all election' to exclude loans from companies.

The policy rationale behind the 'tick the box' approach was to place company-to-trust loans on the same legal footing as inter-company loans with the understanding that small businesses might operate both companies and trusts to maximise the benefits that each legal structure offered them.

The Tax Institute affirms this recommendation, although notes that if a lower business tax rate was applied to all entities, regardless of legal structure, there would no need for a 'tick-the-box' exemption.

Trusts

The taxation of trusts needs to be looked at holistically and in the context of the system as a whole. Consideration should be given to both previous forms of taxation and whether the proportional approach really serves the system well.

Consideration also needs to be given to consistent treatment of the taxation of business income across structures.

The accumulated income of trusts should be taxed at a rate that is more consistent with the reason for the accumulation, that is, the corporate tax rate provides the best surrogate. The number of issues that would be addressed by this simple change are considerable.

There are issues with the interaction of the trust rules with other parts of the legislation (including the international income and credit rules and the CGT rules) and there needs to be a more coherent approach.

The allocation between beneficiaries, generally, could take the model for allocating income that is used for AMITs. The continued attempts to align trust income with tax income of the trust needs a re-think and the question asked, is it really necessary at all?

The taxation of minors needs to be rationalised as it is highly complicated with unintended consequences.

Deceased estates

Addressing the tax exemption on death

The current law reflects a policy intent of ignoring capital gains and losses on death. There is a question as to whether this should be maintained as an appropriate setting in the tax system. The reason for the effective deferral of realisation of a capital gain was to address accusations of the re-introduction of a death tax. Whether that is a valid reason to ignore the capital of a taxpayer on death is questionable, given all other tax liabilities are drawn at death. The deferral of gains on realisation of assets is a practical departure to an economist's view of the taxation of gains over the course of a year. The deferral past death is purely political.

Nonetheless, even if the current setting is maintained, the manner in which this is achieved is open to debate.

A simple outcome with less complexity could be achieved through the provision of a 'choice' to taxpayers. One possible option in this regard could be to treat all assets as having been disposed of for their market value in accordance with general CGT principles. Individuals could then choose on an asset-by-asset basis to treat the transfer (for both sale and acquisition purposes) to have been performed at the asset's cost:

- for a main residence, the treatment would be that which would have applied to the deceased. If a full exemption would have applied to the deceased, no liability arises and the beneficiary acquires the asset at its market value. For a partial exemption, the choice afforded to taxpayers could be a reduction in the new cost base by the amount that would have otherwise been assessable should they not wish for the estate to incur a tax liability. Concessions should be provided to facilitate estates reaching probate;
- for family farms, there may be good reason to defer realisation where the farming business continues to be carried on by a family member; a similar consideration may apply to other types of family businesses. A choice could be provided;
- for trading stock, this would effectively replicate the choices presently available;
- for foreign residents, unless the assets were taxable Australian property, no tax liability would arise in any event;
- for pre-CGT assets, no tax liability would arise in any event; and
- for all other assets, the choice would afford the estate the ability to choose whether to pay tax or not depending upon the asset composition of the estate.

The drafting of such provisions could result in a simpler and better understood regime.

Other CGT reform options

There are three potential options for reforming the cost base rules for properties passing through deceased estates. The first two avenues propose broadening the application of the market value deeming rule in s 128-15(4) ITAA97.

Widen the application of the market value deeming rule on the date of death. The scope of the market value deeming rule on the date of death in s 128-15(4) ITAA97 could be broadened to encompass CGT assets that do not currently qualify for a resetting of the cost base upon death. Although this may result in some currently taxable gains being treated as tax-free, it would improve the operation of the law by minimising the compliance burden of undertaking cumbersome and complicated CGT calculations placed on those whose assets are currently not eligible to reset the cost base of the property to its market value on the date of death.

Other options for deceased estates and wealth taxes

Is there merit in introducing a wealth transfer tax?

It is estimated that, over the next two decades, Australians over 60 years of age will transfer $3.5tr in wealth.[12] Notably, around 78% of the estimated wealth transferred will go to roughly 20% of recipients.[13] This indicates that there is significant inequality in Australia with respect to wealth, and this inequality manifests itself in the realm of inheritance.

The topic of wealth or estate taxes, also known as death duties, has been met with resistance in Australia since their general removal in the 1970s. The history of estate taxes has been usefully outlined in *A brief history of Australia's tax system*:[14]

> **"Estate taxes (death duties)**
>
> Estate taxes were first introduced in the form of probate duties (a tax on property passing by will) charged by courts in the early part of the nineteenth century in

New South Wales. By 1901 estate taxes had been adopted by all of the colonies. The rates were progressive and based on the value of the estate, with reasonably high exemption thresholds, thus limiting the impact on small estates. The duties were an important source of state revenue from the end of the nineteenth century through the first part of the twentieth century. In general, estate duties were relatively low cost to administer and, when introduced, were more readily accepted than a wealth tax, levied throughout a taxpayer's life. Gift duties aimed to ensure that estate duties were not circumvented. In 1914, the federal government also introduced a progressive system of estate taxes to help fund wartime expenses.

By the late 1960s and into the early 1970s, state and federal governments were coming under increasing pressure to amend or remove estate duties. Having not been adjusted since the 1940s, individuals with relatively modest levels of wealth were becoming subject to estate duties. At the same time more wealthy individuals were seen to be avoiding the tax through effective estate planning (Groenewegen 1985). With the increasing impost on smaller estates, estate duties became more costly to administer. Rural producers and small business owners also objected to the taxes on the basis that they impeded business succession.

By the 1970s pressure for estate duty concessions had gradually reduced the tax base. In the end, state tax competition led to the abrupt demise of estate duties. After Queensland dispensed with its tax in 1977, there was concern in other states about emigration of residents and capital and the potential impact of the tax on electoral outcomes (Pedrick 1981). The federal Government also abolished its estate and gift duties in 1979. By 1984 all estate duties had been removed, both state and federal. This occurred despite various tax review committees recommending refinements to improve the equity, efficiency and simplicity of the tax."

This history, and the state of the economy post-COVID-19 necessitating new sources of revenue, is the basis for a healthy discussion as to the merit of introducing[15] a wealth transfer tax in Australia.

The argument in favour of introducing a wealth transfer tax, that wealth inequality in Australia is evidenced by the way wealth is transferred upon death, has already been partly outlined above. In furtherance of that argument, the policy intent underpinning the introduction of a wealth transfer tax would be to minimise that wealth inequality and simultaneously boost government revenue.

In many countries, the wealth transfer taxes are set at, in our opinion, prohibitive rates.[16] In Australia, our tax system already collects revenues on the earning of income and profits and on the transfer of wealth, as set out above. If consideration was given to a wealth transfer tax in Australia, it is our opinion that any rate set should be relatively low as compared to other taxes, for example, 5% above a certain threshold of, say, $2.5m or another reasonable amount. This would appropriately account for other taxes already collected during an individual's lifetime. Nonetheless, it must be noted that such taxes usually collect only a small proportion of overall taxes in jurisdictions where they are levied. Whether the costs of compliance and administration outweigh the benefits of imposing such taxes would need to be examined as part of any consideration.

Administration for deceased estates

As a closing remark, it is noted that there are complexities and excessive burdens imposed on administrators of deceased estates, including lodgment requirements and the need for TFNs. The option for reforming the current inefficiencies due to the requirement for deceased estates to have a separate TFN was put forward by the Inspector-General of Taxation and Taxation Ombudsman in her July 2020 report.[17] We recommend a review of the administrative burdens imposed on deceased estates with a view to improving the system for both taxpayer and administrator.

Options for reform

- Improve the cost base rules for properties passing through deceased estates by (subject to possible exceptions):
  - widening the application of the market value deeming rule on the date of death; and
  - introducing a CGT event to happen on the date of death to reset the cost base.
- Options for deceased estates and wealth taxes:
  - consider the merit of introducing a wealth transfer tax; and
  - remove the separate TFN requirement for simple deceased estates.
- Revisit the taxation of trusts with a view to addressing anomalies in trust income/tax income interactions.
- Consider providing other flexible options for small businesses to operate through (e.g. limited partnerships as flow-through vehicles by abolishing Div 5A ITAA97).
- Allow streaming of all income through trusts consistent with the economic entitlements of beneficiaries.
- Set the accumulated income tax rate for trusts at the corporate tax rate.

Conclusion

The private wealth market is faced with a plethora of rules originally designed to ensure that tax is paid at the right rate at the right time. However, it seems that the rules have become ends in themselves and increasingly complicated without regard to the consequences and behavioural responses that tend to arise. Added to that complication is the lack of coherence and integration across many of the rules with high costs of compliance and administration often in completely ordinary commercial arrangements that do not represent a threat to the Revenue. The rules have

spill-over effects into less sophisticated markets where the costs of compliance are disproportionately excessive. Of course, such inappropriately complicated and costly rules apply in many of the areas that the *Case for Change* has examined, perhaps none more so than the superannuation area (which will be the subject of next month's instalment).

The Tax Institute

References

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9 $25,000 for concessional contributions and $100,000 for non-concessional contributions ($300,000 under the three-year bring-forward rule for eligible individuals).

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11 Board of Taxation, *Post-implementation review of Division 7A of Part III of the Income Tax Assessment Act 1936 – a report to the Assistant Treasurer*, November 2014. Available at https://taxboard.gov.au/sites/taxboard.gov.au/files/migrated/2015/07/Division7a_Report.pdf.

12 J Lin, J Mangan and F Milosavijic, *Back from the dead: Australian inheritance tax*, University of Queensland, August 2018.

13 Ibid.

14 S Reinhardt and L Steel, *A brief history of Australia's tax system*, Tax Analysis Division, Treasury, 4 September 2006. Available at https://treasury.gov.au/publication/economic-roundup-winter-2006/a-brief-history-of-australias-tax-system#P8_113.

15 Many would consider this 'reintroducing'.

16 The UK's rate is 40% above GBP325,000 (with certain exemptions for main residence GBP150,000 and transfers to spouses) plus joint spouse limit can become GBP 650k + 300k; France has a sliding scale for each child beneficiary – over EUR100k: 5% to 45% (nothing for spouse, higher for non-children); the US is complicated but roughly first USD11m exempt then a sliding scale up to 40% between USD11 and USD12m.

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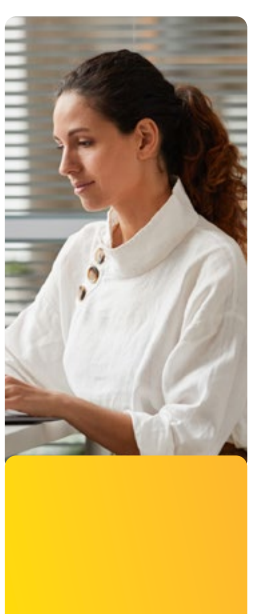
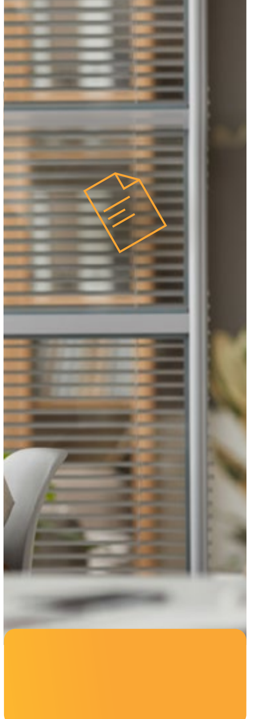

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Five ways that tax litigation is different

by Angela Wood, CTA, Partner, Tax, and Andy Bubb, CTA, Special Counsel, Tax, Clayton Utz

Tax litigation differs from other types of civil litigation in Australia. The legislative framework and its administration by the ATO give rise to considerations which are not relevant in other contexts. In-house tax teams need to be aware of these differences in order to communicate effectively about tax disputes with key stakeholders, particularly senior management, the board of directors and investors. A company's key stakeholders need to be involved in tax litigation to manage broader business risks and because the amounts in dispute can be significant. These stakeholders may be familiar with commercial litigation, so understanding and explaining the differences which arise in tax litigation is critical to ensuring that the organisation's objectives can be met.

Introduction

In this article, the authors compare an income tax appeal by a company in the Federal Court of Australia (FCA) under Pt IVC of the *Taxation Administration Act 1953* (Cth) (TAA53)[1] with a claim for breach of contract, highlighting five key differences. These differences are important because they can inform how tax disputes are managed and explain why the parties might behave in a particular way, even where the relevant rules may not bite until a later time.

Significant information exchange occurs well before litigation

Tax context

Most tax disputes which reach litigation follow an ATO audit, the first stage of which is information-gathering. In an audit, the ATO[2] often issues multiple requests for information so that it can form its view about the level of risk posed by a taxpayer's positions. The ATO sometimes supplements this with interviews to ensure that it has what it considers to be an appropriate level of factual detail to inform its views.

The ATO has a very broad statutory power to require the production of information for the administration or operation of a taxation law.[3] The ATO's normal practice is to seek information without using formal powers,[4] but cooperation is encouraged by the fact that the formal powers exist and carry significant penalties for non-compliance.[5] The ATO can also gather information from third parties, such as a taxpayer's banks, suppliers and investors. Although not standard, broad-ranging fishing requests are allowed.[6]

These information requests allow the ATO to build on the enormous amount of data gathered through tax returns, other lodgment requirements (including country-by-country reports and reportable tax position schedules), and standardised compliance programs such as the justified trust assurance reviews.

Once a contentious issue has crystallised, taxpayers and the ATO spend considerable effort exchanging submissions about the application of the law to the facts. This generally occurs during the position paper stage of an audit, in any independent review or general anti-avoidance rule panel process towards the end of an audit, and also throughout the objections process.

All of these processes mean that the parties are typically well aware of the other side's arguments and potential evidence prior to any litigation being commenced. Arguments for both the taxpayer and the Commissioner are, of course, refined and can evolve during litigation. When evidence is finalised in admissible form, and with the fresh eyes of any additional counsel involved in the litigation phase, new perspectives are brought to the dispute. These shifts in arguments are almost inevitable. However, the long and information-heavy lead up to the litigation reduces the possibility of ambush or surprise.

Once litigation commences, the ATO will generally need to rely on the more limited discovery provisions of the court rules rather than its broad information-gathering powers.[7]

Other contexts

In contrast, parties to contractual disputes do not generally have access to broad, pre-litigation statutory mechanisms to obtain information about another party's case. Unless the parties have contractually agreed to a dispute resolution procedure which involves some degree of information-sharing or a court orders pre-action discovery (which provides only for limited discovery and in limited circumstances), they are generally left to the discovery, subpoena or summons mechanisms in litigation to require their opponent to provide information.[8]

Implications

There are a number of implications of this early information exchange, including:

- ATO audits can be extraordinarily cost intensive, particularly to conduct the burdensome tasks of looking for supportive documents or responding to notices demanding documents which may harm the taxpayer's case. Although much of this exercise now occurs electronically, digitisation has resulted in significantly

more information being created and therefore needing to be reviewed. Further resource intensity also arises if there are complexities concerning legal professional privilege claims, an area of intense ATO interest;[9]

- the process of case review does enable self-reflection by a taxpayer, identifying gaps in its position and developing evidence (lay or expert) to fill these as far as possible;
- the parties to tax litigation are encouraged to assume that discovery will not be necessary or that only limited, targeted discovery will occur.[10] The pre-trial steps in tax litigation are normally focused on preparing and filing submissions and evidence. Although discovery, subpoenas and notices to produce can arise in tax litigation, they are used far less frequently; and
- the parties can be more informed about the strengths and weaknesses of each other's position much earlier in the process, conceivably making successful alternative dispute resolution more likely before proceedings are commenced. Over 90% of the disputes settled by the ATO in the 2021 financial year had not reached litigation.[11]

"... the amount of work which happens during the earlier tax dispute phases ... should not be underestimated."

The "pay now, argue later" regime[12]

Tax context

Where the Commissioner disagrees with a taxpayer's position, he normally concludes an audit by issuing an original or amended assessment to the taxpayer. The tax liability becomes due and payable no later than 21 days after receipt of the assessment.[13] The due date invariably falls prior to a taxpayer exercising its right to object against the assessment, and certainly well in advance of any Pt IVC litigation commencing.

Despite the tax liability being due and payable, the ATO has a policy of entering into 50/50 payment arrangements with taxpayers in certain circumstances where the assessment is disputed.[14] Subject to the ATO's risk assessment in accordance with its own guidelines, and the taxpayer paying half of the primary tax in dispute, the ATO often agrees to not seek to recover the rest of the debt while the dispute continues.[15] Other mechanisms which can satisfy the ATO that it need not take debt recovery action for the full tax liability include the taxpayer entering into a payment plan or providing security.

In a Pt IVC dispute, a taxpayer can commence litigation even if it has not yet paid the tax liability.[16] However, if the taxpayer does not pay the liability or reach agreement with the ATO about management of the debt, the ATO can seek to recover the debt in parallel to objection and litigation processes being pursued by a taxpayer despite the substantive litigation continuing. The ATO can recover the debt by initiating legal proceedings, or the use of its powers to:

- issue a garnishee notice requiring a third party to pay the funds (eg the taxpayer's bank);[17]
- apply to a court for a freezing order preventing the taxpayer's assets from being disposed of, dealt with or diminished in value;[18] and
- issue a creditor's statutory demand for the debt and apply to the FCA to have the taxpayer company wound up if it is insolvent.[19]

Engaging with the ATO can mitigate the chances of any of these steps being taken without advance warning from the ATO to the taxpayer.

Other contexts

Payment of a disputed amount prior to litigation for breach of contract is not required unless this has been agreed in the contract. Rather, an immediate concern regarding payment includes whether the parties continue to make any contracted payments despite the alleged breach. While parties can also use freezing orders and other interlocutory measures to preserve a position while litigation continues, that would rarely extend to payment of disputed funds to one party. Further, it is rarely open for a party to serve a statutory demand on another once litigation has commenced as there would usually be a genuine dispute as to the debt.[20]

Implications

There are a number of implications of the tax debt arising prior to any litigation, including:

- the tax legislation provides the ATO with a powerful position in relation to tax debts. These strong statutory powers typically come to the fore in any hostile disputes where the taxpayer is not being communicative with the ATO or where the ATO considers there is a risk that a tax liability might ultimately remain uncovered; and
- taxpayers need to make arrangements promptly to pay any assessments, negotiate a 50/50 arrangement or reach some other agreed terms so that the ATO does not take recovery action in parallel to the substantive dispute proceedings.

Short filing deadline requires a quick, important decision

Tax context

Where the ATO delivers an adverse objection decision, the taxpayer only has 60 days to commence proceedings in the FCA.[21] The FCA has no power to extend the filing deadline.[22]

As discussed, this short filing deadline is preceded by many interactions with the ATO, normally including an audit and an objection process. However, the short filing deadline means that taxpayers in the objections phase need to be prepared to decide quickly whether proceedings should be commenced. Once a taxpayer has lodged an objection, the ATO can decide it at any time, starting the 60-day clock. The ATO ordinarily communicates with the taxpayer about a forthcoming objection decision and the likely outcome, but even where this occurs, the actual decision generally results in a flurry of activity for the taxpayer in formally deciding how it should proceed.

The short filing deadline does not mean that a hearing will necessarily occur quickly. Both parties may need to prepare and file evidence and submissions, and procedural issues can arise. However, there is an increasing desire of the FCA to actively manage tax litigation as efficiently as possible, including with early identification of key issues in dispute and in relation to managing the amount of witness evidence.[23]

Other contexts

In other commercial matters, the statutes of limitation vary between Australian states and territories, but provide a period of several years to bring civil proceedings. In Victoria, simple contracts generally have a six-year time frame for proceedings to be commenced once an action accrues.[24] Tardy suits for breach of contract may also face defences or counterclaims of misleading and deceptive conduct or various estoppels, but those defences and counterclaims are not an absolute bar to claims.

Implications

There are a number of implications of the short filing deadline following receipt of an adverse objection decision, including:

- during the objection process, taxpayers need to plan as far as possible for the need to make a well-informed decision regarding the commencement of litigation if it becomes necessary. The size and nature of the tax dispute and the taxpayer's business will influence its risk appetite, governance processes and the degree to which other management personnel need to be involved in any decision-making about litigation (eg the CEO, CFO, the general counsel, and the head of public relations). Closely held groups also need to manage the involvement of investors in decision-making. So that a decision about whether to litigate can be made promptly, it is important that these stakeholders are actively engaged before any adverse objection decision is made by the ATO; and
- once proceedings are initiated, certain information filed with the FCA can be accessed by the public and media.[25] It is prudent to be ready to respond to questions or to issue a proactive statement with the taxpayer's comments on the proceedings. Some taxpayers that the authors have worked with have engaged PR firms to assist them with this.

The ATO's broader strategic considerations

Tax context

As the federal government's principal revenue collector, the ATO has strategic considerations which go well beyond any single dispute. Factors that the ATO needs to balance include encouraging voluntary compliance with the law, acting against non-compliance, having the law clarified where necessary, acting fairly between taxpayers, and managing litigation costs.

In deciding whether or not it should settle a dispute, the ATO balances:

- the relative strength of the parties' position;
- the cost versus the benefits of continuing the dispute (eg law clarification, acting against bad taxpayer behaviour); and
- the impact on future compliance for the taxpayer and the broader community.[26]

Taxpayers can only form a view about how the ATO may approach some of these issues. For example, the ATO's willingness to litigate a specific issue often depends on what the ATO is seeing across the taxpayer's industry or in relation to a specific tax issue more broadly, which is based on information held by the ATO and not the taxpayer. The ATO frequently implements programs or taskforces which are targeted at specific issues or industries.[27]

When weighing up these factors, the ATO may determine priorities for cases it would prefer to litigate. Some of these cases may receive test case litigation funding from the ATO where the law is unclear and where the outcome of the dispute will be significant for a substantial section of the public or for an industry.[28] However, the ATO's preferred cases for litigation can be derailed by those taxpayers agreeing to the ATO view or proposing acceptable settlement offers.

Other contexts

Commercial organisations do not have the same responsibilities to encourage compliance within an area they regulate, and do not consider the public interest in the same way as regulators do. Whether they litigate a matter may also be impacted by strategic concerns beyond the litigation itself (eg seeking to discourage other customers or suppliers from breaching their contracts), but these reasons differ in nature to the strategic concerns of a regulator.

Implications

There are a number of implications of the ATO's broader strategic considerations in tax disputes, including:

- the ATO's strategic objectives can have clear implications for how a taxpayer's specific dispute is managed, and this commonly flows into the viability of settlement negotiations;
- how a taxpayer's dispute is managed can change over time due to actions outside the control of both the

taxpayer and even the ATO officers managing the audit or objection on a day-to-day basis. For example, a taxpayer might become the ATO's preferred case for litigation if another taxpayer that was at the head of the queue concedes or settles with the ATO; and

- the ATO's views on the value of law clarification for a particular issue can also change over time, such as if the ATO has an unfavourable court decision and wants to prevent taxpayers from seeking to applying the decision in a widespread manner.

Taxpayers bear a heavy burden

Tax context

Taxpayers bear the burden of proof in tax matters,[29] with the standard of proof being the balance of probabilities.[30] There are two statutory requirements which make the taxpayer's burden decidedly heavy in practice.

First, the taxpayer must prove not just that the ATO's assessment is excessive, but also the specific amount that the assessment should have been.[31] This brings the scope of the dispute into focus, and highlights the benefit to taxpayers from agreeing to the scope of the dispute with the ATO. Often this occurs through the parties' submissions to the FCA prior to trial, but there can be great benefit in this occurring earlier. If the scope of a dispute remains relatively wide, the burden on the taxpayer can be more onerous.

In *FCT v Dalco*, Brennan J explained:[32]

> "If the Commissioner and a taxpayer agree to confine an appeal to a specific point of law or fact on which the amount of the assessment depends, it will suffice for the taxpayer to show that he is entitled to succeed on that point. Absent such a confining of the issues for determination, the Commissioner is entitled to rely upon any deficiency in proof of the excessiveness of the amount assessed to uphold the assessment …"

In the process of seeking to confine the scope of the dispute, taxpayers might be facilitated by the Commissioner's obligations as a model litigant, which includes "endeavouring to avoid, prevent and limit the scope of legal proceedings wherever possible".[33]

Second, the taxpayer is confined to its grounds of objection unless the FCA orders otherwise.[34] In contrast, the Commissioner can defend the assessment on any basis, which enables new arguments that have not been raised at an earlier stage of the dispute. The Commissioner introducing a new basis for defending an assessment will bear favourably on the court allowing the taxpayer to amend its grounds of objection.[35]

The recent FCA decision in *SingTel* provides an example of the Commissioner refining his arguments in defence of an assessment, where the Commissioner was permitted to change the basis on which he had calculated the transfer pricing benefit.[36] The court determined that although the Commissioner's calculations had changed since the assessment was issued, that was permissible because the Commissioner had (in a more general sense) made his determinations on the basis that a transfer pricing benefit arose, which was still the case.

Other contexts

The burden of proof typically requires the claimant to prove, on the balance of probabilities, that each element of a breach of contract is established. Defendants will generally bear the onus of proving any defences or counterclaims such as estoppels or exclusion clauses. However, the burden operates without the additional statutory provisions discussed above in a tax context.

Implications

There are a number of implications of the taxpayer's heavy burden, including:

- because the Commissioner has a more flexible statutory position than taxpayers, little comfort can be drawn from any concessions by the Commissioner outside of litigation, such as in an objection decision. Surprises in tax litigation do happen from time to time; and
- taxpayers should consider trying to satisfy the Commissioner of as many matters possible, confining the dispute, in order to avoid needing to satisfy a court of those matters with admissible evidence at a later time. The lengths that taxpayers may need to go to in order to discharge the burden of proof are significant, particular given that it is not uncommon for tax disputes to be litigated more than 10 years after the relevant events took place.

Conclusion

Understanding these five differences, at least at a thematic level, will assist tax teams in providing insights to other areas of their businesses and enable better decision-making about managing tax disputes.

Critically, the amount of work which happens during the earlier tax dispute phases, particularly during the information-gathering and position paper stages of an ATO audit, should not be underestimated. The large majority of tax disputes are resolved well before litigation. This means that it can be worthwhile to invest early to gather evidence and engage with the ATO in a timely manner, and costly to defer this work until the dispute has crystallised and decisions need to be made in a truncated fashion.

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References

1 Part IVC tax disputes are those which follow an adverse objection decision from the ATO.

2 The authors have referred to the ATO and the Commissioner of Taxation (Commissioner) interchangeably throughout this article.

3 S 353-10(1), Sch 1 TAA53.

4 Australian Taxation Office, *Our approach to information gathering*. Available at www.ato.gov.au/about-ato/commitments-and-reporting/in-detail/privacy-and-information-gathering/our-approach-to-information-gathering/?page=14#Reasons_for_issuing_a_notice.

5 Ss 8C and 8E TAA53.

6 *Australia and New Zealand Banking Group Ltd v Konza* [2012] FCAFC 127 at [39]–[41].

7 Doing otherwise may be a contempt of court in certain circumstances. See *FCT v De Vonk* (1995) 133 ALR 303 at 322–326.

8 Pt 20 of the *Federal Court Rules 2011* (Cth). Preliminary discovery is sometimes available before any proceedings are commenced (r 7.23 of the *Federal Court Rules 2011*).

9 In September 2021, the ATO released its legal professional privilege protocol, which the ATO says contains its "recommended approach for claiming LPP and providing [taxpayers] with information on what you can expect from us in different situations where you claim LPP". Available at www.ato.gov.au/law/view/document?docid=SGM/LPP. See also to the recent FCA decision in *FCT v PricewaterhouseCoopers* [2022] FCA 278.

10 Taxation Practice Note (TAX-1) of the FCA, para 7.1.

11 Australian Taxation Office, *Commissioner of Taxation Annual Report 2020–21*, p 188, Table 6.7. Available at www.ato.gov.au/uploadedFiles/Content/CR/downloads/ATO_annual_report_2020-21.pdf.

12 The statutory regime for payment of tax debts was described in this way in the taxpayer's submissions in *CPG Group Pty Ltd v DCT of the Commonwealth of Australia* [2019] VSC 146 at [59].

13 S 5-5(4) and (7) of the *Income Tax Assessment Act 1997* (Cth).

14 Paras 26 to 45 of PS LA 2011/4.

15 Paras 27 to 28 and 44 to 45 of PS LA 2011/4, and para 22 of PS LA 2011/6.

16 This is in contrast to some state taxes, where the liability must be paid in full before a taxpayer can commence court proceedings. For example, see *Taxation Administration Act 2001* (Qld), s 69(1)(b), and *Reid v Commissioner of State Revenue* [2021] QCAT 322.

17 S 260-5, Sch 1 TAA53. For example, see *Ultra Thoroughbred Racing Pty Ltd v FCT* [2013] FCA 1300.

18 R 7.32 of the *Federal Court Rules 2011*. For example, see *DCT v State Grid International Australia Development Co Ltd* [2022] FCA 139.

19 Pt 5.4 of the *Corporations Act 2001* (Cth). For example, see *DCT v Broadbeach Properties Pty Ltd* [2008] HCA 41.

20 S 459H of the *Corporations Act 2001*.

21 S 14ZZN TAA53. The AAT has the same 60-day time frame (s 14ZZC TAA53) and, unlike the FCA, it has a discretion to extend the time for commencement of proceedings.

22 For example, see *Abuothman v FCT* [2007] FCA 1026 at [44]–[49].

23 Many of these processes are mentioned in Taxation Practice Note (TAX-1) of the FCA, including an outline of the conduct of case management conferences (paras 5.7 to 5.11), the limited nature of discovery (paras 7.1 and 7.2), and the approach to evidence and witnesses (paras 7.3 to 7.6).

24 S 5(1) of the *Limitations of Actions Act 1958* (Vic).

25 Div 2.4 of the *Federal Court Rules 2011*.

26 Australian Taxation Office, *Practical guide to the ATO code of settlement*. Available at www.ato.gov.au/general/dispute-or-object-to-an-ato-decision/in-detail/avoiding-and-resolving-disputes/settlement/a-practical-guide-to-the-ato-code-of-settlement/.

27 Recent examples include the Tax Avoidance Taskforce (available at www.ato.gov.au/general/tax-avoidance-taskforce/), the intangibles migration cluster (available at www.ato.gov.au/General/Consultation/In-detail/Stewardship-groups-minutes/Large-Business-Stewardship-Group/Large-Business-Stewardship-Group-key-messages-24-July-2019/), and the pharmaceuticals cluster (available at www.ato.gov.au/Business/International-tax-for-business/In-detail/Pharmaceuticals-Cluster/).

28 Australian Taxation Office, *Test Case Litigation Program*. Available at www.ato.gov.au/tax-professionals/tp/test-case-litigation-program/.

29 S 14ZZO(b) TAA53.

30 S 140 of the *Evidence Act 1995* (Cth).

31 S 14ZZO(b)(i) TAA53.

32 [1990] HCA 3 at [14].

33 Cl 2(d) of App B to the *Legal Services Directions 2017* (made under s 55ZF of the *Judiciary Act 1903* (Cth)).

34 S 14ZZO(a) TAA53. For example, see *Sibai v FCT* [2021] FCA 1353 at [91].

35 For example, see *Clark v FCT* [2007] FCA 1426 at [31]–[33].

36 *Singapore Telecom Australia Investments Pty Ltd v FCT* [2021] FCA 1597 at [353] (*SingTel*).

Section 100A and tax purpose

by Mark West, CTA, Principal, West Garbutt

The view that tax purpose limits the extent of the "ordinary family and commercial dealing" exclusion from the meaning of "reimbursement agreement" in s 100A of the *Income Tax Assessment Act 1936* is central to the views expressed in TR 2022/D1. This view is claimed to be supported by past case law. But a disciplined analysis of the exact words of s 100A in the context of the approach to statutory interpretation prescribed by the High Court, and past case law, raises serious questions over the correctness of this approach in TR 2022/D1. Instead, the words of s 100A (and the context provided by those words) support a meaning of "ordinary family and commercial dealing" directed to the objective characteristics of the steps and actions taken under a reimbursement agreement – without regard to purpose. This approach is particularly relevant to "ordinary family dealing" where, unlike commercial dealing, it is ordinary for steps and actions to be taken, with characteristics reflecting long-term cooperation with other family members and a lack of self-interest.

Introduction

In TR 2022/D1, issued on 23 February 2022, the ATO acknowledges an "alternative view" (the second acknowledged) in Appendix 3, headed "Tax avoidance not relevant to ordinary dealing exception".

Predictably but disappointingly,[1] the ATO dismisses that alternative view without a proper consideration of the issues.

The ATO introducing that alternative view as "tax avoidance" is unhelpful, when the view is simply that:

- under the principles of statutory interpretation set out consistently by the High Court, the meaning of "ordinary family dealing" should be ascertained from the words, and context provided by those words, in s 100A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36); and
- those words, and that context, do not support that the "ordinary family dealing" exclusion in s 100A should be read down by reference to tax purpose.

The meaning of ordinary commercial (as well as family) dealing is equally affected but because commercial dealings can generally be expected to be conducted on a basis of self-interest, strong tax purposes tend to result in commercial dealings that are "non-ordinary" in other objective ways, even ignoring tax purpose. This has been the story of the historical case law dealing with s 100A.

Family dealings are far more complex. They are relationship-based, not transactional. Consequently, they are long-term and, by their nature, are not self-interested in the same way as commercial dealings. Tax purposes can very well co-exist with other family *purposes* and *actions* that do not follow self-interest, and which may seem "non-ordinary" if tax purpose is the primary measure. Hence, the tax purpose question is typically more acutely relevant to the ordinary family dealing exclusion.

This article seeks:

- to more fully explain the technical basis for the "alternative view" as previously raised in the paper by Alex Whitney and this author, "Trusts – 100A reimbursement agreements; identifying and reducing taxpayer risks", presented at The Tax Institute's Qld Tax Forum in May 2021 (May 2021 paper); and accordingly
- to question the ATO's approach as set out in its recently issued TR 2022/D1 and consequently in its associated PCG 2022/D1.[2]

It is not proposed here to deal with s 100A more widely, only this tax purpose question as it relates (mainly) to "ordinary family dealing".

The May 2021 paper can be reviewed for the author's views on other aspects of s 100A. Extracts from that May 2021 paper are used here only to help define the critical nature of the tax purpose question, and to explain the "alternative view".

When one considers the statements and examples used throughout TR 2022/D1 and PCG 2022/D1, it is submitted that this tax purpose question is the critical difference between how taxpayers see s 100A (and how s 100A has been applied for the past 40 years by the ATO) and the views now being advanced by the ATO.

With respect, the author understands the view about tax purpose in s 100A as advanced in this article to be narrower than that expressed by Logan J in *Guardian AIT Pty Ltd ATF Australian Investment Trust v FCT*.[3] As cited by the ATO (and later noted below), Logan J seemed to accept[4] the relevance of the history of the phrase "in the course of ordinary family or commercial dealing", as coming from *Newton v FCT*,[5] to s 100A.

Still, Logan J warned that:[6]

> "These observations are, with respect, helpful in terms of an understanding of the 'old arguments'. But the position remains that they are not a substitute for the text adopted by parliament."

Also, importantly, Logan J's comments on tax purpose were not strictly part of the *ratio* of the *Guardian AIT* decision, which the author understands to have been that there was no "agreement" as defined.[7]

In any case, the author expects the tax purpose issue to be very relevant in the appeal of *Guardian AIT*.

As in the May 2021 paper, even if others take different views of the relevance of tax purpose to the meaning of ordinary family dealing, this article will have served a purpose if it contributes to a more detailed and disciplined analysis of the law, represented by the exact words of s 100A, relating to that critical issue. Only on that basis will taxpayers and the ATO achieve greater certainty of the effect, and practical implications, of s 100A.

Aspects of an "agreement" generally

It assists the discussion that follows to first reflect that any "agreement" can be referred to by way of different features of the agreement:

- a **purpose** – which might be said to set the *direction* of the agreement, what it aims to achieve (where there may be multiple such aims);
- the **steps or actions** prescribed (or provided for) under the agreement – which might be described as the *journey*; and
- an **outcome or effect** (from the steps/actions) – which should (if all goes well) accord with the purpose (but where there may be multiple outcomes to match multiple purposes), and which might be described as the *destination(s)*.

A journey can have its own features independent of the underlying direction or the destination. It is logically possible that a journey could be the focus of a test of "ordinariness", without being always controlled or defined by the direction set or the destination reached. Such an approach may be deliberately adopted to test the desired "ordinariness" of the actions or steps in an objective way, while deliberately excluding questions of purpose or effect.

When s 100A(13) refers to the exclusion from an agreement (and therefore exclusion from a reimbursement agreement) of family or commercial dealings which have a certain "ordinary" nature, it is legitimate to question what aspect of the subject agreement is being tested for its "ordinariness".

In short, this article seeks to highlight that:

- s 260 ITAA36,[8] to which *Newton's* case[9] related, was a provision directed to the *purpose* or *effect* of an agreement,
- while s 100A is a provision directed to the *steps or actions* prescribed under an agreement.

This is a significant difference to which, in the author's view, insufficient express attention has been directed to date. But this difference is submitted to have been implicitly accepted in the past. It explains why s 100A has been administered in a far less controversial manner for the last 40 years, before the ATO has sought to test how the section could be made to apply more widely, with its 2014 guidance and following examples.

By starting from the assumption that the meaning of "ordinary family dealings" derives from *Newton's* case, admittedly based on certain observations (but only observations) in the case law,[10] the ATO in TR 2022/D1 (and indeed the discussion generally with taxpayers and advisers) has tended to focus on what is ordinary within that "purpose or effect" context derived from *Newton*.

The ATO states that "a dealing is not ordinary family or commercial dealing merely because it is commonplace or involves no artificiality".[11] Aside from the noteworthy narrowing of "ordinary" adopted here by the ATO (by discarding any requirement of artificiality for something to *not* be ordinary), the particular view of ordinariness developed from this point further in TR 2022/D1 is "trapped" in its insistence that the meaning comes from *Newton*.

This is evident, for example, in para 27,[12] which states that "to be in the course of ordinary dealing, the transactions between family members and their entities must be capable of explanation as achieving normal or regular familial or commercial ends". Ends means outcome or effect, as directed by a pre-existing purpose.

Where exactly does this "purpose or effect" context come from in s 100A?

As explained below, the words of s 100A(7) that cause agreements to be reimbursement agreements are about the steps or actions under the subject agreement. They are not about purpose or effect. The context of the words "ordinary family or commercial dealing" in s 100A is in relation to such reimbursement agreements involving steps or actions, where they are used to identify the exclusion of (such reimbursement) agreements "entered into *in the course of* ordinary family or commercial dealing" (emphasis added).[13]

This is a significantly different context to one using "ordinary family or commercial dealing" to identify agreements entered into for a purpose or which have a particular purpose or effect.

Attention is directed to different aspects of an agreement by the different contexts.

It is submitted that s 100A can operate perfectly well (and correctly, as it has for 40 years) on this "steps or actions" basis, achieving its statutory purpose (and only that purpose) as was intended by parliament.

Wishing to maintain a focus on the correct legal interpretation of s 100A, this article does not seek to engage with the history of s 100A, from which a reader can obtain a sense of the purpose of s 100A, in a wider non-statutory interpretation sense.

The author would refer readers to the historical summary included in Michael Butler's excellent 2019 article, "Section 100A: when is a dealing between members of a family not in the course of ordinary family dealing?", presented at The Tax Institute's 2019 National Convention, which provided a comprehensive review of the history of the provision.

Words and structure of s 100A: relevance of tax purpose

We must start with the text of the section itself.

The key "operative" provision is s 100A(1), which deems a beneficiary to not be presently entitled to income of a trust estate where that entitlement arises out of a "reimbursement agreement". That section is quoted below:

> "(1) Where:
>
> (a) apart from this section, a beneficiary of a trust estate who is not under any legal disability is presently entitled to a share of the income of the trust estate; and
>
> (b) the present entitlement of the beneficiary to that share or to a part of that share of the income of the trust estate (which share or part, as the case may be, is in this subsection referred to as the ***relevant trust income***) *arose out of a reimbursement agreement* or *arose by reason of* any act, transaction or circumstance that occurred in connection with, or as a result of, a reimbursement agreement;
>
> the beneficiary shall, for the purposes of this Act, *be deemed not to be, and never to have been, presently entitled to the relevant trust income*." (emphasis added)

If s 100A applies, the amount of income to which the beneficiary is deemed not to be entitled to is taxed to the trustee at the trustee taxation rates. There is no amendment period restriction on s 100A.[14]

The nexus between the present entitlement subject to potential adjusted treatment (from taxation to the beneficiary to the trustee) and a "reimbursement agreement" is provided by way of the words "arose out of" or "arose by reason of".

From the start, it can therefore be noted that s 100A does not test the act of distributing to the beneficiary, including for some tax avoidance purpose. Section 100A asks:

- whether there is a "reimbursement agreement", as defined; and then
- whether the present entitlement "arose out of" or "arose by reason of" that agreement (or any act, transaction or circumstance that occurred in connection with, or as a result of, the agreement).

(Section 100A(2) applies the same treatment as s 100A(1) to beneficiaries who have actually been paid amounts, or had amounts applied to their benefit from, the income of a trust estate. It is otherwise identical to s 100A(1).)

Section 100A(7) is the first of the key "interpretative" provisions in s 100A. That section is quoted below:

> "(7) Subject to subsection (8), a reference in this section, in relation to a beneficiary of a trust estate, to a *reimbursement agreement* shall be read as a reference to an agreement, whether entered into before or after the commencement of this section, that *provides for* the *payment of money or the transfer of property to, or the provision of services or other benefits for, a person or persons other than the beneficiary or the beneficiary and another person or other persons*." (emphasis added)

A "reimbursement agreement" therefore requires a payment of money, transfer of property, provision of services or other benefit to pass to a person other than the beneficiary that is presently entitled.

This is a very wide scope. Beneficiaries will always do these things – referred to as "actions or steps" in this article – in the normal course of consuming or otherwise directing the use of their trust entitlement. For example, even if a beneficiary receives their trust entitlement fully in cash, the beneficiary will make payments and transfers to other people as they spend that entitlement.

The key points from s 100A(1) and (7) are whether there is an "agreement", as defined:

- that provides for these things – the actions or steps; and
- out of which or by reason of which, the subject trust entitlement "arose".

Section 100A(8) modifies s 100A(7) to *exclude* agreements without a tax purpose. The section is quoted below:

> "(8) A reference in subsection (7) to an agreement shall be read as *not* including a reference to an agreement that was *not* entered into for the purpose, or for purposes that included the purpose, of securing that *a person who, if the agreement had not been entered into, would have been liable to pay income tax* in respect of a year of income would *not be liable to pay income tax* in respect of that year of income or would *be liable to pay less income tax* in respect of that year of income than that person would have been liable to pay if the agreement had not been entered into." (emphasis added)

That s 100A(8) must be read with s 100A(9), quoted below:

> "(9) For the purposes of subsection (8), an agreement shall be taken to have been entered into for a particular purpose, or for purposes that included a particular purpose, *if any of the parties to the agreement* entered into the agreement for that purpose, or for purposes that included that purpose, as the case may be." (emphasis added)

Therefore, a reimbursement agreement will not exist where the agreement was not entered into for the purpose (either sole or with other purposes) of reducing the income tax payable of a person.

The "person" does not have to be the beneficiary presently entitled, the person receiving benefits under s 100A(7) or any other specific person.

The s 100A(8) exclusion will not apply if any of the parties to the agreement had a tax reduction purpose.

The author's reading is that this must mean a subjective purpose because it relates to each individual, not the overall objective purpose or effect of the agreement or a scheme. This can be contrasted with the determination of objective purpose required under Pt IVA ITAA36.

It may be arguable that it is one or more of the parties to the agreement who must have the requisite purpose (rather than another person, such as a controller) but, due to the wide definition of agreement, this distinction may only be academic.

In summary, the author's understanding is that there is stated in s 100A a "non-tax purpose" exclusion, but it is a very narrow exclusion – narrower than a lack of an objective tax-related purpose.

With respect, the author understands this to be a narrower view of exclusions under s 100A(8) and (9) than provided by the process followed by Logan J in *Guardian AIT*.[15] (The author would be happy to be proved wrong on this point.)

The sole mention of tax purpose in s 100A is in this *exclusion* under s 100A(8) and (9) – as a reference to the *lack* of tax purpose. On the words of s 100A, tax purpose does not cause inclusion of any "agreements", as defined.

Section 100A(13) is, in the author's view, the critical subsection to consider in detail, because it:

- sets out a very wide meaning of an "agreement" – which causes the concept of "reimbursement agreement" to be very wide; and then
- contains what are the substantive exclusions from (that otherwise very wide scope of) "reimbursement agreement".

Section 100A(13) defines agreement to be:

> "… any *agreement, arrangement or understanding*, whether formal or informal, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings, *but does not include* an agreement, arrangement or understanding *entered into in the course of ordinary family or commercial dealing*." (emphasis added)

This subsection gives the basis of the "ordinary family dealing" or "ordinary commercial dealing" exceptions to s 100A.

There is fundamental disagreement between taxpayers and the ATO about the interpretation of the ordinary family dealing exclusion, mainly over how much of the meaning of the term "ordinary family dealing" in s 100A can properly be drawn from *Newton's* case[16] (from which the wording appears to have been derived).[17]

Key observations from the wording for the relevance of tax purpose

The focus of s 100A is not purpose – tax or otherwise – and the exclusions from what is a reimbursement agreement must be given effect.

The focus of the section is whether there is a reimbursement agreement, as objectively defined, and whether the stated exclusions from that concept apply – not whether the act of distributing the trust income in a particular way has a tax purpose.

The concept of "reimbursement agreement" relates to objectively stated actions or steps that may be taken by any beneficiary in the ordinary course of consuming or directing the use of their entitlement.

Tax purpose – or, more correctly, the lack of it – arises in connection with s 100A only as a very limited exclusion from such a reimbursement agreement.

The exclusions that substantively prevent s 100A from applying to all of those circumstances in which a beneficiary ordinarily consumes or directs the use of their entitlement are the ordinary family or commercial dealing exclusions from the meaning of "agreement".

It is acknowledged that those exclusions are directed to agreements:

- **entered into** – which directs attention to the beginning of an agreement, at which point purpose *could* be a focus; and
- **in the course of** – which is used in contrast to the wording in s 260 ("so far as it has or purports to have the purpose or effect"). It does not direct a consideration of purpose but that the agreements to be excluded must be part of a wider context of ordinary family or commercial dealing.

In the overall context of the words of s 100A and, specifically, of reimbursement agreements as defined, it is submitted the "in the course of" context would usually be that of ongoing family relations in a typical family that shares and "collectively consumes" family resources over time.

On the words, tax purpose is not a part of the exclusions for ordinary family or commercial dealing. Without more, the words do *not* require that:

- a *presence* of tax purpose should limit the scope of these ordinary family or commercial dealing exclusions – thereby expanding the scope of s 100A; or
- an *absence* of tax purpose should expand the scope of these ordinary family or commercial dealing exclusions – thereby reducing the scope of s 100A.

Those ordinary family or commercial dealing exclusions operate to limit an agreement, arrangement or understanding "that provides for" the objectively stated actions or steps which would otherwise be included within the meaning of a "reimbursement agreement".

Accordingly, when applying the concept of ordinary family or commercial dealing in s 100A, it is submitted that the context requires the exclusion (from a reimbursement agreement) of an agreement, arrangement or understanding the steps or actions of which have the objective characteristics of being entered into in the course of family or commercial dealings that are "ordinary" in the way a

beneficiary takes actions or steps to consume or direct the use of their entitlement – those actions being what define a "reimbursement agreement".

Tax purpose is not relevant to this exclusion on the words unless some extra meaning of "ordinary family dealing" is to be imported onto s 100A from elsewhere. Otherwise, on the words of s 100A, tax purpose is relevant only as a (limited and separate) exclusion.

Of course, such an importation of meaning is what the ATO advances in TR 2022/D1.

TR 2022/D1: a tax avoidance section and a composite phrase

TR 2022/D1 includes many references to s 100A being an "anti-avoidance provision" (7 times) and to tax avoidance generally (14 times).

The anti-avoidance nature of s 100A is elevated by the ATO to be the relevant statutory context for the phrase "ordinary family or commercial dealing":[18]

> "78. Statutory context is relevant. Section 100A is an income tax anti-avoidance provision. As observed in the leading judgment of Hill and Sackville JJ in *Prestige Motors* [footnote 44]*:*
>
> > The wording of the exclusion in s 100A(13) derives from the judgment of Lord Denning, on behalf of the Privy Council, in *Newton v Federal Commissioner of Taxation* (1958) 98 CLR 1, at 8. There his Lordship, in discussing s 260 of the ITAA, contrasted an arrangement implemented in a particular way to avoid tax with 'transactions that are capable of explanation by reference to ordinary business or family dealing'.
>
> 79. The essential feature of ordinary family or commercial dealing is that it is ordinary. Consistent with the approach of the Court in *Newton*, dealing is ordinary where a person can examine the acts and predicate that they can be explained by the familial and/or commercial objects they are apt to achieve without further explanation. [footnote 45] This predication test is an evaluative standard that requires an examination of the facts and circumstances of each case. It is the test by which the composite phrase 'ordinary family or commercial dealing' is interpreted in the statutory context in which it appears (an anti-avoidance provision). This test cannot be substituted with an approach that classifies transactions by reference to a dictionary meaning or synonym for the word 'ordinary' separate from statutory context. Dealing is not ordinary just because it is commonplace. [footnote 46] Similarly, dealing can fail to be ordinary dealing even where it is not artificial. [footnote 47]"

The footnotes are also relevant to understanding the ATO approach:

> "44 [*FCT v Prestige Motors Pty Ltd as Trustee of the Prestige Toyota Trust*], at [221–222], per Hill and Sackville JJ, Beaumont J agreeing. That the Parliament had deliberately chosen to use the phrase 'ordinary family or commercial dealing' in the text of subsection 100A(13) following *Newton* has been more recently confirmed in *Guardian* at [137–138], per Logan J.
>
> 45 In the formulation in *Newton,* without further explanation was 'without necessarily being labelled as a means to avoid tax'. See the following passages from *Newton:*
>
> > Their Lordships are of opinion that the word 'arrangement' is apt to describe something less than a binding contract or agreement, something in the nature of an understanding between two or more persons – a plan arranged between them which may not be enforceable at law. But it must in this section comprehend, not only the initial plan, but also all the transactions by which it is carried into effect – all the transactions, that is, which have the effect of avoiding taxation, be they conveyances, transfers or anything else. …
> >
> > Applying these principles to the present case, the first question is – Was there an arrangement? The answer is 'Yes'. The whole complicated series of transactions must have been the result of a concerted plan; and the nature of the plan is to be ascertained by the overt acts done in pursuance of it.
>
> 46 Gibbs CJ in *Commissioner of Taxation (Cth) v Gulland* [1985] HCA 83 (*Gulland)* observed that the phrase adopted by the Privy Council in Newton was intended to '… refer to what was normal or regular, rather than to what had become common or prevalent' and was made 'by way of contrast to the words "without necessarily being labelled as a means to avoid tax" …'.
>
> 47 In our view, the observations of Logan J in *Guardian* at [144–5] are illustrative of a type of dealing that is not ordinary family or commercial dealing; and are not strictly contrary to the view that there may be other categories of dealing which similarly cannot be so classified."

In this way, the ATO seeks to import the tax avoidance purpose as relevant to limiting the exclusion represented by "ordinary family dealing" in s 100A.

Further understanding of the ATO thinking can be drawn from the specific comments made in Appendix 3 in rejecting the alternative view.

Only there[19] (far removed from the ATO's earlier reference, per para 78 cited above, to comments made by Hill and Sackville JJ about *Newton*) does the ATO acknowledge the warning included in the immediately following paragraph in *Prestige Motors*:

> "There is a danger that, when words used in a judgment are translated into the legislation, the change of context may alter the meaning of the words from that which they originally bore."

The ATO also chooses to omit the end of the same paragraph which states that tax purpose was *not* the basis of the decision in *Prestige Motors*.

For this reason, it is useful to cite the full paragraph:[20]

> "*There is a danger that, when words used in a judgment are translated into the legislation, the change of context may alter the meaning of the words from that which they originally bore.* It is clear from both the judgment of the Privy Council and from the language of the High Court on the same case (*Federal Commissioner of Taxation v Newton* (1957) 96 CLR 578) that s 260 was regarded as involving a dichotomy. A transaction was either stamped as one entered into to avoid tax or as one about which it could be predicted that it was entered into in the course of ordinary family or commercial dealing. In the former case the transaction was caught by s 260; in the latter case it was outside the section. *We do not need to decide in the present case whether s 100A imports a similar dichotomy. In particular we do not need to decide whether if an agreement is shown to have been 'entered into in the course of ordinary commercial dealing', the operation of s 100A is spent, regardless of whether the commercial purpose was subsidiary to the purpose of tax avoidance. In our view, none of the transactions was entered into in the course of ordinary commercial dealing.*" (emphasis added)

The ATO tries to "reintroduce"[21] tax purpose as the basis for the decision in *Prestige Motors* to support rejecting the alternative view, that tax purpose is not relevant to the meaning of "ordinary family or commercial dealing".

But if Hill and Sackville JJ are to be taken to mean what they said, they did not decide *Prestige Motors* based on tax purpose. No such statement appears in the judgment. It is not possible to reconcile the statement by Hill and Sackville JJ that they did *not* need to decide on the dichotomy point, with a *ratio* of the decision based on rejecting commercial "ordinariness" because of tax purpose, that is, if Hill and Sackville JJ (as the ATO incorrectly claims[22]) held tax avoidance purpose to be the reason that the commercial agreements were not ordinary.

Per para 167 of TR 2022/D1, tax motivations were noted but it was the design of certain steps and the lack of commercial justification for certain steps (that the steps existed at all, eg the raising of money from NMLA) that led to the conclusion "none of the transactions was entered into in the course of ordinary commercial dealing"[23] – not the tax purpose itself of those steps.

The last sentence of para 167 omits relevant comments and also appears to misquote from *Prestige Motors* in relation to the first (business purchase) arrangement. The correct full quote is:[24]

> "Mr Bloom did not suggest that there was any commercial motivation for the sale of the Business. In the circumstances, the sale can be seen as one element of a larger one-off transaction designed to avoid tax. It cannot be described as an agreement entered into in the course of ordinary commercial dealing."

The comments are about motivation and description of the agreement. They were deliberately (given the earlier comments about not needing to decide on the dichotomy) *not* framed in terms of tax purpose.

The comments by Hill and Sackville JJ are therefore properly understandable as a decision based on the objective characteristics of the (steps or actions of the) dealings (although the likely tax-related motivations were noted), where those characteristics were not regarded as "ordinary commercial dealing".

It is para 163 of TR 2022/D1 that most concisely summarises the ATO thinking against the alternative view:

> "163. We do not agree with the argument referred to in paragraph 162 of this Ruling. Section 100A is an income tax anti-avoidance provision and the composite phrase 'ordinary family or commercial dealing' derives from the judgment of Lord Denning in *Newton*. Section 260 was also an anti-avoidance provision and *Newton* reflected the contemporary meaning of ordinary family or commercial dealing as adopted by the Commonwealth Parliament in subsection 100A(13)."

In the following paragraphs in Appendix 3, the ATO then seeks to support its position by reference to various (s 260) cases – the very cases challenged by the alternative view as irrelevant.

> "... s 100A is not a tax purpose-based section ... 'ordinary family (or commercial) dealing' is also not a tax purpose-based exclusion."

This para 163 can be regarded as identifying what is objectionable about the ATO reasoning:

- whether s 100A being an income tax anti-avoidance provision is a sufficient statutory context to influence how "ordinary family or commercial dealing" should be interpreted – different tax avoidance sections have different wording;
- why "ordinary family or commercial dealing" should be treated as having any special meaning "derived" from *Newton*, when the words, and context from those words, in s 100A do not require such a special meaning; and
- how it can be permissible for the ATO to claim to identify what was the meaning in the mind of parliament, as the claimed "contemporary meaning" of "ordinary family or commercial dealing", from anything other than the words of s 100A.

Statutory interpretation case law

General

The often-cited statement by the majority of Hayne, Heydon, Crennan and Kiefel JJ in *Alcan (NT) Alumina Pty Ltd v Commissioner of Territory Revenue*[25] instructs how statues are to be interpreted:

> "This Court has stated on many occasions that the task of statutory construction must begin with a consideration of the text itself. Historical considerations and extrinsic materials cannot be relied on to displace the clear meaning of the text. The language which has actually been employed in the text of legislation is the surest guide to legislative intention. The meaning of the text may require consideration of the context, which includes the general purpose and policy of a provision, in particular the mischief it is seeking to remedy."

The following comments by French CJ (who was not part of the majority cited above, but decided the case the same way as part of the plurality) from *Alcan (NT) Alumina Pty Ltd v Commissioner of Territory Revenue*[26] also reflect that same accepted general approach to interpreting a statute:

> "The starting point in consideration of the first question is the ordinary and grammatical sense of the statutory words to be interpreted having regard to their context and the legislative purpose. That proposition accords with the approach to construction characterised by Gaudron J in *Corporate Affairs Commission (NSW) v Yuill*[27] as:
>
> > '… dictated by elementary considerations of fairness, for, after all, those who are subject to the law's commands are entitled to conduct themselves on the basis that those commands have meaning and effect according to ordinary grammar and usage.'
>
> In so saying, it must be accepted that context and legislative purpose will cast light upon the sense in which the words of the statute are to be read. Context is here used in a wide sense referable, inter alia, to the existing state of the law and the mischief which the statute was intended to remedy …"

It is useful to also understand from *Alcan (NT) Alumina* that, in rejecting the Commissioner of Territory Revenue's second argument — propounding a view of context in the "widest sense"[28] which was linked to an argument, accepted by the Court of Appeal, that the legislature would not have intended a reduction in revenue by certain past changes[29] — the majority warned that:[30]

> "Fixing upon the general legislative purpose of raising revenue carried with it the danger that the text did not receive the attention it deserves."

Further:[31]

> "There is nothing express in the text of relevant parts of the Act, as enacted, or in amendments made to the Act in 1979 or in 1987 which supports the Commissioner's contention, upheld in the Court of Appeal, that the definition of 'lease' in the legislation did not apply when dealing with a 'conveyance' of a lease. As can be seen from the extracts set out above, essentially the Court of Appeal's reasoning *was not based on the text, but on an inference that the text would not apply because it would be surprising if the legislature intended to sever from a lease something which contributed to its value on a conveyance*. However, in terms, the definition of 'lease' in the Act, as amended over time, was always capable of applying both to the grant of a lease and to the conveyance of a lease. Relevant amendments to the Act up to and including the 2000 amendments were all assessed by the Court of Appeal by reference to a generally ascertained intention to amend the legislation to increase the revenue rather than by reference to the express terms of the Act. *The effect of that approach is to impute erroneously a statutory intention which destroys the effect of a clearly expressed definition*." (emphasis added)

Finally, in response to an "other argument" by the Commissioner of Territory Revenue centred on the "purposive approach to statutory interpretation which has emerged and is now well settled",[32] the response of the majority was:[33]

> "Given the basis on which this appeal is to be allowed, it is not necessary to deal with these arguments beyond the making of two points. First, *tax statutes do not form a class of their own to which different rules of construction apply; they are to be construed by application of the settled principles referred to above*. Secondly, *the fact that a statute is a taxing Act, or contains penal provisions, is part of the context and is therefore relevant to the task of construing the Act in accordance with those settled principles*." (emphasis added)

It is very difficult, from the above, to see how the ATO's comments in para 163 of TR 2022/D1 (and elsewhere in TR 2022/D1) noted above are consistent with the High Court's instructions on the interpretation of (tax and other) statutes.

Why is the meaning of the phrase "ordinary family or commercial dealing" to be coloured by:

- the context of s 100A being an anti-avoidance section — when that seems a context, at the "widest level", similar to the approach rejected in *Alcan (NT) Alumina*;
- a meaning drawn from *Newton's* case, when that case is not even mentioned in the explanatory memorandum to the Bill that introduced s 100A and *Newton* dealt with a materially different section. The s 260 context of *Newton* was a section about purpose, where the (ordinariness) distinction was being drawn based on purpose. Section 100A is a section about reimbursement agreements — defined as being about how beneficiaries act to consume or direct the use of their entitlement — a completely different context. See the attempted representation in Diagrams 1 and 2; and
- a claimed "contemporary meaning" of "ordinary family or commercial dealing" had by parliament but not to be found in the words of s 100A?

Interpreting a specific term: Hunger Project Australia

The ATO's position of attributing a meaning to "ordinary family or commercial dealing" from sources outside s 100A

also seems in conflict with *FCT v Hunger Project Australia*,[34] a case where use of a specific term from one context was rejected when sought to be applied in another.

In that case, the relevant term was "public benevolent institution". Relevant extracted comments from the unanimous decision of Edmonds, Pagone and Wigney JJ in the Full Federal Court follow:

> "38. Whilst past judicial statements concerning the ordinary meaning of a word or expression can often assist in divining the meaning of the word or expression, the common understanding of the meaning of an expression may change over time depending on the particular expression in question. When the question is whether a particular institution is a public benevolent institution, the answer depends on *the common or ordinary understanding of the expression at the relevant time. The question is not to be approached as a legal question to be dealt with by the mechanical application of past authority, irrespective of the present current understanding of the expression in the currently spoken English language*: *Ambulance Service (NSW) v Deputy Commissioner of Taxation* (2002) 50 ATR 496 at [40]–[42] (*Ambulance Service*).
>
> …
>
> 41. As for the reliance on s 8(5) of the EDA Act [*Estate Duty Assessment Act 1914 – 1928* (Cth)], it is difficult to see how the terms of a different Act dealing with a different taxation regime can assist in divining the common or ordinary meaning of the expression public benevolent institution in the FBTA Act [*Fringe Benefits Tax Assessment Act 1986* (Cth)]. The fact that in 1928 the legislature chose to separately exempt from estate duty, inter alia, a 'public benevolent institution' and a 'fund established and maintained for providing money for the use of such institutions' does not mean that the common understanding of a public benevolent institution over eighty years later cannot include an institution that is primarily involved in fund raising.
>
> …
>
> 45. We should add that we do not consider that it is correct to approach the issue of the ordinary meaning or common understanding of an expression used in a statute as if the answer can necessarily be gleaned from the apparent intention of Parliament in the statute, or other statutes that may use the expression. As Allsop J, as his Honour then was, put it in *Ambulance Service* at [80], *the inquiry is not 'a legal question based on defined criteria or a question the answer to which is capable of being divined from the intention of Parliament in a statute, but, rather, to be part of an enquiry as to the meaning or usage of a phrase in the language, though one illuminated by legal authority*.'" (emphasis added)

This approach adopted by the Full Federal Court in *Hunger Project Australia* is consistent with the doubts expressed in *Prestige Motors* — that the meaning of "ordinary family or commercial dealing" in s 100A today cannot be drawn from *Newton's* case, with its tax purpose orientation derived from the "purpose or effect" context in s 260.

It is relevant to note that, in contrast to the legislation and phrase considered in *Hunger Project Australia*, s 260 was within the same Act as s 100A. But it is submitted that the different words of each section create as great a point of distinction as existed in *Hunger Project Australia* (even if sections in the one Act).

Also, while *Newton* was decided before the enactment of s 100A, the words "ordinary family or commercial dealing" are not the exact words used in *Newton* (they were "ordinary business or family dealing") *and* they appear "only" in the judgment and not in the legislation.

Based on *Hunger Project Australia*, the proper wording and context of "ordinary family and commercial dealing" in s 100A and the "present current understanding of the expression" (from para 38 as extracted above) must now be taken into account when applying the exclusions from reimbursement agreements based on that term.

Diagrammatic summary: s 260 versus s 100A contexts

Based on these principles of interpretation, it is submitted that the s 100A concept of excluding agreements entered into in the course of ordinary family or commercial dealing from the meaning of reimbursement agreements, as contrasted with the *Newton* s 260 based approach to ordinary business or family dealing, can be represented in Diagrams 1 and 2.

Diagram 1. Representation of s 260

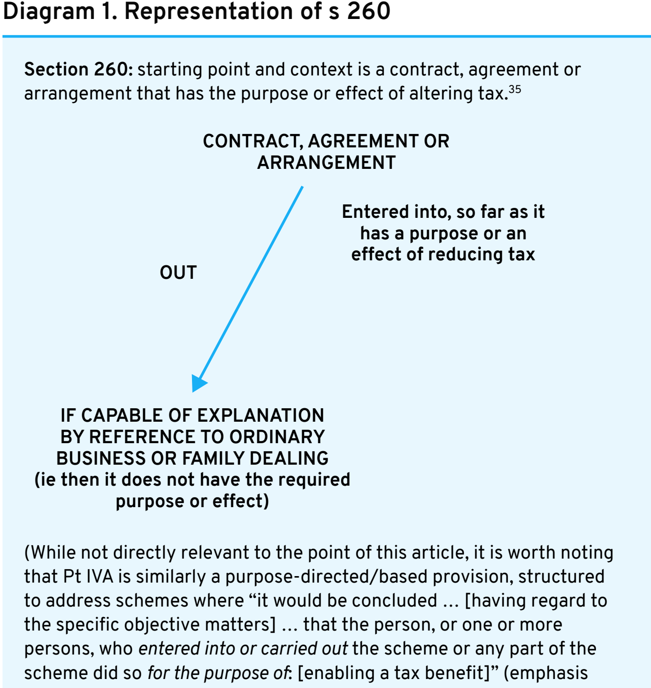
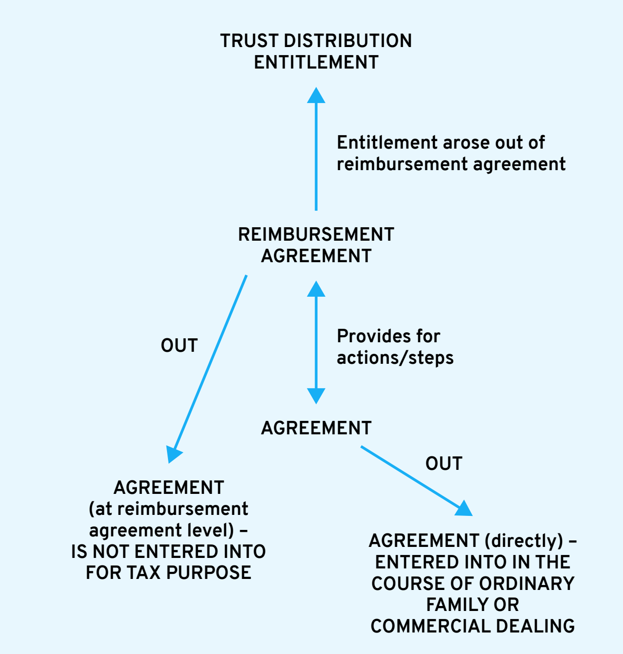


Diagram 2. Representation of s 100A

100A reimbursement agreement: starting point and context is an agreement *that provides for certain specific actions* – the payment of money or the transfer of property to, or the provision of services or other benefits for, a person or persons other than the beneficiary or the beneficiary and another person or other persons. *Tax purpose or effect not relevant.*



Ordinary family or commercial dealing

So where does this leave s 100A in terms of tax purpose and "ordinary family dealing"?

A summary is sought to be made below.

Irrelevance of the Newton meaning of ordinary family (or commercial) dealing

As already noted above, discussion around ordinary family dealing and ordinary commercial dealing traditionally starts with *Newton's* case. However, it is submitted that *Newton's* case provides little *useful* guidance on how to interpret s 100A, despite arguably being the judicial origin of the expression "ordinary family dealing" or "ordinary commercial dealing".

Newton's case was based on s 260, which was concerned with voiding arrangements entered into to avoid taxation. As a starting point, it should be noted that the section involved in *Newton* (s 260) made no textual reference to ordinary family or business dealing.

Instead, ordinary family or business dealing was considered by the Privy Council in *Newton* in the context of the concept of "predication" – a concept which is no longer the core of the anti-avoidance rules (including s 100A). In *Newton*, the Privy Council considered that, for s 260, you must be able to predicate that the arrangement was for the purpose of avoiding tax, if it was "capable of explanation by reference to ordinary business or family dealing", then the arrangement was *not* predicated on the avoidance of tax, meaning s 260 could not apply.

This was a relevant dichotomy, when considering s 260, as a means to construe purpose or effect. If the arrangement could be explained as an ordinary family dealing, it was held not to be for the purpose of avoiding tax – where purpose or effect was the relevant issue in the Privy Council's consideration of s 260. The section included those "purpose or effect" (of reducing tax) words (but not any express "ordinary family or commercial dealing" exclusion) when identifying the contract, agreement or arrangement to which it applied.

The comments already noted above by Hill and Sackville JJ in *Prestige Motors* are a strong basis for hesitancy when seeking to rely on *Newton*. Those comments are repeated again below in full (different emphasis added):

> "*There is a danger that, when words used in a judgment are translated into the legislation, the change of context may alter the meaning of the words from that which they originally bore.* It is clear from both the judgment of the Privy Council and from the language of the High Court on the same case (*FCT v Newton* (1957) 96 CLR 578) that *s 260 was regarded as involving a dichotomy.* A transaction was either stamped as one entered into to avoid tax or as one about which it could be predicted that it was entered into in the course of ordinary family or commercial dealing. In the former case the transaction was caught by s 260; in the latter case it was outside the section. *We do not need to decide in the present case whether s 100A imports a similar dichotomy.* In particular we do not need to decide whether if an agreement is shown to have been 'entered into the course of ordinary commercial dealing', the operation of s 100A is spent, regardless of whether the commercial purpose was subsidiary to the purpose of tax avoidance. In our view, none of the transactions was entered into in the course of ordinary commercial dealing."

This is a very important paragraph in *Prestige Motors*. It starts by striking a note of caution that seeking to import the meaning of words used in the context of *Newton's* case into s 100A may lead to a misinterpretation – a prescient warning.

The paragraph then goes on to query whether s 100A imports the same dichotomy as s 260, ie the predication issue.

The justices in *Prestige Motors* explicitly refrained from ruling whether such a dichotomy existed. But the fact that the justices felt that they could determine that the dealings were not ordinary commercial dealings without ruling on this dichotomy is itself informative.

At the very least, it means that *Prestige Motors* is authority that finding a tax (avoidance) purpose is not necessary for the exclusion in s 100A(13) *not* to apply. The dealings under consideration can be found to *not* be "ordinary" on other bases.

Unfortunately, *Prestige Motors* left unanswered the question of whether a tax (avoidance) purpose can be a relevant consideration when determining whether an arrangement is (not) an ordinary family or commercial dealing.

Equally, *Prestige Motors* is certainty *not* authority that a tax (avoidance) purpose alone prevents a dealing from being an ordinary (family or) commercial dealing.

But, independently of *Prestige Motors*, the irrelevancy of the *Newton*-sourced meaning of "ordinary family or business dealing" (with its "purpose and effect" orientation) to an interpretation of the similar (but not identical) "ordinary family or commercial dealing" term in s 100A is supported (actively so – beyond the mere warning in *Prestige Motors*) by the statutory interpretation cases discussed earlier. From those cases:

- "the task of statutory construction must begin with a consideration of the text itself" – and the text of s 100A does not require (or allow) the introduction of a tax purpose element into the meaning of "ordinary family or commercial dealing". This is because to introduce that purpose element restricts the scope of the "ordinary family or commercial dealing" exclusion, so as to impermissibly expand the scope of s 100A on a basis not to be found in the text; and
- *Hunger Project Australia* (decided after *Prestige Motors*) is authority against the very thing warned against by Hill and Sackville JJ in *Prestige Motors* – the importation of the meaning of a term from a materially different statutory context. For s 100A, that is the importation of the meaning of "ordinary family and commercial dealing" from the s 260 context with its purpose-based dichotomy.

Finally, it is relevant to specifically note the dates of the case law discussed:

- *Prestige Motors* – 1998;
- *Alcan (NT) Alumina* – 2009 (before the ATO's 2014 examples); and
- *Hunger Project Australia* – June 2014 (again, before the ATO's initial July 2014 examples).

Characteristics (of steps or actions), not purpose

As discussed earlier in respect of *Prestige Motors*, from the comments in the judgment following the above (twice) cited extract, the basis on which the ordinary commercial dealing exclusion was held not to apply was the objectively "non-ordinary" commercial characteristics of the (steps or actions taken under the) whole of the arrangements.

It is submitted that this is the correct way to apply s 100A – that it is the characteristics of the actions or steps under an agreement relating to the consumption or use of a beneficiary's trust entitlement, not the purpose of the agreement or of distributing to the beneficiary, that determines whether there is an ordinary family or commercial dealing.

In the context of the definitions of "reimbursement agreement" and "agreement", the rules of statutory interpretation support that the exclusion for ordinary family (or commercial) dealing is directed to the "ordinariness" of the actions or steps to which attention is directed in the definition of "reimbursement agreement" – how beneficiaries consume or use their entitlements. There is no basis to insert tax purpose into that reasoning. The words of s 100A, and the context of those words, do not allow or require it.

In applying this view, weighing ordinary family dealings could perhaps come to be considered to be similar to weighing the nature of a deduction. It is the "essential character" of an expense that determines its nexus as incurred to derive income or in the course of carrying on a business, not the intention.

This analogy is raised because that principle makes the deduction provisions workable, consistent with the legislative text, without overstating the factual analysis needed to apply the tax law.

It is to be expected (and hoped) a similar workable approach, consistent with the legislative text of s 100A, would be sought and favoured by the courts.

(In the author's experience and view, the ATO's focus on tax purpose "overloads" the facts required to be considered to apply s 100A because the meaning of ordinary family dealing is taken by the ATO to be affected by virtually anything and everything – family relations, relative tax rates, relative family wealth etc. As a consequence, intrusive enquiries into private matters and formal interviews have been used, to date, by the ATO in seeking to apply its "tax purpose" based interpretation.)

The structure of the text in s 100A is relevant

The structure of s 100A is part of the context and is relevant to how the provision should be applied.

Of relevance here is the separation of tax avoidance purpose matters into a separate exclusion, that is, s 100A(8). This is a strong indication that a consideration of tax purpose is not part of interpreting "agreement" as defined in s 100A(13).

The author's reading of s 100A is that a consideration of whether an agreement has a tax avoidance purpose only occurs at the reimbursement agreement level, once it is satisfied that there is an "agreement" at all – as defined in s 100A(13) and reflected in Diagram 2 – which of course involves the (earlier) *separate exclusion* from "agreement" for ordinary family or commercial dealing. This reinforces that the consideration of tax purpose is a separate exercise to the consideration of ordinary family or commercial dealing.

This, in turn, supports that it is the characteristics of an agreement that determine whether the agreement was entered into in the course of an ordinary family dealing or ordinary commercial dealing, not the purpose of those dealings.

What characteristics are "ordinary" in family dealing?

The concept of ordinary family dealing requires further detailed thought, which this article does not attempt to fully address.

As opposed to ordinary commercial dealing, "ordinary family dealing" has had effectively no judicial consideration until recently with *Guardian AIT* – any other case where it could have been an issue was instead decided on other grounds.

But *Guardian AIT* was strictly decided on the agreement point – and the ATO is already seeking to limit the case to its facts. In any case, on the facts, and with respect, *Guardian AIT* did not (it did not need to) address the "ordinary family dealing" question as fully and directly as proposed by this article – in terms of definitively deciding whether "tax purpose" is relevant to that concept in s 100A.

In line with the comments in *Prestige Motors*, taxpayers seeking to rely on the ordinary family dealing exclusion should expect to have to convince the courts that the arrangements are in fact explainable as – have objective characteristics of – "ordinary" family dealing.

In attempting to discharge that onus, there are a number of further unanswered questions when it comes to ordinary family dealing which may have to be confronted, for example, whether "ordinary" suggests that it is an objective test on a "whole community" basis, or whether "ordinary" refers to what is ordinary for a specific family (ie whether it is a subjective test).

In the context of other areas of law, particularly in family or succession law, the courts have been willing to consider what value might be expected to be shared within families. For example, the development of family provision applications (by which a family member may seek a greater share of a deceased's estate) had its origin in a view that a parent had a natural obligation to make provision for their child or spouse.

The author queries whether, when considering what constitutes ordinary family dealing in the context of s 100A, the courts would cast back to these family or succession law principles.

The author ventures that an ordinary family dealing, in a modern context when it comes to individual family members' consumption or use of value or wealth, would include:

- for the "caretakers" of family wealth (typically parents) to be trusted to manage the family wealth for best possible return and use – conduct which is undertaken based on the very natural goal of seeking to maximise family wealth through prudent management to, among other things, ensure sufficient finances for future emergencies, care for family members who cannot finance their own care (due to age, illness or mental incapacity) or preserve value for successive generations of the family;
- for all family members to contribute to the family wealth as they choose – not just parents to children, but also adult children to parents/wider family; and
- for "unexpended" family wealth in any one year to be returned to/concentrated in a family trust, including possibly the family trust from which the trust entitlements originally flowed – as that trust structure, by which no one family member owns that wealth, may best provide (non-tax-based) protection against the risks of claims against any one family member.

Family members, including beneficiaries of family trusts, can naturally be expected to cooperate in these endeavours for the simple reason that families have long-term emotional connections. If a more mercenary view is required, family members do so because, by participating in this management, the family member can expect benefits to return to them if they require them in the future, due to illness or incapacity, or through intergenerational wealth transfer. Either way, joint management and consumption of their assets and income is what families do, in the ordinary (and non-artificial) course.

If a family cooperating to prudently preserve and deploy its wealth is ordinary, then the scenario where:

- a trustee makes a beneficiary presently entitled to income;
- that beneficiary unilaterally chooses not to call on that entitlement to be paid; and
- the beneficiary instead allows the value that entitlement represents to be satisfied by being used for family purposes,

should (in the author's view) be taken to be an ordinary family dealing.

It is also part of this family cooperation that family members often do not require a detailed accounting of their entitlements, as long as there is trust in the "caretakers" of the family wealth (typically parents).

Ideally, it is hoped that the courts interpret "ordinary family dealing" in s 100A as an objective concept by reference to a typical family.

The alternative, a subjective basis or one otherwise requiring evidence of what is ordinary for each individual family, would require families to detail and provide evidence of internal family dealings – which by their nature are intensely private matters (eg affected by illness, divorce, relationship issues etc) – in the public domain of the courts.

Referring back to the treatment of deductions where subjective purpose is sometimes considered where the objective nexus is not apparent, it may be that the courts will establish an objective concept by reference to a typical family but entertain specific and subjective evidence of what is ordinary in a particular family where the facts vary from that objective concept.

Conclusion

In an article published in 2010,[37] Peter Walmsley, Deputy Chief Tax Counsel of the ATO, addressed the matter of "ordinary family dealing" and Pt IVA. In that article, it was stated:[38]

> "The drafters of Pt IVA were faced with two principal difficulties:
>
> ...
>
> However, the first, and the more important, was the necessity, in the context of general provisions, to *distinguish behaviour affected or indeed motivated, subjectively, by taxation considerations – which covers a lot of behaviour that is normal, expected and wholly inoffensive or even desirable – from artificial tax avoidance*. The distinction that they derived from the cases was that between ordinary commercial and family dealing and its opposite. But they were advised not to use the actual words 'ordinary commercial or family dealing' – wisely, in the author's opinion, as they are a little too vague and too subjective." (emphasis added)

Instead, in Pt IVA, the approach was adopted of setting out indicia or factors by which different kinds of dealing may be (objectively) distinguished:[39]

> "The end result remains the same: if the scheme does not 'bespeak *the purpose of tax avoidance*' (once again to use a phrase from the old case law), having regard to those factors, it is ordinary dealing *in the relevant sense*; and if it does, it is not." (emphasis added)

Section 100A represents an alternative approach to an anti-avoidance provision, that does not have as its primary mechanism (its relevant sense) a test of purpose.

Not all tax avoidance provisions need to primarily test purpose.

Rather, s 100A primarily tests the characteristics of the steps and actions under agreements, independent of their purpose. The meaning of "ordinary family and commercial dealing" in this context (in this relevant sense) does not draw its meaning from *Newton's* case, which was concerned with another tax purpose-directed/based provision (s 260).

There is nothing exceptional or "loose" that can be claimed to arise from such an operation of s 100A. As noted by Mr Walmsley, there is behaviour that may be affected or indeed motivated, subjectively, by taxation considerations – which covers a lot of behaviour that is normal, expected and wholly inoffensive or even desirable.

In particular, many normal family interactions/dealings will be affected or motivated to some extent by taxation considerations but can still be normal, expected and wholly inoffensive or even desirable.

By its words and structure, s 100A is not intended to apply to such family interactions/dealings.

Despite the fact that the apparent scope of s 100A is vast, by s 100A(7) including in the meaning of reimbursement agreement virtually all of the ways that a beneficiary may consume or direct application of their trust entitlement, some family dealings are deliberately removed from this vast scope by the "ordinary family dealing" exclusion from agreement in s 100A(13).

Just as s 100A is not a tax purpose-based section, the exclusion from s 100A based on "ordinary family (or commercial) dealing" is also not a tax purpose-based exclusion.

This was (and is) a deliberate design feature of the provision.

This article has sought to highlight and support this position.

The article questions the preconception that the meaning of "ordinary family and commercial dealing" can and must come from outside s 100A, from *Newton's* case.

As stated in the introduction, this article seeks to encourage a more detailed and disciplined analysis of the law as represented by the exact words of s 100A (free from current preconceptions). Only on that basis will taxpayers and the ATO achieve greater certainty of the effect, and practical implications, of s 100A.

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West Garbutt

References

1 Disappointingly because the ATO acknowledges that this alternative view has been "put to the Commissioner" in discussions, and an attempt to explain it has been made in a paper by Alex Whitney and the author, "Trusts – 100A reimbursement agreements; identifying and reducing taxpayer risks", presented at The Tax Institute's Qld Tax Forum on 27 to 28 May 2021. But the ATO has chosen, in its long-awaited draft ruling TR 2022/D1, not to fully explain and respond to that view. This article seeks to expand on the technical basis for the alternative view.

2 The ATO claims, as at para 47 of PCG 2022/D1, to have provided guidance on its "administrative position" on s 100A by examples published on its website since July 2014, available at www.ato.gov.au/law/view/document?DocID=SGM/trusttaxation. But those examples have been wholly unsupported by any publicly stated, detailed technical analysis until the issue of TR 2022/D1. The examples failed to even raise, much less comment on, various technical issues (including the "alternative view" the subject of this article) and pre-existing (in 2014) statutory interpretation case law. In the author's view, this raises a serious issue over whether those examples can be regarded as genuine guidance by the ATO.

3 [2021] FCA 1619.

4 [2021] FCA 1619 at [137] and [138].

5 (1958) 98 CLR 1.

6 [2021] FCA 1619 at [140].

7 [2021] FCA 1619 at [154]–[155], [173] and [174].

8 Section 260 started with: "(1) Every contract, agreement, or arrangement made or entered into, orally or in writing, whether before or after the commencement of this Act, shall *as far as it has or purports to have the purpose or effect* of in any way, direct or indirectly ..." altering the incidence of income tax, relieving tax liability etc (emphasis added).

9 (1958) 98 CLR 1.

10 *FCT v Prestige Motors Pty Ltd as trustee of the Prestige Toyota Trust* 98 ATC 4241 at 4262, where reference is made by Hill and Sackville JJ to the "ordinary commercial dealing" exclusion wording being derived from Lord Denning in Newton's case.

11 Para 23 of TR 2022/D1.

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13 S 100A(13), the meaning of which flows onto and must be read with s 100A(7).

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35 As noted earlier, s 260 started with: "(1) Every contract, agreement, or arrangement made or entered into, orally or in writing, whether before or after the commencement of this Act, shall *as far as it has or purports to have the purpose or effect* of in any way, direct or indirectly …" altering the incidence of income tax, relieving tax liability etc (emphasis added).

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22-023EVT_05/22

A Matter of Trusts

by Laura Spencer and Rob Jeremiah, CTA, Sladen Legal

Tax-effective succession of a family trust

Discretionary trusts are common structures for family businesses. How do we effectively transition these structures to the next generation?

A significant transfer of wealth to succeeding generations is happening in Australia and this will no doubt continue over the coming decades. As seen in practice, much of this wealth is linked to businesses owned by discretionary trusts.

In this article, "discretionary trust" refers to an express private trust pursuant to which:

- the trustee has a wide discretion in relation to dealings with the trust property;
- there is a single class of discretionary objects, none of which have more than a mere right to the due administration of the trust; and
- the trustee has a discretion to appoint income or capital to any one or more (including to the exclusion of the others) of the discretionary objects (the beneficiaries) as they see fit from time to time.

When preparing for the succession of family businesses and their related wealth, consideration needs to be given as to how to appropriately effect that transition.

In this article, the methods by which family businesses owned via discretionary trusts can be transitioned to the next generation are considered. Ultimately, as the family expands, consideration needs to be given to who will be the successors of the business, which descendants may wish to exit the business, and how to facilitate that exit.

Providing a specific interest

In the first instance, it is important to understand the interest that is being transitioned in a discretionary trust. The word "interest" in the strict legal sense can be either vested or contingent. In summary:

- a vested interest is one which is not dependent on whether an event happens; whereas
- a contingent right is one which depends on whether an event occurs.

Particular approaches in tax, such as that in IT 2340, may deem beneficiaries of a discretionary trust to have an interest in the trust. The position in IT 2340 supplants the position at law only in the context of determining the Commissioner's approach to determine ultimate underlying ownership under Div 149 of the *Income Tax Assessment Act 1997* (Cth). The position at law is that a beneficiary of a discretionary trust has no more than an expectancy to receive income or capital. The beneficiary will not have a vested interest in the trust unless and until the trustee exercises their discretion in favour of the beneficiary to create such an interest.

The interest of beneficiaries of a discretionary trust in the fund of the trust relies on the trustee exercising a power in their favour. This was explained by Redlich JA in the Victorian Court of Appeal decision of *Lygon Nominees Pty Ltd v Commissioner of State Revenue*[1] as follows:

> "The nature of a discretionary beneficiary's interest under a discretionary trust as a consequence of the objects' rights to have the trust properly administered, does not confer the required proprietary interest. The right of an object to take legal proceedings to prevent a disposal of income or capital by the trustee to persons outside the class of designated objects does not involve the assertion of a proprietary right by the object. While the objects of the power are able to enforce the fiduciary duties of the donee of such a power, the objects will acquire no direct interest in the property which is subject to the power until such time as the power may be exercised in their favour. Until the trustee elects to exercise the power of appointment in the object's favour, the interest of the object is no more than an expectancy to receive income or capital …"

Therefore, when considering the transition of a discretionary trust, advisers must be cognisant of the fact that a proprietary interest in a trust or its assets will not be transferred from one generation to the next until the trustee of the trust exercises their discretion to create a specific interest in favour of a particular beneficiary contemplated as such under the terms of the trust deed. With this in mind, the tax consequences of three potential methods by which a business operated via a discretionary trust may be transitioned to the next generation are considered. The methods are:

1. continuing with the trust and providing for exits via disclaimers;
2. undertaking a trust split; and
3. converting the trust to a unit trust.

Continuing with the trust

In this first scenario, the existing discretionary trust structure is maintained. The trustee of the trust continues to administer the trust in accordance with the terms of the trust deed, and each member of the next generation could be the beneficiary of income or capital distributed to them at the trustee's discretion.

To facilitate an exit, the exiting child could receive a capital distribution and then disclaim their interest in the trust. However, there would not be a proportional shift of entitlements to any other remaining beneficiary. Therefore, consideration needs to be given to an alternative method to shift interests, such as a sale by the trustee of a portion of the business assets to a separate entity controlled by the remaining beneficiary.

A key consideration when determining the method to be developed to confer a benefit on a potential beneficiary is the preparation and execution of a valid and effective disclaimer. A properly drafted disclaimer executed at the appropriate time will release the trustee from all claims, actions, proceedings, accounts, costs, damages, entitlements, demands and other amounts that the exiting child may be entitled to as against the trustee and in respect of the administration of the trust.

Planning points to note are:

- a disclaimer of an interest in a trust by a beneficiary must be made to the trustee of the relevant trust. A review of the entire structure of a group should therefore be undertaken and consideration given to whether disclaimers are to be made in respect of more than one trust contained in the family group;
- for the disclaimer/s to be valid, they must be supported by evidence that the beneficiary is disclaiming their interest. Silence or otherwise passive behaviour will not suffice;[2] and
- as found in the recent case of *FCT v Carter*,[3] care must be taken to ensure that the disclaimer is made at the appropriate time. The High Court determined that a disclaimer may be effective for trust purposes but not have any retrospective effect for distributions made or deemed to have been made before the date of the disclaimer.

Where a discretionary trust structure is to continue for the benefit of succeeding generations, it is imperative to consider who will control the trust once the current controllers (often the parents) cease to do so. The shares in relevant corporate trustees may be left to the person or persons of the next generation who are to take control of the day-to-day operation of the business, and as a result, they may appoint themselves as directors. However, ultimate control of the trust does not sit with the directors but rather with the party or parties holding the role of "appointor" under the trust deed.

The appointor of the trust has the power to remove the trustee and appoint another entity in their place. It is outside of the scope of this article to consider the appointor role in detail, except to note its importance when considering the succession of a discretionary trust. Successive appointor roles or a corporate appointor should be incorporated into the succession plan. In the case of the latter, further consideration must be given to the appropriate shareholders of the corporate trustee, with asset protection and succession being key questions for consideration.

Trust splitting

At para 1 of TD 2019/14, the ATO described a trust split as follows:

> "… 'trust split' refers to an arrangement where the parties to an existing trust functionally split the operation of the trust so that some trust assets are controlled by and held for the benefit of a subset of beneficiaries, and other trust assets are controlled and held for the benefit of others. A trust split usually involves a discretionary trust that is part of a family group. A common reason given for 'splitting' the trust is to allow different parts of the family group to have autonomous control of their own part of the assets held on trust (that is, their own part of the trust fund)."

In TD 2019/14, the Commissioner expressed the view that CGT event E1 will occur as the result of the trust split where, due to the trustee having new personal obligations and rights, a new trust has been declared or settled. Therefore, critical to CGT consequences being triggered is the trustee's right to be indemnified from the assets of the trust of which it is the trustee.

If the right of indemnity of each trustee continues to apply to all of the assets of the trust fund, then, in the views of the ATO and Steward J of the Federal Court, and cited by the ATO in TD 2019/14, the appointment would not cause CGT event E1 to occur. However, if at a time after the appointment of the additional trustees the right of indemnity of each trustee was limited to specific assets which they each held (their specific parcel of shares), CGT event E1 may, at least in the ATO's opinion, be taken to have occurred.

There are several additional CGT events which should be considered in respect of a trust split. However, it is noted (at a high level) that, based on the legislation, case law and current ATO guidance, where documentation is appropriately drafted and the split carefully implemented, a CGT liability should not arise. Prior to the implementation of a trust split, the directors of the trustee should consider seeking a private binding ruling (PBR) to seek confirmation from the ATO that what is proposed will not cause a resettlement.

In addition to federal tax considerations, it is important to be mindful of potential state duty consequences that arise from a trust split. For example, in certain state jurisdictions in Australia, the changing of a trustee can trigger duty liabilities. It is essential that a careful review of the terms of the trust deed and terms of the appointment of a new trustee over some of the assets of the trust be undertaken prior to the trust split to ensure that it does not trigger state duty consequences. This may include ensuring that the new trustee would not benefit under the relevant trust after their appointment.

Conversion of the trust

A third method to achieve succession of the discretionary trust is a conversion to a unit trust. This could be achieved by varying the terms of the deed of the relevant trust under

a power in the trust deed such that specific persons or entities controlled by them would hold units which carry voting rights, income rights and capital rights proportionate to their unit holdings. The unitholders could then transfer the units via a sale or transfer under the terms of their will.[4]

The key tax consideration when undertaking trust conversions is whether a resettlement occurs. Subsequent to the Federal Court's decision in *FCT v Clark*,[5] the ATO issued what became TD 2012/21. In TD 2012/21, the Commissioner expressed the view that CGT event E1 and CGT event E2 will not occur where the terms of the trust are changed pursuant to a valid exercise of a power contained within the trust's constituent document, unless:

- the change causes the existing trust to terminate and a new trust to arise for trust law purposes; or
- the effect of the change leads to a particular asset being subject to a separate charter of rights and obligations such as to give rise to the conclusion that that asset has been settled on terms of a different trust.

The reasoning in TD 2012/21 indicates that removing discretionary powers of a trustee and altering the interests of beneficiaries do not cause the termination or resettlement of a trust. In PBRs on point, the Commissioner has expressed the view that the following points are central to the determination of whether a termination or resettlement occurs:

- the relevant trust deed contains a power which allows the trustee to remove discretionary powers and convert the terms of the deed to a unit trust; and
- the beneficiaries, in substance, remain the same.

Subsequent to satisfying these considerations, further analysis should be made in respect of other CGT events. With appropriate drafting, and provided the relevant powers in the trust deed exist, CGT liabilities may not result. To ensure that outcome, careful analysis of the CGT provisions in the context of a client's circumstances must be undertaken and, where the position is uncertain, a PBR should be sought from the Commissioner.

A hindrance to the conversion method may be state duty. Where a variation to the deed of the trust is so significant that it severs the continuity of the trust and results in a declaration of a new trust or a change in beneficial ownership of the dutiable property of the trust, a duty liability may rise.

Whether a variation is significant enough to cause such a result is determined on a case-by-case basis. In the context of Victoria, guidance from the State Revenue Office indicates a stricter approach than that of the ATO in respect of resettlements. As with the Commissioner, the commissioners of each state or territory revenue authority are able to issue PBRs where the duty treatment of a particular trust conversion is uncertain or unclear. In the authors' view, the trustee should consider seeking a PBR to confirm the tax outcomes prior to the implementation of a proposed conversion.

Conclusion

A high volume of matters involving the succession of family businesses which operate via discretionary trusts is occurring. It is expected that this will continue in the coming years and at an accelerated rate as further transfers of wealth occur.

In this article, three methods to facilitate tax-effective "succession" of a discretionary trust have been considered. When facing these matters in practice, each will be unique and require careful consideration of the circumstances of the family members and their goals. Advisers must consider the various tax consequences of succession methods as they can be significant and far-reaching. Further, when implementation is to occur, the trust law requirements that must be met in order to facilitate an effective transition must be front of mind.

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Superannuation

by William Fettes and Daniel Butler, CTA, DBA Lawyers

A guide to SMSF succession planning: part 2

We examine the tax considerations associated with the payment of superannuation death benefits, and some of the options and pitfalls associated with planning to make a timely payment of benefits.

This is the second part of a series of articles on SMSF succession planning. In part 2, we examine the tax considerations that arise in relation to paying superannuation death benefits comprising a taxable component.

We also consider the options and pitfalls associated with planning to make a timely payment of benefits to a member who may not have long to live.

Tax considerations on death

The tax profile of death benefits is, of course, a relevant consideration in succession planning.

Where a death benefit is paid to a tax dependant (ie a death benefit dependant under s 302-195 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97)), the dependant generally receives the benefit tax-free regardless of any taxable component that forms part of that payment.

A tax dependant means any of the following:

- the deceased person's spouse or former spouse;
- the deceased person's child, aged less than 18 at the time of death;
- any person with whom the person has an interdependency relationship; or
- any other person who was a dependant of the deceased person just before they died.[1]

Accordingly, adult independent children do not generally qualify as death benefit dependants. Thus, the taxable component of any death benefit payment that they receive (usually when there is no surviving spouse) will be subject to a "death tax" – typically 15% plus the 2% Medicare levy. Only the tax-free component is tax-free.

When you consider that the average SMSF holds over $1m in assets, the tax exposure of benefit payments made to adult independent children is likely to be significant.

Tax applicable on a lump sum payment of death benefits

Table 1 summarises the position in relation to the payment of death benefit lump sums.

Planning for an exit

Given the impact of the effective death tax on death benefits paid to adult independent children, one option that some members consider is planning to withdraw their superannuation benefits before they die. Naturally, we never know the "hour nor the minute" of when death may strike. However, statistics suggest that the vast majority of people have some warning before they pass away.

Under the current tax rules, provided the member is over age 60 and has met a full condition of release (eg based on retirement or attaining age 65), their benefits may be withdrawn from the superannuation environment tax-free. As superannuation is concessionally taxed, money invested outside superannuation is generally not as tax-efficient.

However, relying on this withdraw before you die approach is not always a straightforward exercise as the member and SMSF trustee may need time to:

- pay required pro-rated minimum payments in respect of any pensions that are in place that will be commuted as part of a withdrawal;

Table 1. Payment of death benefit lump sums

	Tax-free component	Taxable component (element taxed in the fund)	Taxable component (element untaxed* in the fund)
Tax dependant	Not included in the recipient's assessable income	Not included in the recipient's assessable income	Not included in the recipient's assessable income
Non-tax dependant	Not included in the recipient's assessable income	Included in the recipient's assessable income but the recipient is entitled to a tax offset that ensures that the rate of income tax does not exceed 15%	Included in the recipient's assessable income but the recipient is entitled to a tax offset that ensures that the rate of income tax does not exceed 30%
The above rates do not include the Medicare levy, currently 2%.			

* Generally, there is no element untaxed in an SMSF. The one exception is where insurance is involved. Section 307-290 ITAA97 can operate to make a superannuation death benefit that is paid as a lump sum partly consist of the element untaxed if the fund has previously claimed deductions for insurance premiums in respect of members, eg life insurance. However, the element untaxed from an SMSF has no practical effect if it is received by a tax dependant or if the deceased attained age 65 or over prior to their death.

- commute one or more pensions prior to paying any lump sums;
- sell off fund assets to obtain liquidity (eg in relation to pension payments); or
- transfer assets in specie (ie as part of a pension commutation or a lump sum payment from accumulation phase benefits).

Thus, hoping for a quick exit in the future can be subject to a number of hurdles since we cannot predict the hour or minute of our death.

Importantly, an exit plan based on there being ample time to withdraw a superannuation benefit is vulnerable due to the numerous hurdles that could result in such a strategy failing. For example, if the member loses mental capacity to make a decision, or otherwise is physically incapacitated due to rapidly deteriorating health, achieving a timely exit may not be possible in the time available.

Some suggest that appointing an attorney under an enduring power of attorney (EPoA) can be used to overcome these issues. However, this proposed solution is not so simple, as we shall see.

Risks associated with relying on attorneys under an EPoA

Some seek to rely on a spouse, close family member, trusted friend or adviser to withdraw their benefit pursuant to an EPoA at the appropriate time. However, relying on an EPoA in this situation involves a number of risks, including:

- the legislation governing EPoAs differs between each state and territory and only the Tasmanian power of attorney legislation contains express language empowering an attorney to deal with a person's superannuation interest(s). Therefore, it is recommended that any EPoA documentation contain express authority to deal with superannuation;
- without an SMSF deed expressly authorising an attorney under an EPoA to act for a member, the EPoA might not be effective, eg in relation to the attorney exercising a member's rights and entitlements under an SMSF deed as an SMSF is a form of trust and an EPoA does not authorise an attorney under a trust as the trust deed is the relevant document that governs the rights and obligations under the trust; and
- an attorney withdrawing a member's benefit may not be acting in the donor/principal's best interests if others (including the attorney) are attempting to benefit from the withdrawal. Indeed, the situation might give rise to a conflict unless the EPoA contains appropriate wording authorising an attorney to act (ie on the basis of it being permitted conflict).

Additionally, it is important to note that there is a difference between an attorney seeking to exercise membership rights and entitlements under an SMSF deed, and valid legal decisions being implemented at the trustee level. For instance, even if there is complete confidence in the attorney being authorised to deal with membership rights and entitlements (and assuming there is no conflict), there is still the question of properly implementing a timely payment at the trustee level.

As noted above, there are various steps that must generally be implemented by the SMSF trustee as part of an exit strategy, such as:

- payment of a lump sum from an accumulation interest;
- payment of the member's required minimum pension payments in cash;
- commutation (in part or in full) of a pension interest and payment of the commuted amount outside of the superannuation environment (ie as a lump sum); and
- where assets are being transferred in specie, signing applicable transfer forms and updating legal registers etc in relation to ownership changes.

Timely and legally effective decision-making by the trustee

Although it is readily accepted that having an EPoA is critical for SMSF succession planning, robust exit planning should also ideally focus on timely and legally effective decision-making at the trustee level.

After all, it is the trustee who holds legal title to the fund's assets, and it is the trustee who must uphold and comply with the terms of the trust deed and comply with the payment standards in relation to the voluntary cashing of benefits under the *Superannuation Industry (Supervision) Regulations 1994* (Cth). An attorney who is not a trustee/director cannot generally control this process.

Thus, a robust exit plan generally requires putting in place appropriate succession planning arrangements which ensure that the SMSF trustee (generally, this should be a special-purpose company) is always in a position to make timely and legally effective decisions at the appropriate time. For instance, a sound succession plan should always include a clear path for the member's attorney under an EPoA to become a director of the SMSF trustee in place of a member who cannot act or who has lost mental capacity.

Of course, this kind of planning is not just relevant for making a timely payment of benefits as part of an exit strategy. It is also critical to helping ensure that a fund continues to meet the definition of an SMSF in s 17A of the *Superannuation Industry (Supervision) Act 1993* (Cth) where a member can no longer act as a trustee/director (eg due to being incapacitated).

Conclusion

In part 1 of this article, we focused on some of the key components for successful SMSF succession planning, including how to plan for control of a fund in the context of death and loss of mental capacity.

In part 2, we examined the tax considerations associated with the payment of superannuation death benefits, and some of the options and pitfalls associated with planning to

make a timely payment of benefits to a member who may not have long to live.

As you will appreciate, there is no easy "one-size-fits-all" solution for SMSF succession planning. However, the intention of this article is to inform readers of some general considerations that should be taken into account as part of formulating a robust SMSF succession plan. Expert advice should be obtained if there is any doubt.

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Reference

1 Note that this limb of the definition imports the common law meaning of dependant, which is accepted to include financial dependency.

Alternative Assets Insights

by Ken Woo, CTA, and
Darren Mack, ATI, PwC

Tax elections: managed trusts

As we approach year-end, trustees of managed trusts should consider the tax elections that they make, as the choice is not always straightforward.

Introduction

A broader policy behind the tax rules for managed trusts is to place the investor in the same or similar position that they would be in had they invested directly in the underlying assets of the trust. Where the tax outcomes do not align with the investment returns or cash yield, this can result in unitholders being taxed twice on certain amounts, or taxed on income and gains before received. Sometimes, there is a need to create better certainty or to simplify the administrative burden of tax compliance.

The tax rules sometimes provide an alternative treatment to help address these issues. As trusts are not all the same, the alternative treatment is offered as a choice, or election, to the trustee.

As fund products seek to deliver on promises and meet investor expectations, the importance of elections becomes clearer. In this article, we revisit the more common elections that trustees should consider, including the following:

- managed investment trust (MIT) capital account elections;
- franking credit benchmark ceiling elections;
- attribution managed investment trust (AMIT) elections;
- AMIT multi-class elections;
- taxation of financial arrangements (TOFA) "opt-in" elections;
- TOFA fair value elections;
- TOFA foreign exchange (FX) retranslation elections;
- TOFA hedging elections;
- TOFA financial reports elections;
- short-term FX elections; and
- foreign hybrid limited partnership (FHLP) elections.

Governance

The ATO is focusing on tax risk management frameworks. Before considering the implications of tax elections, trustees should be aware of the terms of the trust deed, disclosures made in offer documents, stated policies (eg tax, distribution and unit pricing), and the consistency of treatments from fund to fund and from year to year.

MIT capital account election

What is it?

Where an Australian fund qualifies as an MIT, it is eligible to make an election to treat gains and losses on the disposal of "covered assets", such as shares and units, and capital gains and losses.[1]

Benefit

The capital account election was originally designed to provide certainty to trustees of investment trusts that gains on the realisation of equity investments are treated as capital gains rather than ordinary income. Capital account treatment therefore allows investors to benefit from eligible discount capital gains from MIT distributions/ attributions.

How?

The making of a capital account election is reflected on the tax return form. The election can only be made in the first year the trust qualifies as an MIT.[2]

Beware

The capital account election only applies to certain assets (ie covered assets) and is irrevocable. In addition, where the trust qualifies to make the election and the trustee chooses not to make the election, deemed revenue treatment applies to the covered assets (although, arguably, not in all cases).[3] Trustees may be deemed if they do (elect), and deemed if they don't.

Franking credit benchmark ceiling election

What is it?

A trust must generally hold shares at risk for more than 45 days in order to obtain the benefit of franking credits from a dividend or distribution.[4] This is commonly referred to as the holding period rule. However, as an alternative to the holding period rule, superannuation funds and widely held trusts can elect to apply a formula-based ceiling (calculated by applying the All Ordinaries Index (Index) to the "net equity exposure" of the taxpayer plus an uplift) to determine their entitlement to recognise franking credits in respect of the whole or part of the portfolio.[5]

Benefit

The franking credit benchmark ceiling election was designed to reduce compliance for institutional taxpayers which were considered low revenue risk.

How?

A franking credit benchmark ceiling election is not required to be lodged with the ATO. The trustee of the trust should retain a record of the election.

Beware

The franking credit benchmark ceiling election is irrevocable unless the Commissioner exercises his discretion. Where the equity exposure of the taxpayer differs from the Index, the buffer afforded by the ceiling may not be sufficient in some years where there are significant franked distributions, for example, where the composition of the portfolio changes over time. In addition, the benchmark ceiling election may no longer be appropriate where the fund is an AMIT which is deemed to have satisfied the 45-day rule (subject to integrity measures).

AMIT election

What is it?

Certain widely held unit trusts which are MITs may also be eligible to elect to be classified as AMITs.[6]

Benefit

MITs that become AMITs are afforded certainty of fixed trust status, and the tax components are "attributed" (including the streaming of tax components) to unitholders (rather than relying on traditional trust taxation concepts such as present entitlement). In addition, AMITs can treat acceptable discrepancies as timing differences (referred to as "unders" and "overs"), and determine cash distributable income independently of taxable income. Where taxable income exceeds cash distributable income, members of an AMIT can make cost base uplifts to mitigate double taxation. An AMIT is also deemed a "qualified person" for franking credit entitlement purposes subject to the Commissioner's discretion.

How?

The trustee of an eligible MIT can make the election and should make a record of that election. However, the election is not required to be lodged with the ATO. The choice to become an AMIT is then evidenced by lodging an AMIT tax return form instead of a trust tax return form. Importantly, the trust deed/constitution may need to provide the trustee with the power to make the election.

Beware

The choice to become an AMIT is irrevocable. However, AMIT status requires the trust to be an MIT on an ongoing basis and the trustee will therefore need to monitor MIT eligibility criteria (such as the widely held/closely held tests), particularly if the trust is in the start-up phase. In addition, trustees will need to navigate a number of integrity measures which may incur penalties/additional taxes arising in certain circumstances. These include where unders/overs culpability thresholds are exceeded, where there are discrepancies in "AMIT member annual" statements, and where overs of franking credits cannot be adjusted in the prescribed manner.

AMIT multi-class election

What is it?

AMITs with multiple unit classes may be eligible to elect for each class to be treated as a separate AMIT.[7]

Benefit

Under the election, AMITs can essentially become an umbrella fund, with separate classes where each class is treated as a separate AMIT. Each class can have different investment strategies and management fees which can appeal to different types of investors. This can result in reduced compliance and costs.

How?

The trustee of an eligible AMIT can make the election and should make a record of that election. However, the election is not required to be lodged with the ATO. The choice is then evidenced by lodging an AMIT tax return form with schedules for each class.

Beware

AMITs that elect for multi-class treatment will need to lodge separate schedules for each class as part of thier annual AMIT tax return. In addition, multi-class AMITs will need to be aware that entity tax attributes such as tax losses are quarantined to each class on a separate AMIT basis. If the trust fails AMIT status for a given income year, the taxable income of the trust must be calculated in aggregate across all classes.

TOFA "opt-in" election

What is it?

Where the TOFA regime does not automatically apply (because certain thresholds are not met), the trustee can elect that TOFA applies.[8]

Benefit

TOFA allows trusts to make a number of tax timing elections which could better align tax outcomes for unitholders and/or reduce the administrative compliance burden of the trust and thereby lower costs. See further below for information about TOFA tax timing elections.

How?

While the ATO has provided a form that can be used to make this election, it is not a requirement to use this form and the election is not required to be lodged with the ATO. The trustee of the trust should retain a record of the election.

Beware

Trustees should be aware that the election is irrevocable and only applies to financial arrangements entered into from the income year the election is made.

TOFA fair value election

What is it?

Trusts taxed under the TOFA regime can elect that certain financial arrangements (including equities that are recorded at fair value through profit and loss in the financial statements) are taxed on a fair value basis[9] rather than a prescribed compounding accruals or realisation basis.

Benefit

Under a TOFA fair value election, the taxation treatment of financial arrangements is aligned with the accounting treatment (ie fair value through profit and loss), thereby minimising timing differences.

How?

While the ATO has provided a form that can be used to make this election, it is not a requirement to use this form and the election is not required to be lodged with the ATO. The trustee of the trust should retain a record of the election.

Beware

Trusts should be aware that the election is irrevocable and only applies to financial arrangements entered into or acquired from the income year the election is made. In addition, as investments are treated on a market to market or fair value basis, the cash yield of the trust may not align with the tax outcomes to unitholders. The eligibility criteria must be met on an ongoing basis. The revenue account treatment of gains may mean that the CGT discount concession is forgone.

TOFA FX retranslation election

What is it?

Trusts taxed under the TOFA regime can elect that foreign currency exchange fluctuations (on financial arrangements denominated in foreign currency), ie FX gains and losses, are taxed in alignment with the accounting treatment, thereby minimising timing differences.[10]

Benefit

The TOFA FX retranslation election simplifies the calculation of FX gains and losses for tax purposes by aligning it with the accounting treatment of FX gains and losses.

How?

While the ATO has provided a form that can be used to make this election, it is not a requirement to use this form and the election is not required to be lodged with the ATO. The trustee of the trust should retain a record of the election.

Beware

Trusts should be aware that the election is irrevocable. Depending on the volatility of the foreign currency, the economic gain may vary depending on whether the FX translation is taken into account. The TOFA FX retranslation election can apply to all foreign currency denominated financial arrangements, or it can be limited to certain qualifying foreign currency accounts.

TOFA hedging election

What is it?

Trusts taxed under the TOFA regime can elect that the hedging election applies to qualifying hedging arrangements to align the tax character and timing of hedging arrangements with the treatment of the underlying hedged item.[11]

Benefit

Trusts that make the hedging election can manage the mismatches that arise in character (ie revenue versus capital in nature) and timing in respect of hedging instruments and hedged assets/liabilities. Mismatches can occur where, for example, gains from the realisation of hedging instruments are recognised as ordinary income, whereas gains from the realisation of the underlying hedged instrument are recognised as a capital gain (character), and/or where each arrangement has different maturity dates (timing).

How?

While the ATO has provided a form that can be used to make this election, it is not a requirement to use this form and the election is not required to be lodged with the ATO. The trustee of the trust should retain a record of the election.

Beware

The requirements to satisfy the hedging election are complex and may require significant time and costs to comply. The documentation requirements to evidence the existence of an effective hedge and to undertake hedge accounting are particularly onerous. In the 2020–21 Federal Budget, the government announced that it would make technical amendments to the TOFA legislation to enable access to hedging rules on a portfolio hedging basis. Draft legislation in respect of these proposals is yet to be released.

TOFA financial reports election

What is it?

Trusts taxed under the TOFA regime can elect that the financial reports election apply to tax financial arrangements (including equities) to align the tax treatment of these arrangements with the accounting treatment.[12]

Benefit

Under the TOFA financial reports election, the tax treatment of financial arrangements is consistent with the accounting treatment eliminating timing differences on financial arrangements. This can significantly reduce tax compliance costs.

How?

While the ATO has provided a form that can be used to make this election, it is not a requirement to use this form and the election is not required to be lodged with the ATO. The trustee of the trust should retain a record of the election.

Beware

Trusts should be aware that the election is irrevocable and only applies to financial arrangements entered into from the income year the election is made. In addition, the cash flow of the trust may not align with the tax outcomes. The revenue account of treatment of gains may mean that the CGT discount concession is forgone. As with most of the TOFA tax timing elections, the eligibility criteria must be met on an ongoing basis.

Short-term FX election

What is it?

Short-term FX gains and losses (ie those arising between acquisition or disposal and payment time, where that time is less than 12 months) are generally treated as having the same character as the relevant asset (eg if the FX gain or loss relates to a capital asset, it will take on the character of the capital asset). A trust can elect that this treatment does not apply and the FX gain or loss is treated separately as an assessable amount or allowable deduction, respectively.[13]

Benefit

Trustees may decide that it is more beneficial to recognise an FX gain or loss as assessable or deductible rather than incorporating those amounts in the calculation of the cost base of assets.

How?

The election must be in writing but is not required to be lodged with the ATO. The trustee of the trust should retain a record of the election.

Beware

A newly established trust is currently not able to make this election as it must have been made by 16 January 2004 unless the Commissioner provides a later date. However, the Commissioner is not empowered to allow a longer period for a choice to be made for entities that were not in existence at the start of the applicable commencement date (1 July 2003) or that did not come into existence within 90 days after the start of the applicable commencement date.[14] Both the current and previous governments have proposed amendments to these rules to allow new entities to make this election, but no legislation has been released to date.

FHLP/FHC election

What is it?

Australian trusts investing in a qualifying foreign limited partnership and/or a foreign limited liability company can elect to treat those entities as an FHLP and a foreign hybrid company (FHC), respectively — allowing for partnership tax treatment rather than defaulting to corporate tax treatment.[15]

Benefit

Partnership treatment allows certain tax attributes to flow through an FHLP/FHC, such as foreign income tax offsets in respect of underlying foreign income taxes. In some scenarios, realised gains on assets of the FHLP/FHC may be capital gains and may be eligible to qualify as discount capital gains.

How?

The FHLP/FHC election is not required to be lodged with the ATO and is evidenced by the lodgment of a partnership return for the FHLP or FHC. The Australian trust must lodge the partnership return if it is the largest investor in the FHLP/FHC unless its holding is less than 10%.

Beware

Whether an FHLP/FHC election should be made requires careful consideration of the potential tax attributes that can be obtained by the partner, a thorough understanding of the level of compliance required (eg the annual partnership return), and an understanding of the availability and access to relevant information. In addition, where the foreign limited partnership/foreign limited liability company is a controlled foreign company, and the partner is an attributable taxpayer, FHLP/FHC treatment applies automatically. A combination of contentious tax issues and inconsistent approaches to compliance has resulted in increased ATO scrutiny on cross-border investments into foreign investment vehicles.

The takeaway

Meeting the obligation to act in the best financial interests of investors, and maintaining a robust tax risk management framework for good governance, are essential. Additionally, financial products need to meet the outcomes promised to, and the expectations of, their target audience. Trustees need to carefully consider the implications of an election, not only based on the current circumstances of the fund, but also with a view to future scenarios and volatile market conditions.

Further, in some situations, such as with digital assets, there may be sufficient uncertainty as to the legal form and tax recognition points which are emerging and as yet unresolved. As some elections are irrevocable (perhaps to mitigate the perceived “undue optimisation” of choice), further care and diligence are needed when making an election where there is uncertainty. Perhaps one thing is certain: the increasing importance of flexibility.

While elections come down to choice, the implications require careful consideration as there are benefits, risks and trade-offs to assess.

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1 S 275-115 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).

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3 S 275-120 ITAA97.

4 S 207-145(1)(a) ITAA97, and Div 1A of former Pt IIIAA of the *Income Tax Assessment Act 1936* (Cth).

5 S 160APHR of Div 1A of former Pt IIIA ITAA36

6 S 276-10 ITAA97.

7 S 276-20 ITAA97.

8 S 230-455(7) ITAA97.

9 S 230-210 ITAA97.

10 S 230-255 ITAA97. Where TOFA applies, the weighted average cost election under reg 775-145.01 of the *Income Tax Assessment (1997 Act) Regulations 2021* (Cth) is not needed.

11 S 230-315 ITAA97.

12 S 230-395 ITAA97.

13 S 775-80 ITAA97.

14 ATO ID 2013/53.

15 Div 830 ITAA97.

Events Calendar

Upcoming month

JUNE
2–3
Thu–Fri

Online

Trusts Intensive

8 CPD hours

JUNE
3
Fri

NSW Online

Women in Tax National Congress

6.5 CPD hours

JUNE
15
Wed

NSW Online

International Masterclass

7 CPD hours

JUNE
23
Thu

Online

Regional Tax Masterclass

7 CPD hours

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

Cumulative Index

The following cumulative index is for volume 56, issues (1) to (11). Listed below are the pages for each issue:

Vol 56(1): pages 1 to 84
Vol 56(2): pages 85 to 142
Vol 56(3): pages 143 to 212
Vol 56(4): pages 213 to 278
Vol 56(5): pages 279 to 340
Vol 56(6): pages 341 to 400
Vol 56(7): pages 401 to 454
Vol 56(8): pages 455 to 508
Vol 56(9): pages 509 to 590
Vol 56(10): pages 591 to 666
Vol 56(11): pages 667 to 744

A

Absolute entitlement
trust vesting ... 38, 39
Accelerator funding
R&D tax incentives ... 530
Accommodation expenses ... 92, 217
Accountants
embracing change ... 185–194
lawyers, distinctions between ... 250–252
SMSFs
– deeds ... 125, 127
– liability ... 181–183
– professional indemnity ... 175
– valuation documentation ... 174, 175
Accountants' concession ... 434
Accumulation phase accounts
SMSFs ... 182
Active assets
CGT small business concessions ... 147, 359, 362, 523–525
Active income
single business tax rate ... 299
versus passive income ... 297, 300, 301
Activity test
Child Care Subsidy ... 553, 555, 558, 559
Administrative penalties – see also **Penalties**
default assessments ... 94, 347, 348
electronic sales suppression tools ... 284, 285, 515, 516
statement penalty provisions
– safe harbour ... 677–681
Administrative practice
rule of law ... 569–574
Adult children
discretionary trust arrangements ... 515
primary production land ... 620, 621
Advisers
SMSF deeds, non-qualified suppliers ... 125–128
Advocacy
public benevolent institutions ... 379–381
Affiliates
aggregation rules ... 359, 361, 362, 365
Affordable housing
NSW
– build-to-rent developments ... 79
– property tax rate ... 129, 130
rising property prices, Australia ... 282
Victoria, build-to-rent developments ... 441
Agents – see **Tax agents**
Aggregated turnover
calculation ... 92
company tax rates ... 15–17
consolidated groups ... 365, 366
entities "connected with" another entity ... 346, 347, 596
"small business entity", definition ... 357
SMEs ... 296, 297, 300
summary of tests ... 358
Aggregation of interests
landholder duty ... 196–198
Aggregation rules ... 359, 361
Agreements – see **Reimbursement agreements**
Agricultural industry
biotechnology and medical patents ... 594–596
Airbnb ... 190, 615
Alienation of income
personal services income ... 622
Allocation of profits
professional firms ... 404, 406, 407, 543–551, 626–637
Allowance for corporate equity ... 168
Allowances
FBT
– employee travel ... 217
– living-away-from-home ... 217, 597
travel and overtime meal allowances ... 92
Angel investors
R&D tax incentives ... 529
Annual general meetings
electronic communications ... 345
Anti-avoidance rules ... 167
Anti-streaming rules ... 167
Appointors
discretionary trusts, incapacity ... 258, 259
Apportionment
capital expenditure deductions ... 415
software distribution rights ... 203, 204
APRA funds
non-arm's length income being applied to ... 436, 437
Artificial intelligence ... 163, 190, 191, 245–248, 255
Asprey report ... 169
Assessable income
land, sale and subdivision ... 9
Assessments – see also **Default assessments**
objections, extension of time ... 150
Assets – see also **CGT assets; Depreciating assets**
instant asset write-off ... 362
market valuation of, SMSFs ... 174–177, 182, 183
use of, safe harbour method ... 32
Associated companies
foreign income ... 353, 354
ASX listing rules
employee share schemes ... 685
"At risk" rule
R&D entities ... 407
Attribution managed investment trusts
corporate collective investment vehicle sub-fund trusts
– AMIT rules applied to ... 375–377
– non-qualification as an AMIT ... 263, 264, 377
– tax treatment ... 217, 265, 374
infrastructure support ... 533
multi-class election ... 723
tax election ... 723
Auditor contravention report ... 175, 176, 179, 180
Auditors
SMSFs
– auditor number misuse ... 460
– evidence ... 175
– liability ... 181–183
– valuation documentation ... 174, 175
Audits
litigation ... 696–699
SMSFs
– auditor number misuse ... 460
– non-arm's length income and expenses ... 179
Australia
Australia–UK DTA ... 236, 347
corporate income tax rates ... 15
international transfer pricing ... 230
IP box effective tax rates ... 239
rising property prices ... 282
"royalty", definition ... 99
tax structure compared with OECD ... 105
tax treaty network ... 231, 283
Australian Agriculture Worker Program ... 460
Australian Capital Territory
tax reform ... 89
Australian Charities and Not-for-profits Commission
public benevolent institution ... 285, 379–382
reforms ... 283
Australian economy
digitalisation ... 368
R&D benefits ... 531
recovery ... 104
SMEs, role ... 296
tax policy settings ... 164, 165
Australian financial services licence ... 74
Australian Register of Therapeutic Goods ... 513
Australian resident ... 347
Australian resident trusts
foreign resident beneficiaries, capital gains ... 11–14, 35–37, 123, 124, 232
Australian tax system
corporate residency and tax liability ... 165
corporate tax rates ... 164
efficiency ... 106, 108
employment taxes ... 469–476
equity ... 106, 108
individuals income tax ... 609, 610
reform ... 104–109, 144
role of innovation ... 531–541
rule of law ... 569–574
simplicity ... 107, 108
Australian Taxation Office
administrative and interpretative guidance ... 2
Advice under development program ... 298
client identity verification ... 5, 461
digital change agenda ... 185–187
employee/contractor decision tool ... 471
GST property decision tool ... 346
Inspector-General and Ombudsman reviews ... 404, 510
legal professional privilege ... 284
litigation ... 696–699
National Tax Liaison Group meeting ... 2
private company unpaid present entitlements, Div 7A ... 515, 519–521
professional firms ... 404, 406, 407, 546, 547, 626–630
reportable tax position schedule ... 304–306
residency rules ... 404
"royalty", definition ... 204
Single Touch Payroll ... 404, 471
SMSF auditor number misuse ... 460
SMSFs
– audit evidence ... 175
– non-arm's length income and expenses ... 179
Tax Avoidance Taskforce ... 345, 353, 371–373
Australian Treasury
Div 7A consultation paper ... 27–33
global minimum tax rate ... 345
Not-For-Profit Tax Concession Working Group ... 475
patent box regime ... 146, 235
treaty negotiation project ... 231, 283
Australians working overseas
exemption of certain income ... 617, 622
Automation ... 190, 191, 245–248, 252–254, 619

B

Baby boomers ... 423
Backing business investment ... 407
Backpacker tax
appeal ... 347
Bare trusts ... 254
Base erosion and profit shifting ... 165, 230, 540
Base rate entity rules
company tax rates ... 15–17
passive income ... 16, 17, 296, 300
SMEs ... 296
Belgium
IP box effective tax rates ... 239
Benchmark ceiling election
franking credits ... 722, 723
Benchmark interest rate
Div 7A ... 91
Binding death benefit nominations ... 648
SMSFs ... 125, 126, 260, 479, 482
– wills versus BDBNs ... 329, 330, 490, 491
Biotechnology and medical patents ... 17, 91, 146, 235, 513, 594–596
Black Economy Taskforce ... 458, 618, 622
Black swan events ... 254, 255
Blackhole expenditure ... 229, 409, 413–416
Blockchain-based crowdfunding
R&D tax incentives ... 530
Board of Taxation
CGT roll-overs ... 171
corporate tax residency ... 165, 404
FBT compliance cost review ... 472
granny flat arrangements ... 95
R&D tax incentives ... 113
review of income tax residency rules ... 617
review of international tax arrangements ... 232, 233
small business tax concessions ... 357, 361, 363–366
tax consolidation rules ... 227
tax residency rules ... 404
Boilerplate clauses
share sale agreements ... 68
Bootstrapping
R&D tax incentives ... 530
Bright-line tests ... 545
Build-to-rent developments
NSW ... 79, 131
Victoria ... 440–442

Burden of proof
tax litigation ... 699
Burial rights
GST supply ... 7
Business capital expenditure
blackhole expenditure ... 413–416
international tax ... 229
Business continuity test
same business test ... 49–51
similar business test ... 50–53
Business entities
COVID-19 measures ... 144
derivation of passive income ... 300
sale or cessation, capital expenditure deductions ... 415
taxation and imputation ... 166–168, 297, 298
Business real property ... 301
Business structure – see also **Corporate structure; Restructuring**
professional firms ... 545–549

C

Canada
corporate income tax rates ... 15
work-related expenses ... 619
Capacity
appointors or guardians ... 258, 259
SMSF succession planning ... 648, 649
Capital account election
MITs ... 722
Capital account or revenue account
election, corporate collective investment vehicle sub-fund trusts ... 377
pre-paid rent ... 8, 9
Capital gains
pre-CGT transactions ... 317–323
Capital gains discounting
corporate collective investment vehicles ... 265
Capital gains tax – see also **CGT assets; CGT roll-overs**
Asprey report recommendations ... 169
Australian trusts, foreign beneficiaries ... 11–14, 35–37, 123, 124, 232
deceased estate beneficiaries ... 349–351
event A1 ... 47, 291, 301, 319, 426, 463, 464, 602, 603
event C2 ... 157, 319
event E1 ... 39, 319, 717
event E2 ... 319, 717
event E3 ... 319
event E5 ... 38, 319
event E6 ... 319
event E7 ... 39, 319
event E8 ... 319
event I1 ... 323, 612
event I2 ... 37, 323
event J1 ... 319
event J2 ... 364
event J5 ... 364
event J6 ... 364
event K3 ... 319, 323
event K6 ... 317, 319–323
event K7 ... 616, 617
foreign exchange rules ... 228, 229
foreign-source income ... 36, 37, 232
granny flat arrangements ... 6, 95–97
housing affordability ... 282
jointly owned land ... 601–604
main residence exemption ... 615
Reform of the Australian tax system ... 169
summary of CGT events ... 170
trust vesting ... 37–39
trusteeship changes ... 426
Capital losses
quarantining ... 168, 621
Car limit
GST ... 7, 678
Car parking benefits
FBT ... 92, 93, 410, 473, 671
Carrying on a business
active assets ... 523–525
business proposed ... 413, 414
rental properties ... 219
Cars – see **Electric vehicles; Motor vehicles**
Carve-outs
tax indemnity ... 65
Cash flow boost ... 297, 672, 673
Cash flow taxation
SMEs ... 300, 301
Cemeteries
GST, supply of burial rights ... 7
Central management and control
corporate residency ... 165
SMSF tax residency ... 177, 178
Cessation of business
capital expenditure deductions ... 415
Cessation of employment
employee share schemes ... 513, 684
CGT assets
definition ... 463
identification ... 463–465
interests in property ... 463, 464
pre-CGT transactions ... 317–323
record-keeping ... 465
whether “active assets” ... 523–525
CGT discount
individuals ... 614, 619
CGT exemptions
deceased estates, main residence ... 288–291
granny flat arrangements ... 6, 95
retirement, small business owners ... 359, 365, 367
CGT roll-overs
proposed reform ... 171
small business ... 366, 367
Change
ATO change agenda ... 185
EQ/IQ balance ... 192, 193
remote working ... 188
robotics, automation and artificial intelligence ... 190, 191, 249, 250, 252–256
sharing economy ... 188, 189
tax profession ... 185–194, 243–256
Charities and not-for-profit entities
“charity”, definition ... 420
FBT concessions ... 470, 475
harmonisation of administration ... 419, 420
public benevolent institutions ... 285, 379–382
reforms ... 283
tax treatment ... 419–422
Child care ... 107
Child Care Subsidy ... 456, 553–560, 618
Child support garnishees ... 404
Children – see also **Adult children**
admission to SMSFs ... 260–262
death benefit dependants ... 480, 483
discretionary trusts ... 515
Churning rules ... 227
Circular trust resolutions ... 43, 44
Clearance certificates
share sale agreements ... 68
Client identity verification ... 5, 461
Clothing
work-related expenses ... 673, 674
Clubs
games and sports exemption ... 345
Collectables and personal-use assets
SMSFs, valuation requirements ... 182, 183
Commercial debt forgiveness
natural love and affection ... 460
Commercial parking stations ... 93, 410, 671
Commercialisation
intellectual property ... 537, 538, 540
Commissioner of Taxation
access powers ... 431–435
accountants' concession ... 434
annual report 2019-20 ... 535
business structure ... 545
commercial debt forgiveness ... 460
default assessments ... 218, 219
discretion
– to disregard Div 7A ... 22
– to extend two-year period, deceased estate ... 290, 291
foreign investment rules ... 675
general administration power ... 570–572
information-gathering, statutory powers and functions ... 484–486
information notices ... 285, 286, 431, 432
legal professional privilege ... 432–434, 484
litigation ... 696–699
personal services income ... 545
public ruling system ... 572–574
remedial powers
– Inspector-General and Ombudsman reviews ... 404, 510
rule of law ... 569–574
SMSF auditor number misuse ... 460
tax records education direction ... 459
transfer pricing issues ... 492–494
Common law
Harman principle ... 484
Companies
AGMs, electronic communications ... 345
tax losses, utilisation ... 168, 169
Company tax rates – see **Corporate tax rates**
Comparables
transfer pricing issues ... 492–494
Compliance
charities and NFPs ... 419
client identity verification ... 5, 461
professional firms ... 404, 406, 407, 630
small business costs ... 361
tax professionals ... 191, 192
Computer software
royalty withholding tax ... 99–102
whether distribution rights are royalties ... 202–204
Concessional contributions
tax rates ... 437, 438
Concessional tax treatment – see **Tax concessions**
Concessional tracing rules ... 47
“Connected with”
aggregated turnover ... 346, 347, 361, 362, 596
Consideration
acquisition of land, GST ... 219, 220
real and genuine ... 134–136
share sale agreements ... 67, 68
Consolidated groups
aggregated turnover ... 365, 366
determining losses transferred ... 54–56
interaction of loss rules ... 57–59, 227
international tax ... 227
recouping losses transferred ... 54
reportable tax position schedule ... 304
transferring losses to ... 53
Consumption taxes
reform ... 163, 166, 233
Contempt of court
tax agents ... 217, 218
Continuity clauses
partnerships, jointly owned land ... 604
Continuity of ownership test
concessional tracing rules ... 47
concessions ... 62
losses ... 45–49
notional shareholders ... 47–49
saving provision ... 46
substantial continuity of ownership ... 47
Contractor/employee distinction
ATO decision tool ... 471
payroll tax liability ... 470
Contracts
sale and purchase of land, GST ... 152–155
Contribution reserving ... 73, 74
Contributions – see **Superannuation**
Controlled foreign companies
active income ... 300
Controlled foreign currency rules ... 230, 231
Copyright
depreciation ... 459
software distribution rights ... 202, 203
software licences ... 239
Corporate collective investment vehicles
corporate collective investment vehicle sub-fund trusts
– AMIT rules applied to ... 375–377
– deemed to be a unit trust ... 264
– non-qualification as an AMIT ... 263, 264, 377
– tax treatment ... 217, 265, 374
legislation ... 217, 263–266, 374–377, 513, 563
Corporate groups
tax consolidation rules ... 227
Corporate limited partnerships
aggregated turnover, “connected with” concept ... 347, 596
Corporate structure – see also **Business structure; Restructuring**
corporate collective investment vehicles ... 265
for future initial public offering ... 156–159
SMEs ... 296–302
Corporate tax compliance
reportable tax position schedule ... 304–306
Corporate tax rates
base rate entities ... 15–17, 296
disincentive to foreign investment ... 166
dual rate system ... 165
enterprise tax plan ... 15
foreign investment ... 164
global minimum tax ... 345
imputation system ... 299
IP box comparison ... 239
OECD countries ... 165, 166
patent box concession ... 146
single business tax rate ... 299, 301
SMEs ... 297, 298, 301
Corporate tax residency
permanent establishments ... 231
rules ... 119–121, 404
source-based income ... 230, 231
tax liability ... 165
Corporate trustees
SMSFs, succession planning ... 649
Corporate venture funds
R&D tax incentives ... 530
Corporations
Australian tax treaty network ... 231, 283
business capital expenditure ... 229
consolidated groups ... 227
diverted profits tax ... 163
foreign exchange rules ... 228, 229
foreign income tax offsets ... 231, 232
foreign income trusts ... 232, 233
hybrid mismatch rules ... 163
international tax ... 163–171, 227–233
permanent establishments ... 231
residence versus source-based taxation ... 230, 231
residency ... 119–121, 404
structure – see **Corporate structure; Restructuring**
tax consolidation rules ... 227
tax losses, utilisation ... 168, 169
TOFA ... 227, 228
transfer pricing rules ... 229, 230
Correctional services officers
work-related expenses ... 673, 674

Cost base rules
corporate collective investment vehicle sub-fund trusts, adjustments 376
deceased estates 691, 693
Cost of living
measures to assist with 594
tax offset 594, 595
Covenant to pay
mergers and acquisitions 64–68
COVID-19 measures
businesses, financial support 144
Div 7A loan repayment extension 91, 92
loss recoupment 45, 52, 59, 61, 62
permanent establishments created by 7
recovery from impact 104
SMSF challenges 174, 176, 177, 180
Tax Institute support 87
Tax Institute volunteers 86
tax professionals, impact on 185, 186, 215
tests, deductibility 459, 594, 596
Cross-border transactions
software, royalty withholding tax 99–102
transfer pricing 229, 230
Crowdfunding
R&D tax incentives 530
Cryptocurrency 245, 260
Cyprus
IP box effective tax rates 239

D

Data-matching
foreign tax jurisdictions 353, 372, 373
sharing economy 458
De minimis provisions
transfer pricing 229, 230, 233
Death
pre-CGT assets 323
Death benefit dependants 480
Death benefits — see **Superannuation death benefits**
Death duties 693, 694
Debt/equity rules 167
Debt forgiveness
Div 7A 25, 32
natural love and affection 460
Debt funding
R&D tax incentives 530
Deceased estates
CGT liability 349–351
CGT main residence exemption 288–291, 691
cost base rules 691, 693
foreign residents 693
pre-CGT assets 323
private wealth transfer 691, 693
small business roll-over 364
superannuation
– death benefits 479–482
– wealth transfer 691
tax exemption on death 693
Decentralised autonomous organisations 564
Declarations
of trust
– formal requirements 314
– property unexecuted 268, 269
share sale agreements 68
Deductible gift recipients
ACNC registered charities 283
public benevolent institution tax concessions 379–382
reform 420
Deductions for expenditure
blackhole expenditure 413–416
cash flow taxation model, SMEs 300, 301
correctional services officers 673, 674
COVID-19 tests 459, 594, 596
employee remuneration trusts 645, 646
employee share schemes 513, 514, 597
employee travel 217
environmental protection activities 292–294
pre-paid rent 8, 9
R&D 113–117, 407
reasonable amounts 150
temporary full expensing 407, 513
vacant land 147, 148
Deemed dividends
Div 7A 25–33
Default assessments
GST 218, 219, 348
income tax 218, 347
onus of proof 93, 94, 218
Deferred taxation
employee share schemes 345, 346, 368
luxury car tax 346
Depersonalisation
transfer pricing issues 492–494
Depreciating assets
cars, business use 7
cash flow taxation model, SMEs 300
exploration or prospecting 461
full expensing 362, 363
intangible, self-assessing effective life 459
rental properties 616, 617
temporary full expensing 407, 513
Deregistration
tax agents 217, 218, 461, 462
Developers
property tax reforms (NSW) 131
Digital businesses
software distribution rights 202–204
Digital technologies
investment boost 595
Small Business Digital Taskforce 368
Digital transformation agenda
ATO 185
Directors
fees, derivation issues 516, 517
SMSFs, succession planning 649, 650
Disability 96
Disabled persons
granny flat interest eligibility 96
Disclaimers
discretionary trusts, tax effectiveness 598, 639–644, 716
Disclosure — see **Reporting obligations**
Discretionary trusts
adult children arrangements 515
appointors, incapacity 258, 259
beneficiaries
– foreign residents, capital gains 11–14, 35–37, 123, 124, 232
– identifying 71
circular trust resolutions 43, 44
conversion to unit trusts 716, 717
disclaimers, tax effectiveness 598, 639–644
distribution resolutions 214
extending vesting date 312–316
foreign persons 42, 43
intergenerational wealth transfer 715–717
land tax surcharges 42, 43, 71
not validly created 267–269
pre-CGT transactions 318, 319
real and genuine consideration 134–136
SMEs, taxation 298, 299
succession, tax effectiveness 715–717
trust splitting 39–42, 716
Discrimination
residency of taxpayer 347
Dispute resolution
R&D administration costs 537
Disregarded small fund assets rule 561, 562
Distributable surplus
Div 7A loans 28, 29
Distribution rights
software
– royalty withholding tax 99–102
– whether royalties 202–204
Diversity and inclusion 402, 403, 457, 553
Diverted profits tax
corporate compliance costs 163
Dividend access shares
pre-CGT transactions 319
Dividend stripping 167
Dividends
Div 7A
– deemed 25–33
– distributable surplus 28, 29
– later set-off 26, 27
Division 7A
14-year amendment periods 28
assets, safe harbour method 32
benchmark interest rate 91
breaches, self-correction 31
Commissioner's discretion to disregard 22
deemed dividends 25–33
employee remuneration trusts 646
FBT anti-overlap provisions 33
interposed entity rules 24, 25
later dividends 26, 27
loans
– 10-year loans 29, 30
– 14-year amendment periods 28
– debt forgiveness 25, 32
– definition 519
– distributable surplus 28, 29
– ordinary course of business 32
– pre-4 December 1997 .... 26, 30
– proposed rules 29
– repayment 22–24, 91, 92
– taxable purpose 692
– transitional rules 30, 31
minimum yearly repayments and COVID-19 .... 91, 92
non-resident private companies 31, 32
proposed reform 22–33, 692
Treasury consultation paper 27–33
unpaid present entitlements 27, 30, 31, 515, 519–521
Documentation
AGMs, electronic communications 345
Commissioner's access powers 431–435
declaration of trust 314
director fees, derivation issues 516, 517
foreign assessable income, genuine gifts or loans 371–373
Harman principle 409, 410, 484, 485
legal professional privilege 285, 286
SMSFs
– additional members 260–262
– communication with trustees 182
– non-qualified suppliers of deeds 125–128
– valuation of assets 174, 175
tax litigation 696, 697
trust property 267–269
trusteeship changes 426, 427
Double tax agreements
Australian network 231, 283
Australia–UK 236, 347
Due diligence
share sale agreements 67
Duty of care
accountants and auditors, SMSFs 181
Dwelling
acquired from a deceased estate 288–291
granny flat interest in 96

E

Early-stage innovation companies
incentives for investment 533
Earning activities
environmental protection activities 292, 293
Economic support payment 594
Education — see **Tax education**
Effective life
intangible assets, depreciation 459
Elder abuse
granny flat arrangements 95
Electric vehicles 89, 90, 216, 474
Electronic sales suppression tools
administrative penalties 284, 285, 515, 516
Emotional quotient/intelligence quotient balance 192, 193
Employee/contractor distinction
ATO decision tool 471
payroll tax liability 470
Employee option plans 408, 409
Employee remuneration trusts
tax rules 645, 646
Employee share schemes
ASX listing rules 685
cessation of employment 513, 684
concessions 360
deferred taxation 368, 513
disposal restrictions 345, 346, 364
expenses, deductibility 513, 514, 597
genuine disposal restrictions 597
incentives for investment 534
initial public offering 685
payroll tax liability 683
performance rights 685
residency of individuals 683, 684
salary sacrifice 684, 685
tax reforms 147
zero priced options 685
Employees
definition 470, 471, 476
Employment taxes 469–476
FBT 469, 470, 472–475
harmonisation across Australia 475, 476
PAYG withholding 472
payroll tax 470, 471, 474, 476
End-user licence agreements
software 202, 203
Enduring power of attorney
delegation 258
role 648
SMSFs 261, 720
Enterprise tax plan
corporate tax rates 15
Entities "connected with" another entity
aggregated turnover 346, 347, 596
Environmental protection activities
deductible expenditure 292–294
Equitable estoppel 566–568
Equity
Australian tax system 106, 108
Equity crowdfunding
R&D tax incentives 530
Equity holders
individual professional practitioners 546
Estate planning — see **Succession and estate planning**
Estate taxes 693, 694
Estoppel by encouragement 566–568
Evidence
declaration of trust 314
director fees, derivation issues 516, 517
foreign assessable income, genuine gifts or loans 371–373
loan accounts, discretionary trusts 427
SMSF audits 175
transfer pricing issues 492–494
trust property, declaration unexecuted 268, 269

Excess concessional contributions
non-arm's length income and expenses....436–438
Excess GST
passing on....220
Exchange of information
foreign income....353
MIT withholding tax....377, 533
Exempt current pension income
SMSFs....561, 562
Exemptions
CGT
– granny flat arrangements....6, 95
– main residence, deceased estates....288–291
clubs, games and sports exemption....345
FBT, skills training....6
Expenditure
deductibility — see **Deductions for expenditure**
Exploration
depreciating assets....461
share exchange, profits....517
Express trusts
not validly created....267–269

F
Fair value election
TOFA election....724
Fairness
tax system....106, 107, 456, 570, 574
False or misleading statements
penalty provisions....677–681
Families
adult children arrangements....515
child care....107
Child Care Subsidy....456, 553–560
SMSFs, additional members....260–262
working mothers....107, 456, 553
Family businesses
small business tax concessions....357–368
Family dealing — see **Ordinary family or commercial dealing**
Family farms
tax exemption on death....693
Family law
tax equalisation....425, 426
Family provision claims....481
Family trusts — see **Discretionary trusts**
Federal Budget 2016-17....374–377, 521
Federal Budget 2017-18....362
Federal Budget 2018-19....423, 458, 521
Federal Budget 2019-20....353, 561
Federal Budget 2020-21
corporate residency test....165
FBT record-keeping....472
loss carry back measures....168
small business tax concessions....357
Federal Budget 2021-22
corporate collective investment vehicles....374–377
corporate tax residence....119
employee share scheme reforms....147, 369
individual tax residency rules....404, 612, 622
loss carry back measures....59, 61, 168
patent box regime....146, 235, 540
tax cuts....17
Federal Budget 2022-23
cost of living tax offset....594–596
COVID-19 tests, deductibility....594, 596
fair tax policies....456
key tax measures....594
Medicare levy low income thresholds....595, 596
patent box regime....594–596
PAYG instalment systems....595
small business measures....595
Tax Institute submission....456, 457
tax reform....510
training....595
Federal community benefit bond....421, 422
Federal election....594, 668, 669
Females — see **Women**
Fiduciary powers
appointors, discretionary trusts....259
Financial accommodation
Div 7A, unpaid present entitlements....515, 519–521
Financial accounts
SMSFs, valuation requirements....182, 183
Financial arrangements
international tax....227, 228
Financial dependants....480
Financial planners
SMSF deeds....125, 127
Financial reports election
TOFA tax election....724, 725
Financial statements
tax uncertainty, reportable tax position schedule....305
First Home Super Saver Scheme....282
"First uses"
depreciating assets....461
Fixed entitlement
trust distributions to superannuation funds....326, 327, 387
Fixed trusts
identifying beneficiaries....72
non-arm's length income....386, 387
Flow-through tax treatment
corporate collective investment vehicle sub-fund trusts....374–376
Food and drink expenses....217
"For exploration"
depreciating assets....461
Foreign beneficiaries
Australian trusts, CGT....11–14, 35–37, 123, 124, 232
Foreign companies
corporate tax....165
permanent establishments created by COVID-19....7
private companies, Div 7A....31, 32
reportable tax position schedule....304
Foreign duty surcharges
discretionary trusts....71
Foreign exchange rules
gains and losses....228, 229
short-term foreign exchange election....725
Foreign hybrids
aggregated turnover, "connected with" concept....347, 596
limited partnerships, tax election....725
Foreign income
associated companies....353, 354
tax offsets....231, 232
trusts....232, 233
undeclared....283, 284, 353, 354, 371–373
Foreign investment
breach of rules, penalties....674, 675
corporate collective investment vehicles....217, 263–266, 374–377, 513
corporate tax rates disincentive....166
corporate tax regime....164
encouragement....165, 235
international tax complexity....230
property tax (NSW)....131
Foreign limited liability company
tax election....725
Foreign persons
breach of foreign investment rules....674, 675
land tax surcharges....42, 43
Foreign residents
deceased estates....693
discretionary trust beneficiaries, capital gains....11–14, 35–37, 123, 124, 232
Div 7A, private companies....31, 32
main residence exemption....610, 615, 620
share sale agreements....68
withholding tax, MITs....533
workers, tax rates....460
Foreign-source income
CGT....36, 37
Forgiveness of debts
Div 7A....25
Formal notices
Commissioner's information requests....431, 432
France
corporate income tax rates....15
IP box effective tax rates....239
Franking credits
benchmark ceiling election....722, 723
refund....167
refundable excess....297, 299
Franking distributions
company tax rates....17
Franking rate variation
SMEs....296, 297
Freezing orders
worldwide....407, 408
Fringe benefits tax
cars....473, 474
– cents per kilometre....597
– electric....474
– parking benefits....7, 8, 92, 93, 410, 473, 671
COVID-19 tests, deductions....459
Div 7A, anti-overlap provisions....33
employee remuneration trusts....645
employee travel allowances....217
inefficiencies....472, 473
living-away-from-home allowances....217, 597
NFP concessions....470, 475
"otherwise deductible" rule....473, 475
rates....469
record-keeping....363, 364, 472
revenue source....469, 470
skills training exemption....6
work-related travel....474
Fuel excise reduction....594
Future tax liability....424
initial public offerings....156–159

G
G20
global minimum tax rate....345
Games and sports exemption....345
GDP uplift factor
tax instalments, variation....595
Gender equity....107, 456, 618
General anti-avoidance rules
professional firms....404, 406, 407, 543
"Genuine disposal restrictions"
employee share schemes....597
Germany
corporate income tax rates....15
Gifts
foreign income disguised as....283, 284, 353, 371–373
Gig economy — see **Sharing economy**
Global economy
innovation....529
Global innovation index 2016....536
Global tax environment — see **International tax**
Going concern concession
sale and purchase of land, GST-free....152
Gold schemes....286
Goods and services tax
Australia compared with OECD countries....105
car limit....7, 678
consideration, acquisition of land....219, 220
corporate collective investment vehicles....265
default assessments....218, 219, 348
GDP uplift factor for tax instalments....595
gold schemes....286
jointly owned land....601–604
low-value imported goods....91
luxury cars, avoidance arrangements....346
property decision tool....346
reform....105
sale and purchase of land, contractual issues....152–155
superannuation fund, not registered for GST....598, 599
supply of burial rights....7
Goodwill....367
pre-CGT or post-CGT asset....321
Government support
infrastructure investment....539
intellectual property, commercialisation and retention....540
R&D tax incentives....530, 532, 539, 540
Granny flat arrangements
CGT....6, 95–97
Groups — see **Consolidated groups**
Guardians
incapacity....258, 259
Gym membership
work-related expenses....674

H
Hardship
property tax (NSW)....131
Harman principle....409, 410, 484, 485
Harmonisation
administration, charities and NFPs....419, 420
"employee", definition....476
payroll tax....474, 476
"worker", concept of....475, 476
Health and wellbeing
changing work environment....511
mental health surcharge (Vic)....90
Hedging election
TOFA election....724
Henry review....105, 108, 419, 475, 531, 611, 614, 618, 621, 622
High-income earners....614, 617
Higher education — see **Tax education**
Holding period and payment rules....167, 722
Home Guarantee Scheme....594
Hourly rate cap
Child Care Subsidy....553, 555–558
Housing affordability
NSW
– build-to-rent developments....79
– property tax rate....129, 130
rising property prices, Australia....282
Victoria, build-to-rent developments....441
Hungary
IP box effective tax rates....239
Hybrid mismatch rules
corporations....163

I
Identity verification....6
Implied undertaking....484, 485
Imputation system
company taxation....166, 167, 299
integrity measures....167
interaction with tax concessions....167
reform options....167, 168
refund of franking credits....167
SMEs....297, 299
In-house assets
SMSFs....179, 180, 182, 183
In-house software
depreciation....459
In specie asset transfer
superannuation death benefits....482
Incapacity
appointors or guardians....258, 259

Incentive schemes – see also **Tax incentives**
Child Care Subsidy 553–560
employee option plans 408, 409
employee share schemes 534
Income
foreign-source, CGT 36, 37
Income alienation 622
Income from personal services 543
Income from property 543
Income splitting
professional firms 543
Income stream assets
SMSF valuation requirements 183
Income tax
Australia's reliance on 105
default assessments 218, 347
individual residents 17
introduction in Australia 166
Income tax returns
tax uncertainty, reportable tax position schedule 305
Indirect control test
public entities, aggregated turnover 347
Individual professional practitioners 546–551
Individual taxpayers – see **Personal income tax**
Individuals income tax 609
CGT discount 610, 614, 619–621
concessions and offsets 609, 610
investment income 611
levies 610
main residence exemption 610, 614–616, 619, 620
marginal rate taxation 610–613, 618, 621
personal services income 612, 617, 618, 622
rates and thresholds 609
rates of tax 610
reform options 622
tax residency and source 611, 612, 617, 622
vacant land rules 620, 621
work-related expenses 610, 613, 614, 618, 619
workforce participation 613, 618
Industry Innovation and Science Australia 111, 117
Information-gathering
ATO, foreign data 353, 372, 373
Commissioner of Taxation
– access powers 431–435
– notice 285, 286
corporate tax compliance 304–306
Harman principle 409, 410, 484, 485
tax litigation 696, 697
Information notices
Commissioner of Taxation 285, 286, 431, 432
Infrastructure
innovation
– government support 539
– importance of 532
– incentives for 529–541
Initial public offering
employee share schemes 685
restructuring for 156–159
Innovation
access to finance 536
Australian system, issues and options 536–541
cycle 529, 530
definition 529
government support 531
infrastructure 536
– importance of 532
– incentives and 529–541
patents, depreciation 459
R&D collaboration in Australia 536, 537
risk 530, 531
role of tax system 531, 532
tax professionals 246, 247
Input tax credits
car limit 7, 678
GST property decision tool 346
Insolvency
retention obligations 6
Inspector-General of Taxation
reviews of ATO 404, 510
Instant asset write-off 362, 407
Insurance tax
international tax 229, 230
Intangible assets
depreciation, self-assessing effective life 459
intellectual property 538
Integrity measures
imputation system
– manipulation 167
– SMEs 297
loss carry back rules 60
loss duplication arrangements 227
R&D 11
small business tax concessions 361–363, 367
superannuation taxation 385
vacant land rules 617
Intellectual property
commercialisation 537, 538, 540
government support 540
intangible assets 538
offshore markets 538
patent box concessions 146, 235–241
sale, whether "active assets" 525
software distribution rights 204
transfer pricing 538
Intelligence quotient 192, 193
Interdependency relationships 480
Interest income
not base rate entity passive income 16, 17
Intergenerational wealth transfer 482
deceased estates 691, 693, 694
discretionary trusts 715–717
trust estates 689, 690
International investment – see **Foreign investment**
International "revenue rule" 307–310
International tax
Australian tax treaty network 231, 283
business capital expenditure 229
consolidated groups 227
corporate tax residency 404
corporations 163–171, 227–233
foreign exchange rules 228, 229
foreign income tax offsets 231, 232
global minimum tax rate 345
landholder duty (NSW) 307–310
permanent establishments 231
residence versus source-based taxation 230, 231
tax consolidation rules 227
TOFA 227, 228
transfer pricing rules 229, 230
trusts, foreign income 232, 233
Interposed entity rules
Div 7A 24, 25
Investment – see also **Foreign investment**
corporate collective investment vehicles 217
corporate tax regime 164
individuals income tax 611
infrastructure, access to finance 536
innovation and risk 530, 531
Investment properties
negative gearing 282, 611, 616, 617, 621
vacant land rules 617, 620, 621
Ireland
IP box effective tax rates 239
Italy
corporate income tax rates 15

J
Japan
corporate income tax rates 15
Job creation and artificial intelligence 191
JobKeeper payments
eligibility 516
R&D expenditure 407
Johnson report 563
Joint tenants
deceased estates 289, 290
Jointly owned land 601–604
partition 602
partnership issues 602–604

K
Know-how
software 100, 101

L
Labour market issues 470
Land – see also **Vacant land**
consideration for acquisition, GST 219, 220
jointly owned 601–604
primary production, adult children 620, 621
sale and purchase, GST contractual issues 152–155
sale and subdivision 9
Land tax (NSW)
build-to-rent developments 79
reform 89, 129–132
Land tax (SA)
reform 89
Land tax (Vic)
build-to-rent developments 440–442
reform 90
Land tax surcharges
discretionary trusts 71
foreign persons 42, 43
Landholder duty rules
aggregation of interests 196–198
property tax (NSW) 132
property transfers (NSW) 307–310
Large businesses – see **Corporations**
Leases
pre-paid rent, allowable deductions 8, 9
vacant land 148
Legal profession
accountants, distinctions between 250–252
AI 191, 252
innovation 246, 247
Legal professional privilege 284–286, 432–434, 484, 697
Licensing
depreciation 459
patents 239, 240
software
– distribution rights 202–204
– royalty withholding tax 99–102
Life events test 615
Lifetime business retirement cap 367
Limited recourse borrowing arrangements
SMSFs, non-arm's length income 179, 385
Liquidation
retention obligations 6
Litigation
burden of proof 699
information-gathering 696, 697
reimbursement agreement 514
SMSF professionals 174, 181
Living-away-from-home allowances 217, 597
Loan accounts
tax and estate planning 427, 428
Loan agreements
complying, private companies 520
COVID-19 measures 91, 92
Loans
Div 7A
– 10-year loans 29, 30
– 14-year amendment periods 28
– debt forgiveness 25, 32
– distributable surplus 28, 29
– ordinary course of business 32
– pre-4 December 1997 26, 30
– proposed rules 29
– repayment 22–24, 91, 92
– taxable purpose 692
– transitional rules 30, 31
– unpaid present entitlements 515
foreign companies, loans to Australian companies 354
foreign income disguised as 283, 284, 353, 371–373
Loss carry back rules
claiming offset 60
integrity rules 60
temporary measures 59–61, 168, 513
Losses
business continuity test 49–53
consolidated groups and multiple entry consolidated groups 57, 58
continuity of ownership test 45–49
corporations, utilisation 168, 169
foreign exchange rules 228, 229
loss carry back measures 59–61, 513
non-commercial, capital expenditure deductions 416
quarantining 168, 231, 621
strategies to utilise 61, 62
tax consolidation rules 53–59, 227
Low and middle income tax offset 6, 594–596
Low emissions technologies
biotechnology and medical patents 594–596
Low income earners 297
Low-value imported goods
GST 91
Lump sum death benefits 479, 482, 719, 720
Luxembourg
IP box effective tax rates 239
Luxury car tax 7, 216, 346, 678, 679

M
Machine learning 248, 249, 253
Main residence exemption
complexity of provisions 614
deceased estates 288–291, 691, 693
foreign residents 610, 615, 620
individuals income tax 610, 611, 614–616, 619, 620
record-keeping 615
relationship breakdown 616
tax equalisation 425
"Main use"
property 524
Malta
IP box effective tax rates 239
Managed investment scheme 264
Managed investment trusts 263, 377
infrastructure support 532, 533
tax elections 722–725
Marginal rate taxation
individuals 610–613, 618, 621
Market valuation of assets
superannuation 174–177, 182, 183
Market value deeming rule
deceased estates 691, 693
Market value substitution rules
SMSFs, non-arm's length income and expenses 178, 179
Marriage breakdown – see **Relationship breakdown**
Matrimonial home
presumption of advancement 221–223
Maximum net asset value test 357, 359, 361
Medical and biotechnology patents 17, 91, 146, 235–239, 513, 594–596
Medicare levy
individuals income tax 610, 612, 613

low income thresholds............. 594–596
professional firm profits........... 628, 632

Meetings
electronic communications.............. 345

Member Profile
Brady Dever.. 468
John Elliott 226
Phil Shepherd 608
Alison Stevenson.................................. 528
Linda Tapiolas 688

Mental health and wellbeing
surcharge (Vic)...90

Mergers and acquisitions
share sale agreements 64–68
tax indemnity.................................... 64–68

Migration program tax rates.............. 460

Minimum tax rates
global minimum tax rate................... 345

Minimum yearly repayments
Div 7A complying loan agreements and COVID-19..................................91, 92

Motor vehicles
car limit 7, 678
car threshold amount...............................7
electric vehicles 89, 90, 216
FBT.. 473, 474
– car parking benefits 7, 8, 92, 93, 410, 473, 671
– cents per kilometre 597
luxury car tax........ 7, 216, 346, 678, 679
stamp duty...89

Multi-class election
AMITs 723

Multinational anti-avoidance law
software distribution rights 203

Multinational corporations
software, royalty withholding tax...99–102

Multinational groups
hybrid mismatch rules 163

Multiple entry consolidated groups 227
loss rule modifications....................57, 58

N

National Tax Liaison Group meeting......2

Natural love and affection
commercial debt forgiveness........... 460

Negative gearing.....282, 611, 616, 617, 621

Negligence
accountants and auditors, SMSFs... 181–183

Netherlands
IP box effective tax rates................... 239
work-related expenses 619

New South Wales
build-to-rent developments 79
electric vehicles
– duty..90
– tax incentives 216
landholder duty rules................. 307–310
payroll tax 90
property tax.............................89, 129–132
wind farms, fixtures and valuation 76–79

New Zealand
corporate income tax rates...................15
income tax system................................475
work-related expenses 619

Non-arm's length expenditure
SMSFs.......... 148, 149, 178, 179, 199–201, 384–387
superannuation contributions, tax impact 436, 437

Non-arm's length income
fixed trusts................ 326–328, 386, 387
SMSFs........... 148, 149, 178, 179, 199–201
superannuation contributions, tax impact 436, 437
Tax Institute submission to Treasury.. 592
trust distributions to superannuation funds 326, 327, 384–387

Non-concessional contributions
tax rate for excess.................................437

Non-discrimination clause
residency of taxpayer 347

Non-resident companies – see **Foreign companies**

Non-residents – see **Foreign residents**

Norway
electric vehicles 216

Not-for-profit entities – see **Charities and not-for-profit entities**

Notices
Commissioner's information requests.................. 285, 286, 431, 432

Notional estate provisions.................. 258

Notional shareholders
continuity of ownership test.........47–49

O

Obituary
Roger Lyne Hamilton SC................... 388

Objections
ATO process, Inspector-General and Ombudsman reviews 404, 510
extension of time.................................150
GST assessments................................. 348
income tax assessments....................347
stay order, small business reviewable decisions 513

OECD
global company tax rates 15
global minimum tax rates................. 345
Model Tax Convention on Income and on Capital.............................101, 204
Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting...............................165, 204, 230
Pillar One and Pillar Two reforms.................................... 2, 230, 231
R&D investment 531
tax structure compared with Australia 105

Offshore income – see **Foreign income**

Onus of proof
default assessments............. 93, 94, 218
transfer pricing issues 492

"Opt-in" election
TOFA election...723

Option plans
employee incentive schemes......................................408, 409

Ordinary course of business
Div 7A loans 32

Ordinary dealing exception
reimbursement agreements......................... 514, 515, 701

Ordinary family or commercial dealing
interpretation................................. 707–711
public benevolent institution 708
reimbursement agreements.... 411, 487, 488, 512, 514, 515, 701–705
tax avoidance...............................705, 706

Ordinary income tax
jointly owned land.......................601–603
– partition.. 602

Otherwise deductible rule 217, 473, 475, 692

Overtime meal allowances.....................92

Ownership interest
deceased estates, two-year rule... 289, 290

P

Pacific Australia Labour Mobility scheme... 460

Parents
Child Care Subsidy.....................553–560

Partnerships
aggregated turnover, "connected with" concept.............................347, 596
commercial debt forgiveness........... 460
foreign limited, tax election...............725
jointly owned land......................602–604

Passive income
base rate entity............. 16, 17, 296, 300
derivation by business entities........300

Patent box
concessional tax treatment.............. 146
government support for innovation industries 540
introduction to Australia...........235–241
medical and biotechnology innovations.......... 17, 91, 146, 235–239, 513, 594–596

Patents
depreciation 459

PAYG
GDP uplift factor for tax instalments.. 595
instalment systems, modernisation...................................... 595

PAYG withholding.....................................472

Payroll tax
"employee", definition 474, 476
employee share schemes 683
harmonisation, lack of 474, 476
reform levels 108
state Budgets................................... 89, 90
workforce issues 470

PCR tests
deductibility........................459, 594, 596

Penalties – see also **Administrative penalties**
foreign investment rules........... 674, 675
legal practice, unqualified entities..... 127
SG statement, failure to lodge..........149
SMSF deeds, non-qualified suppliers 126
statement penalties, safe harbour..677–681

Pension exemption
small funds.................................... 561, 562

Performance rights
employee incentive schemes.......................................408, 409
employee share schemes 685

Permanent
term not in definition of "commercial parking station" 93

Permanent establishments
corporate residence 231
created by COVID-19 impacts 7

Personal income tax – see **Individuals income tax**

Personal services business......... 612, 618

Personal services income
alienation... 622
capital expenditure deductions 416
individuals income tax................................ 612, 617, 618, 622
professional firms...................... 543–547

Pharmaceutical companies
patents 236–239

Phoenixing
luxury car tax 346

Plant and equipment
depreciation 616

Platform economy – see **Sharing economy**

Point of sale
electronic sales suppression tools 284, 285

Pollution
environmental protection activities 292–294

Polymerase chain reaction tests
deductibility........................459, 594, 596

Portugal
IP box effective tax rates.................. 239

Power of attorney
delegation 258

Precious metals
GST gold schemes............................... 286

Prepayment of rent
allowable deductions........................... 8, 9

Presumption of advancement
matrimonial home......................221–223

Primary carers
Child Care Subsidy.....................553–560

Primary place of employment
aircraft crew car parking benefits, FBT... 7, 8

Primary production land
adult children............................... 620, 621

Private companies
Div 7A
– loans 692
– non-resident 31, 32
– unpaid present entitlements.................515, 519–521
foreign income............................ 353, 354
self-assessment, reportable tax position schedule 304

Private unit trusts
landholder duty aggregation.... 196–198

Private wealth transfer 689–695

Productivity Commission.....164, 419, 540

"Profession" defined 189

Professional firms
allocation of profits.........404, 406, 407, 543–551, 626–637

Professional indemnity
insurance 126, 181
SMSF professionals 175, 181

Professional liability
accountants and auditors, SMSFs... 181–183

Profit allocation
professional firms...........404, 406, 407, 543–551, 626–637

Project DO IT....................................353, 371

Proof of identity 5, 461

Property
interests in, CGT asset............. 463, 464
main use, treated as deriving rent.. 524
used for carrying on a business 523

Property decision tool
GST.. 346

Property prices.. 282

Property settlement
spouse as sole director............425, 426

Property tax (NSW)
reform..89, 129–132

Property transfers
presumption of advancement 221–223
stamp duty (NSW)...................... 307–310

Property valuations
SMSFs..175, 176

Proprietary estoppel 566, 567

Prospecting
depreciating assets.............................. 461

Public benevolent institution
NFP entity registered as................... 285
ordinary family or commercial dealing...708
social welfare purpose............. 379–382

Public cemeteries
GST, supply of burial rights.....................7

Public companies
reportable tax position schedule 304

Public entities
aggregated turnover
– "connected with" concept......... 596
– indirect control test 347

Public ruling system.....................572–574

Purchase of land
GST contractual issues..............152–155

Q

Quarantined losses 168, 231, 621

Queensland
tax reform 89, 90

R

Ralph review 610

Rapid antigen tests
deductibility........................459, 594, 596

Rates of tax – see also **Corporate tax rates**
death benefits....................................... 480
foreign resident workers................... 460
individuals income tax 610

non-concessional contributions.......437
superannuation contributions,
non-arm's length income....... 437, 438
windfall gains tax (Vic) 440–442

R&D
agricultural industry............................ 596
"at risk" rule 407
dispute resolution, administration
costs...537
government support 532, 539, 540
gross domestic spending................... 535
investor risks.................................530, 531
offset rates..114, 115
patent box
concession................146, 235–241, 596
tax incentives.......... 91, 111–118, 167, 297,
529–541
– administration costs 537
– administration of................535, 536
technology and risk 243

Real and genuine consideration...................................134–136

Real estate
negative gearing................. 282, 611, 616,
617, 621

Real property
CGT, deceased estate
beneficiaries.................................349–351
GST property decision tool 346
landholder duty (NSW)..............307–310

Reasonable care
false or misleading statement
penalty 680

Receivers
retention obligations.................................6

Reconstruction
transfer pricing issues 492–494

Record-keeping
CGT assets 465
electronic sales suppression
tools 284, 285
FBT exemption.............................363, 364
main residence exemption................. 615
tax records education direction...... 459
transfer pricing............................229, 230

Reforms — see also **Tax reforms**
charities and NFPs......................283, 421
consumption taxes.......................163, 166
deductible gift recipients.........283, 420
Div 7A... 22–33, 692
employee share schemes....................147
imputation system 167, 168
private wealth taxation............ 689–695
transfer pricing rules........................... 230

Refundable excess franking credits...297, 299

Reimbursement agreements
adult children arrangements............. 515
"agreement", aspects of.....................702
definition 512
draft ruling and guideline..........514, 515
exclusions... 404
interpretation...............................487, 488
ordinary family or commercial
dealing................................. 298, 701–705
tax purpose.................................... 703–705
whether enforceable 410, 411

Related-party lease agreements
SMSFs, market valuation 176, 177

Relationship breakdown
elder abuse 95
main residence exemption..................616
property settlement, spouse as
sole director 425, 426

Remedial powers
Commissioner of Taxation
– and rule of law................................574
– Inspector-General and
Ombudsman reviews..........404, 510

Remote working....................................... 188

Rent
build-to-rent developments
– NSW..79, 131
– Victoria 440–442
main use of property........................... 524

pre-paid, allowable deductions.........8, 9
SMSFs, market valuation 176, 177

Rental properties
negative gearing................. 282, 616, 617
used for carrying on a
business.............................219, 523–525

Repatriation
undeclared foreign
income....................... 283, 284, 371–373

Reportable tax position schedule
corporate tax compliance........304–306

Reporting obligations
charities and NFPs................................ 419
corporate tax compliance........304–306
sharing economy 91, 458
Single Touch
Payroll 404, 471, 472, 476
standard business reporting 192
trustee beneficiaries 298, 299, 301

Research and development — see **R&D**

Residency — see **Tax residency**
employee share schemes........ 683, 684

Resident of Australia................................ 119

Resident trust for CGT purposes...........37

Residential property
foreign duty surcharges......................... 71

Restructuring
corporate collective investment
vehicles 265
for future initial public
offering..156–159
small business restructure
roll-over 364
SMSFs, landholder duty
aggregation 196–198

Results test 618

Retirement
small business
owners............357–359, 361, 363, 365

Retirement exemption
CGT, small business
owners.............................. 359, 365, 367

Retirement phase accounts
SMSFs... 182

Retraining
FBT exemption..6

Revenue account or capital account
pre-paid rent 8, 9

Revenue or capital losses 168

Reversionary pensions......................... 648

Ride-sharing 243

Ride-sourcing
reporting obligations.............................. 91

Risk
emergent technologies 243–247
innovation 530, 531

Risk assessment framework
professional firms............404, 406, 407,
543, 546–551, 626–631

Risk distribution...................................... 244

Risk management
tax election, managed trusts....722–725

Robots..........190, 191, 249, 250, 252–256

Roll-overs
corporate collective investment
vehicles, relief...................................... 265
pre-CGT assets..................................... 323
small business restructures............. 364

Royalties
active versus passive income...........300
patented inventions....................235–241
"royalty", definition........... 99, 204, 236
software distribution
rights............................99–102, 202–204

Rule of law...569–574

S

Safe harbours
deceased estates, main residence.....291
statement penalty
provisions.....................................677–681
transfer pricing..................229, 230, 233

Salary packaging 470, 473, 475

Salary sacrificing................. 474, 684, 685

Sale of business
capital expenditure deductions........ 415

Sale of land
GST contractual issues..............152–155

Sales
electronic sales suppression
tools 284, 285

Same business test............................ 49–51

Same share, same interest rule............46

Saving provision
continuity of ownership test................46

Secondary income earners
disincentives 609, 613, 618

Self-assessment
intangible depreciating assets......... 459
private companies, reportable tax
position schedule 304
unlimited assessment period 488

Self-managed superannuation funds
accountants and auditors,
liability..181–183
additional members...................260–262
auditor number misuse 460
deeds, non-qualified
suppliers 125–128
exempt current pension
income...561, 562
imputation system and SMEs............297
in-house assets 179, 180, 182, 183
landholder duty aggregation....196–198
litigation risks 174, 181
market valuation of
assets.............................174–177, 182, 183
non-arm's length income and
expenses......................148, 149, 178, 179,
199–201, 436, 437
real and genuine consideration........ 134
succession planning 648–650,
719–721
tax residency...................................177, 178
unit trust investments 199–201
wills
– additional members 261
– versus BDBNs....329, 330, 490, 491

Shadow economy.................................... 458

Sham transactions
gold schemes 286

Share capital tainting rules...................167

Share sale and purchase agreements
mergers and acquisitions 64–68
restructuring for initial public
offering.. 156

Sharefarming agreement............566, 567

Shares
director fees, derivation
issues...516, 517
employee option plans 408, 409
employee share
schemes....................147, 345, 346, 364
pre-CGT transactions................. 317–323
profit-making intention........................517

Sharing economy
embracing change................................. 188
reporting obligations............91, 458, 618
workforce issues...................................470

Short-term foreign exchange election...725

Similar business test........................ 50–53

Simplified trading stock rule............... 363

Single business tax rate...............299, 301

Single Touch Payroll.....404, 471, 472, 476

Single women
superannuation balances
inequality... 456

Skills training
boost for small business 594, 595
FBT exemption..6

Small business CGT concessions
active asset test............................147, 359
active assets...................................523–525
aggregated turnover test 357
aggregation rules 359
maximum net asset value
test...359, 360
overview..358, 359

restructure roll-over............................. 364
retirement exemption..... 359, 365, 367
roll-overs...366, 367

Small Business Digital Taskforce...... 368

Small business entities
aggregated turnover test 357, 360
base rate entities...................................16, 17
eligibility thresholds..................357, 359
"small business", definition..... 357, 360

Small business tax concessions
Board of Taxation
review 357, 361, 363–366
integrity measures........... 361–363, 367

Small businesses
income tax offset.................................. 366
innovation and risk............................... 530
skills and training boost...........594, 595
stay order, reviewable objection
decisions.. 513
technology investment boost 595
temporary full expensing
concessions 407, 513
transfer pricing reform 230

Small to medium-sized enterprises
base rate entity rules 296
cash flow taxation model..........300, 301
CGT relief... 358
corporate tax rate 299, 301
depreciating assets, full
expensing 362, 363
digital capability.................................... 368
Div 7A loans 692
franking rate variation...............296, 297
GDP uplift factor, tax
instalments 595
imputation system 297, 299
role in Australian economy 296
taxation 296–302
trusts......................................298, 299, 301

Social impact bonds 420, 421

Social media..187

Social security
granny flat arrangements.............95, 96

Social welfare purpose
public benevolent
institution.................................... 379–382

Societies, associations and clubs
games and sports exemption........... 345

Software
patents 239
R&D tax incentives..................... 537, 540
royalty withholding tax.................99–102
sale, whether "active assets"........... 525
whether distribution rights are
royalties.......................................202–204

Sole or dominant purpose
environmental protection
activities 293

Sole traders
taxation 297, 299

Source-based taxation
versus residence-based 230, 231

South Australia
tax incentives, electric vehicles 216
tax reform 89, 90

Spain
IP box effective tax rates................... 239

Spectrum licences
depreciation 459

Spouse
death benefit dependants 480
sole director, property
settlement..................................425, 426

Stamp duty
beneficiary of property....................... 425
build-to-rent developments
(NSW)..79
housing affordability 282
or annual property tax
(NSW)..129–132
property transfers (NSW)......... 307–310
state Budgets.................................... 89, 90
trusteeship changes 426
trusts... 429

Standard business reporting................ 192

Start-up entities
employee share schemes....360, 364–366, 368
incentives and infrastructure....529–541
small business tax concessions....363
State Budgets
tax reform....89, 90
Statement penalty provisions
safe harbour....677–681
Statutory construction
tax legislation....13, 14
Statutory interpretation
corporate tax residence....120
generally....706, 707
ordinary family or commercial dealing....707–711
rule of law....569
"text", "context" and "purpose"....487
Sub-trusts
private company unpaid present entitlements, Div 7A....520, 521
Succession and estate planning
discretionary trusts....715–717
fixed trusts....72
loan accounts....427, 428
private wealth....689–695
real and genuine consideration....134–136
sharefarming, equitable estoppel....566–568
SMSFs....648–650, 719–721
– additional members....261
– corporate trustees....649
– directors....649, 650
– loss of capacity....648, 649
– wills versus BDBNs....330, 490, 491
strategies....423–429
tax equalisation provisions....424–426
testamentary trusts....423, 424
trust property....267–269
trust splitting....39–42, 716
wills, CGT liability....349–351
Superannuation
contributions
– reserving....73, 74
– tax impact of non-arm's length income and expenses....436, 437
gender inequality....456
imputation system and SMEs....297
private wealth transfer....691
remission of additional SGC....149
taxation integrity measures....385
Superannuation death benefits
concepts....479
death benefit dependants....480
dependants....480
determining whether a person benefits....481
in specie asset transfer....482
lump sum payments....482, 719, 720
tax obligations....479, 480
tax rates....480
timing issues....480, 481
used for expenses....482
Superannuation funds
GST, not registered....598, 599
self-managed – see **Self-managed superannuation funds**
Superannuation guarantee charge
remission of additional SGC....149
Superannuation pension assets
valuation requirements....182, 183
SuperStream changes
SMSFs, additional members....261
Supply of going concern....152

T
Tasmania
tax reform....89
Tax advisers
embracing change....185–194
Tax agents
"agent", meaning....681
deregistration....217, 218, 461, 462
monitoring by Tax Practitioners Board....214
reasonable care....681
unregistered entity....675, 676
Tax and estate planning
loan accounts....427, 428
tax equalisation provisions....424–426
testamentary trusts....423, 424
Tax avoidance
luxury car tax....346
ordinary dealing exception....701
ordinary family or commercial dealing....705, 706
reportable arrangements....305
undeclared foreign income....283, 284
Tax Avoidance Taskforce....345, 353, 371
Tax compliance
client identity verification....5, 461
tax professionals....191, 192
Tax concessions
charities and NFPs....419–422
individuals income tax....610
interaction with imputation system....167, 297
medical and biotechnology patents....17, 91, 146, 235–239, 513
patent box regime....146, 235–241, 513
public benevolent institutions....379
small businesses....357–368
SMEs....297
windfall gains tax (Vic)....440–442
Tax consolidation
corporate collective investment vehicles....265
interaction with loss recoupment....53–59, 168, 227
pre-CGT assets....322, 323
Tax debts
stay order, small business reviewable decisions....513
Tax deductions – see **Deductions for expenditure**
Tax disputes
litigation....696–699
share sale agreements....67
Tax education
Advanced Superannuation Dux Award, study period 2, 2020
– Helen Cameron....103
Advanced Superannuation Dux Award, study period 1, 2021
– Natalie Metcalfe....466
CommLaw1 Dux Award, study period 2, 2021
– Erin Clark....686
CommLaw1 Dux Award, study period 3, 2020
– Deanne Whelan....19
CommLaw2 Dux Award, study period 3, 2020
– Deanne Whelan....19
CommLaw3 Property Law Dux Award, study period 1, 2021
– Xin Sun....161
CTA1 Foundations Dux Award, study period 1, 2021
– Matthew Sowerbutts....225
CTA2A Advanced Dux Award, study period 1, 2021
– DJ Alexander....295
CTA2A Advanced Dux Award, study period 2, 2021
– Patrick Norman....526
CTA3 Advisory Dux Award, 2020; Justice Graham Hill Scholarship
– Brayden Irving....355
Emerging Tax Star Award 2021; Gordon Cooper Memorial Scholarship
– Helena Papapostolou....417
Graduate Diploma of Applied Tax Law, 2020 graduates....20
professional development....144
retraining and reskilling benefits, FBT....6
student representative
– Hansini De Fonseka....606
Tax Adviser of the Year Awards
– nominations....3
Tax elections
AMITs....723
foreign hybrid limited partnership/ foreign hybrid company election....725
financial reports election....724, 725
foreign limited partnership....725
franking credits benchmark ceiling election....722
managed trusts....722–725
short-term foreign exchange election....725
TOFA fair value election....724
TOFA foreign exchange retranslation election....724
TOFA hedging election....724
TOFA "opt-in" election....723
Tax equalisation provisions
tax and estate planning....424–426
Tax file number reporting....299, 301
Tax incentives
early-stage innovation companies....533
electric vehicles....216
housing affordability....282
patent box....91, 235, 237, 238
R&D....111–118, 146, 167, 297, 529–541
venture capital....533, 534
Tax indemnity
carve-outs....65
mergers and acquisitions....64–68
tax warranties....66
Tax law partnerships
jointly owned land....602–604
Tax liability
corporate residency....165
future initial public offerings, restructuring for....156–159
litigation proceedings....697
pre-CGT transactions....317–323
Tax losses – see **Losses**
Tax offsets
cost of living....594, 595
foreign income....231, 232
individuals income tax....609, 610
loss carry back....59–62, 168, 513
low and middle income....6, 594–596
R&D....111–117, 407
R&D rates....114, 115
small business....366
Tax planning
foreign income risks....353, 354
loan accounts....427, 428
strategies....423–429
tax equalisation provisions....424–426
testamentary trusts....423, 424
trust rectification....428, 429
Tax Practitioners Board
client identity verification....5, 461
tax agents
– contempt of court....217, 218
– deregistration....461, 462
– monitoring....214
– unregistered entity....675, 676
Tax professionals
artificial intelligence....163, 245–248
– robotics and automation....190, 191, 249, 250, 252–256
client identity verification....5, 461
COVID-19 effects....215
embracing change....185–194, 243–256
EQ/IQ balance....192, 193
innovation....243, 244, 247
"profession", definition....189
tax compliance, future of....191, 192
Tax purpose
"ordinary family and commercial dealing" exclusion....701–712
reimbursement agreements....703–705
Tax rates – see **Corporate tax rates; Rates of tax**
Tax records education direction....459
Tax reform
Australian tax system....104–109, 144
build-to-rent land tax/stamp duty....79
corporate tax rate....301
employee share schemes....147
employment taxes....469–476
global minimum tax rate....345
government support for infrastructure....540
property tax (NSW)....129–132
small business tax concessions....357–368
state Budgets....89
Tax Institute submissions on....2
taxation of trusts....298, 301
Tax residency
backpacker tax....347
corporations
– rules....119–121, 404
– source-based income....230, 231
– tax liability....165
individuals....404, 611, 612, 617, 622
pre-CGT assets....323
SMSFs....177, 178
Tax returns
share sale agreements....67
tax uncertainty, reportable tax position schedule....305
Tax revenue
alternative source....166
corporate tax....163, 164
future revenue-raising....144
Tax system – see **Australian tax system**
Tax treaties
Australian network....231, 283
"royalty", definition....99, 204
Tax warranties
tax indemnity....66
Taxable purpose
Div 7A loans....692
Taxable value uplift....440
Taxation of financial arrangements
fair value election....724
financial reports election....724, 725
foreign exchange retranslation election....724
hedging election....724
international tax....227, 228
"opt-in" election....723
Taxation Ombudsman
reviews of ATO....404, 510
Technological change
tax profession....185–194, 243–256
Technology investment boost....595
Telecommunications site access rights
depreciation....459
Temporary full expensing concessions....407, 513
Tenant protections
property tax reforms (NSW)....131
Tenants in common
jointly owned land....601
Testamentary trusts
tax and estate planning....423, 424
The House Sitters....190
The Tax Institute
Constitution....280
COVID-19 impact....403
diversity and inclusion policy....402, 403, 457
independent Chair....402
leadership....457
member resources....668
membership renewal....668, 669
micro-credential learning....402, 403
National Council....280, 510
National Tax Liaison Group meeting....2
Professional Bodies Tax Forum....344
professional development....144, 402
Strategic Advisory Committee....280
submissions
– by Tax Policy and Advocacy team....344, 592
– Federal Budget....456, 457, 510
– NALI/NALE amendments....592
– to ATO, client identity verification....5

Tax Adviser of the Year Awards............3
Tax Policy and Advocacy team................3, 89, 344, 510, 511, 668
tax reform......................89, 344, 510, 511
Tax Summit: Challenge Accepted............................145, 280, 281
technological investment..................402
The Case for Change..........2, 3, 86, 109, 144, 146, 163, 227, 228, 230, 296, 301, 344, 456
Tse, Jerome..402
volunteers..2, 86
website update......................................669

Therapeutic goods
biotechnical and medical patents..513

Thodey review..........................105, 106, 108

Timing issues
capital expenditure deductions........415
objections, extension of time............150
private company unpaid present entitlements, Div 7A................519, 520
reimbursement agreements.............. 411
superannuation death benefits..480, 481

Total business income
reportable tax position schedule....304

Total superannuation balance
contribution reserving............................74
market valuation of assets.....................................174, 182, 183

Trading stock
75% test... 321

Training
boost for small business..........594, 595
retraining and reskilling benefits, FBT..6

Transfer balance cap
tax-free earnings....................................297
transfer of wealth, deceased estates..691

Transfer pricing
intellectual property............................ 538

Transfer pricing rules
Commissioner's views..............492–494
Div 7A loans...28
international tax........................229, 230
software distribution rights....203, 204

Transparency
Australian tax system..........................108
charities.. 283

Travel allowances............................. 92, 217

Trust beneficiaries
disclaimers of rights........598, 639–644

Trust deeds
express trust not validly created..267–269
rectification of error.................428, 429

Trust disclaimers — see **Disclaimers**

Trust distributions
fixed entitlement.........................326, 327
resolutions.. 214

Trust income
adult children arrangements............ 515

Trust rectification
tax planning...................................428, 429

Trust splitting...................................... 39–42
succession and estate planning...................................39–42, 716

Trust stripping................................ 487, 512

Trust vesting
capital gains and losses................37–39
extending vesting date.............. 312–316
tax liabilities.. 298

Trustee beneficiaries
reporting obligations........298, 299, 301

Trustees
Australian discretionary trusts, foreign capital gains.........11–14, 35–37, 123, 124, 232
change of....................149, 150, 426, 427
commercial debt forgiveness.......... 460
express trust not validly created..267–269
real and genuine consideration...............................134–136
reimbursement agreements.........................512, 514, 515
SMSFs
– 5% in-house asset rule...................................180, 182, 183
– roles and responsibilities 174
– valuation of assets........................175

Trusts
Australian tax system..........................108
establishment...................................70–72
extending vesting date.............. 312–316
foreign income............................. 231, 232
reimbursement agreements........... 298, 487, 488, 512, 514, 515
tax professionals...................................190
taxation
– private wealth..................... 689, 690
– SMEs.............................298, 299, 301

Two-year CGT deceased estates main residence rules..................288–291

U

Uber...190, 243

Uncertainty
reportable tax position schedule.... 305

Undeclared foreign income.......................... 283, 284, 371–373

Unders and overs regime
corporate collective investment vehicle sub-fund trusts 376

Ungeared unit trusts
SMSFs, in-house asset rule...............180

Unimproved land value (NSW)
property tax... 130

Unit trusts
conversion from discretionary trusts... 716, 717
corporate collective investment vehicle sub-fund deemed to be.. 264, 375
landholder duty aggregation.... 196–198
SMEs, taxation............................ 298, 299
SMSFs
– investments in......................199–201
– ungeared..180

United Kingdom
Australia–UK DTA........................236, 347
company dividends.............................. 168
corporate income tax rates..................15
IP box effective tax rates.................. 239
negative gearing................................... 621
patent box legislation 239–241
transfer pricing reform...................... 229
work-related expenses........................619

United States
corporate income tax rates..................15

Unlisted entities
SMSFs, market valuation 176

Unpaid present entitlements
"any other form of financial accommodation"..................................404
Div 7A loans............30, 31, 515, 519–521
pre-16 December 2009 as debts....... 27
reimbursement agreements.........................410, 411, 488

Unrelated clients test............................ 618

V

Vacant land
deductions......................................147, 148
investment properties...... 617, 620, 621

Valuation
SMSF assets.................174–177, 182, 183
wind farms (NSW)............................ 76–79

Value uplift..440

Vehicles — see **Cars**

Venture capital
incentives for investment........533, 534
R&D tax incentives.............................. 529

Vesting — see **Trust vesting**

Vesting date
trusts.. 312–316

Victoria
landholder duty aggregation.... 196–198
mental health and wellbeing surcharge...90
tax incentives, electric vehicles....... 216
tax reform 89, 90
windfall gains tax.......................440–442

Virtual meetings
AGMs... 345

Voluntary disclosure of information..373

W

Waste
environmental protection activities 292–294

Wealth transfer tax......................693, 694

Wellbeing.. 511

Wills
CGT liability 349–351
fixed trusts.. 72
SMSFs
– additional members 261
– versus BDBNs ... 329, 330, 490, 491

Wind farms
fixtures and valuation (NSW)........ 76–79

Windfall gains tax
build-to-rent developments (Vic)...440–442

Withholding tax
MITs..377, 533
royalties, software charges.......................99–102, 202–204

Women
Child Care Subsidy disincentives 553, 554
superannuation balances, inequality... 456
workforce participation...................... 613

Work-related expenses
correctional services officers 673, 674
individuals income tax........................610, 613, 614, 618, 619

Work-related travel
FBT...474

"Worker" concept..........................475, 476

Workforce participation
disincentives, secondary earners................................609, 613, 618

Working holidays.......................................347

Working mothers..................107, 456, 553

Working remotely.................................. 188

Worldwide freezing order..........407, 408

Z

Zero emission vehicles
tax incentives... 216

Zero priced options
employee share schemes................. 685

Legislation

A New Tax System (Australian Business Number) Act 1999
s 41 ....601, 602

A New Tax System (Family Assistance) Act 1999 560
Sch 2
– Pt 1 560
– Pt 5 560

A New Tax System (Goods and Services Tax) Act 1999 .... 265, 375
Div 81 7
Div 138 604
Div 165 286
s 9-20(1)(da) 598
s 29-40(1)(a) 358
s 38-185 286
s 38-325 ....152, 153
s 38-325(1) 154
s 38-325(2)(b) 154
s 38-385 286
s 38-385(c) 286
s 69-10 678
s 123-7(1A) 358
s 131-5(1)(a)(i) 358
s 142-10 220
s 162-5(1)(a)(i) 358
s 188-10(1) 598
s 188-10(2) 598
s 188-20 598
s 188-25 599
s 188-25(a) 599
s 188-25(b) 599
s 188-25(b)(i) 599
s 188-25(b)(ii) 599
s 195-1 ....601, 603

A New Tax System (Luxury Car Tax) Act 1999
s 9-5(1) 678
s 15-30 678
s 15-30(3) 678
s 15-35 678
s 15-35(3) 678
s 27-1 678

Acts Interpretation Act 1901
s 15AA 487

ASX Listing Rules
r 1.1 685

Australian Securities and Investments Commission Act 2001 217

Bill of Rights 1689 (UK) 569

Boosting Cash Flow for Employers (Coronavirus Economic Response Package) Act 2020 672
s 5(1)(g) 672

Budget Savings (Omnibus) Act 2016 118

Charities Act 2013 ....381, 419, 420
s 11(1)(b) 382
s 12(1)(l) 382

Child Care Act 1972 553

Child Care Bill 1972 553

Civil Law (Property) Act 2006 (ACT)
s 201(2)(a) 269

Companies Act 1981 316

Companies (Application of Laws) Act 1981 (Vic) 316

Conveyancing Act 1919 (NSW)
s 2 601
s 23C(1)(b) 269
s 25 601
s 25(2) 604
s 163B(2) 258

Conveyancing and Law of Property Act 1884 (Tas)
s 60(2)(b) 269

Copyright Act 1968 ....203, 239

Coronavirus Economic Response Package (Payments and Benefits) Rules 2020 407
Div 2 407
Div 3 407
s 9(6)(b) 516

Corporate Collective Investment Vehicle Framework and Other Measures Act 2022 ....513, 684

Corporations Act 2001 ....74, 147, 263, 345, 357, 365, 375, 376, 692
Ch 8B 217, 374
Pt 5.4 700
s 45A(2) 369
s 201F 649
s 251A(6) 427
s 254T 28
s 459H 700
s 1305 ....430, 641
s 1322 428

Corporations Amendment (Meetings and Documents) Bill 2021 345

Customs Act 1901
s 69(1AA) 358

Duties Act 1997 (NSW) 42, 307
Ch 4 .... 307, 309
s 54(3) 39
s 104JA 42
s 149 310
s 150(1) 310
s 150(1A) 310
s 150(2) 310
s 152 310

s 154 ... 308, 310
s 154(2)(a) ... 310
s 154(3) ... 308, 310
s 154(5) ... 310
s 158A ... 310
s 163G ... 310
s 163K ... 310
Duties Act 2000 (Vic) ... 441
Ch 2 ... 196
Ch 3 ... 196
s 3(1) ... 198
s 7(1)(b) ... 196
s 40 ... 196, 198
s 40(1)(a) ... 196
s 40(1)(c) ... 198
s 78 ... 198
s 79(2)(a) ... 198
s 85 ... 309
s 89D(a) ... 196
Duties Act 2008 (WA)
s 95 ... 422
s 96A ... 422
s 96B ... 422
s 96C ... 422
s 179 ... 309
Estate Duty Assessment Act 1914-1928
s 8(5) ... 708
Evidence Act 1995
s 140 ... 700
Excise Act 1901
s 61C(1AA) ... 358
Family Law Act 1975
s 90AE(2)(b) ... 426
Federal Court Rules 2011 ... 675
Pt 20 ... 700
Div 2.4 ... 700
r 5.23(2)(c) ... 676
r 7.23 ... 700
r 7.32 ... 408, 700
r 7.32(1) ... 408
Finance Act 2012 (UK) ... 239
Finance Act 2016 (UK) ... 240
Financial Planners and Advisers Code of Ethics 2019 ... 127
Financial Sector (Collection of Data) Act 2001 ... 357
s 5(3) ... 17
Foreign Acquisitions and Takeovers Act 1975 ... 42
s 81 ... 674
s 94(1) ... 674
s 95 ... 674
s 95(1) ... 674
Foreign Acquisitions and Takeovers Fees Imposition Amendment (Near-new Dwelling Interests) Bill 2018 ... 623
Fringe Benefits Tax Assessment Act 1986 ... 6
Pt III
– Div 2 ... 477
– Div 10A ... 8, 410, 671
s 5B(1D) to (1E) ... 382
s 20 ... 8, 410
s 30 ... 217
s 31G ... 597
s 39A ... 8, 410, 671
s 39A(1) ... 92
s 39A(1)(a)(ii) ... 671
s 39A(1)(a)(iii) ... 671
s 47(7) ... 477
s 57A(1) ... 382
s 58GA(1A) ... 358
s 58X(5) ... 358
s 135C ... 369, 370
s 136(1) ... 33, 93, 410
s 136(2) ... 410
s 140 ... 477
Fringe Benefits Tax Assessment Bill 1986 ... 476
Guardianship and Administration Act 2019 (Vic)
s 50 ... 259
Income Tax Amendment (Labour Mobility Program) Bill 2022
Sch 6 ... 460
Income Tax Amendment Regulations 2005 (No. 7) ... 483
Income Tax Assessment (1997 Act) Regulations 2021
reg 775-145.01 ... 726
Income Tax Assessment Act 1915
s 27 ... 695
Income Tax Assessment Act 1922 ... 119
s 2(i) ... 119
s 31 ... 695
Income Tax Assessment Act 1930 ... 119, 121, 624
Income Tax Assessment Amendment Act 1979
cl 18 ... 512
Income Tax Assessment Amendment (Capital Gains) Bill 1986 ... 228
Income Tax Assessment Bill (No. 5) 1978 ... 487
Income Tax Assessment Regulation 1997
reg 302-200.01 ... 480
reg 302-200.02 ... 480
Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974
s 7 ... 99
Income Tax Rates Act 1986
s 23(2) ... 15
s 23AA ... 16, 358
s 23AB(1) ... 16
s 23AB(2) ... 15–17
s 23AB(2)(ii) ... 17
s 26 ... 384
Sch 7
– Pt I ... 347
– Pt III ... 347
Income Tax (Transitional Provisions) Act 1997
Subdiv 40-BA ... 363
Subdiv 40-BB ... 117, 293, 361, 363, 407
Subdiv 328-D ... 293
s 40-77 ... 461
s 40-120(2)(b) ... 358
s 40-155 ... 358
s 118-110 ... 623
s 137-10 ... 98
s 328-180 ... 363
s 328-181 ... 363, 407
Instruments Act 1958 (Vic)
s 126 ... 562
Intellectual Property Laws Amendment (Productivity Commission Response Part 2 and Other Measures) Act 2020 ... 236
Internal Revenue Code (US)
s 7805 ... 571
s 7805(a) ... 571
International Tax Agreements Act 1953 ... 375
ITAA36 ... 120, 168
Pt III
– Div 2
– Subdiv BAA ... 285
– Div 3
– Subdiv G ... 623
– Div 3B ... 171, 228
– Div 5 to 8 ... 172, 602
– Div 5A ... 298, 302
– Div 6 ... 12, 123, 263, 296, 298, 302, 514
– Div 6AA ... 423, 690
– Div 6AAA ... 283
– Div 6C ... 302, 377, 690
– Div 6D ... 35, 43, 298
– Div 6E ... 12, 36, 123
– Div 7A ... 22–33, 159, 283, 296, 300, 301, 305, 353, 354, 373, 404, 426, 515, 519–521, 645, 646, 668, 689, 692
– Subdiv EA ... 25
– Div 10 to 13 ... 172
– Div 13 ... 492, 493
– Div 13A ... 360, 685
– Div 15 ... 229
– Div 16E ... 228
Pt IIIAA
– Div 1A ... 726
– s 160APHR ... 726
Pt IVA ... 17, 24, 60, 61, 117, 171, 235, 373, 406, 411, 434, 488, 512, 514, 515, 517, 538, 543, 545, 550, 551, 612, 618, 626, 646, 704, 708, 712
Pt IX ... 384
Pt X ... 283, 359
s 6 ... 233, 545
s 6(1) ... 100, 119, 120, 203, 236, 602
s 6(1)(a) ... 612
s 23AG ... 622, 623
s 23AH ... 623
s 26(a) ... 465
s 26(e) ... 469
s 26(g) ... 416
s 26AAC ... 360, 685
s 44 ... 32
s 45B ... 512
s 47A ... 32
s 82KZMA(2) ... 370
s 82KZMA(2)(a) ... 358
s 82KZMD ... 8, 358, 370
s 90 ... 603
s 92 ... 603
s 95 ... 11, 232
s 95(1) ... 234
s 95(2) ... 37
s 95A ... 642
s 95A(1) ... 515, 598
s 97 ... 36, 302, 639, 641–643
s 97(1) ... 515, 598, 641–643
s 98 ... 11, 12, 36, 123, 643
s 98(2A) ... 36
s 98(3) ... 36
s 98(4) ... 43
s 98A(2) ... 35
s 99 ... 37, 643
s 99A ... 298, 300–302, 639, 640, 643, 692
s 99A(4A) ... 411
s 99B ... 232, 283, 284, 481, 570
s 99B(1) ... 234
s 99B(2) ... 234
s 99B(2A) ... 234
s 100A ... 33, 35, 214, 298, 300, 404, 410, 411, 487, 488, 512, 514, 515, 547, 637, 668, 701–712
s 100A(1) ... 703
s 100A(2) ... 703
s 100A(7) ... 411, 512, 702, 703, 712, 713
s 100A(8) ... 411, 487, 703, 704
s 100A(9) ... 703, 704
s 100A(10) ... 713
s 100A(13) ... 298, 487, 512, 702, 704–706, 709, 710, 712
s 101A(3) ... 481
s 102 ... 254
s 102AG(2)(a)(i) ... 430
s 102AG(2AA) ... 423
s 102UE ... 302
s 102UI ... 302
s 102UK(1)(ca) ... 43
s 102UK(2) ... 44
s 102UK(3) ... 44
s 102UM ... 43
s 108 ... 31, 32
s 109BC ... 31, 32, 354
s 109C ... 24
s 109C(3) ... 25
s 109CA ... 32
s 109D ... 23, 27, 32
s 109D(1) ... 91
s 109D(3)(b) ... 519, 520
s 109D(4) ... 519
s 109D(5) ... 26
s 109E ... 22, 23
s 109E(3) ... 23
s 109E(5) ... 91
s 109F ... 25
s 109F(3) ... 26
s 109G(3) ... 25–27, 32
s 109G(3A) ... 27
s 109K ... 24, 692
s 109L ... 24, 25
s 109M ... 32
s 109N ... 520
s 109N(1)(b) ... 91
s 109Q ... 30
s 109R ... 22–24
s 109R(2) ... 23, 24
s 109RB ... 22, 31
s 109RB(3) ... 22
s 109T ... 24, 25, 33, 354
s 109V ... 24, 25, 33
s 109W ... 24, 25, 33
s 109X ... 24, 25
s 109XA ... 27
s 109XB ... 27, 91
s 109Y(2) ... 28
s 109ZB ... 33
s 109ZC ... 26, 27, 33
s 109ZC(2) ... 27
s 109ZC(3) ... 27
s 128B(2B) ... 99
s 128D ... 99
s 160A ... 172
s 160M ... 172
s 160U ... 172
s 160Z ... 172
s 160ZD ... 172
s 160ZH ... 172
s 160ZK ... 172
s 160ZL ... 172
s 160ZM ... 172
s 160ZZQ(14) ... 291
s 160ZZQ(15) ... 291
s 160ZZR ... 370
s 160ZZS ... 317, 318
s 166 ... 410, 484, 486
s 167 ... 93, 94, 218
s 170 ... 570
s 170(1) ... 68, 358
s 170(10AA) ... 28
s 170(14) ... 358
s 170B ... 571
s 177D(1) ... 713
s 177D(2) ... 406
s 202A ... 16
s 254 ... 6
s 254(1)(a) ... 6, 7
s 254(1)(d) ... 6
s 260 ... 545, 623, 702, 704, 706, 707, 709, 710, 712, 713
s 273 ... 384, 386, 387
s 273(6) ... 384
s 273(7) ... 384
s 318 ... 375, 646
Sch 2F ... 43, 327, 365
– s 272-5 ... 326, 387
– s 272-90 ... 359
ITAA97 ... 6, 120, 479
Pt 2-42 ... 544, 545, 622, 623
Pt 3-1 ... 302
Pt 3-3 ... 302
Pt 3-30 ... 384
Div 35 ... 416
Div 40 ... 62, 233, 298, 363
Div 42 ... 172
Div 43 ... 233, 293, 301
Div 83A ... 159, 346, 360, 364, 597, 645, 683–685
Div 102 ... 13
Div 114 ... 623
Div 115 ... 614
Div 121 ... 465
Div 122 ... 370
Div 128 ... 37, 323, 615
Div 134 ... 157
Div 137 ... 95
Div 149 ... 317, 318, 321, 322, 715
Div 152 ... 357, 359, 361, 365, 370
Div 160 ... 59
Div 165 ... 49, 318, 321
Div 166 ... 47, 49, 62
Div 175 ... 51
Div 230 ... 228
Div 250 ... 233
Div 290 ... 73

Div 293 ... 73, 438, 637
Div 302 ... 479
Div 320 ... 229
Div 321 ... 229
Div 355 ... 407
Div 360 ... 533
Div 615 ... 323, 370
Div 705 ... 322
Div 707 ... 53, 172
Div 768 ... 623
Div 770 ... 232
Div 775 ... 171, 228
Div 815 ... 538
Div 830 ... 726
Div 855 ... 11, 12, 14, 35, 36, 39, 76, 77, 123
Div 974 ... 309, 310
Subdiv 40-B ... 293
Subdiv 40-E ... 302
Subdiv 83A-C ... 685
Subdiv 108-D ... 465
Subdiv 115-A ... 36, 159
Subdiv 115-C ... 12, 13, 36, 123, 124, 302
Subdiv 118-B ... 614, 623
Subdiv 118-I ... 157, 159
Subdiv 122-A ... 323
Subdiv 124-M ... 68, 157, 159, 323
Subdiv 124-N ... 170
Subdiv 126-A ... 318, 616
Subdiv 126-B ... 538
Subdiv 130-B ... 157
Subdiv 137-A ... 95
Subdiv 152-B ... 359
Subdiv 152-C ... 297, 359
Subdiv 152-D ... 359, 367, 370
Subdiv 152-E ... 170, 359, 364
Subdiv 165-CC ... 168
Subdiv 165-CD ... 168
Subdiv 166-E ... 48
Subdiv 195-C ... 375
Subdiv 207-B ... 302
Subdiv 328-C ... 60, 346, 596
Subdiv 328-D ... 300, 302, 363, 366
Subdiv 328-G ... 369, 370
Subdiv 355-G ... 116
Subdiv 355-H ... 116
Subdiv 707-A ... 53, 55, 56
Subdiv 707-C ... 55, 62
Subdiv 719-F ... 53
Subdiv 768-A ... 167
Subdiv 768-H ... 36
Subdiv 815-A ... 492–494
Subdiv 815-B ... 492, 494
Subdiv 900-B ... 92
s 1-3 ... 291
s 5-5(4) ... 700
s 5-5(7) ... 700
s 6-5 ... 9, 171, 415, 623, 624, 645
s 6-10 ... 623
s 8-1 ... 8, 171, 408, 409, 413, 415, 514, 597, 645, 646
s 10-25 ... 68
s 15-10 ... 416
s 25-40 ... 415
s 25-125 ... 596
s 26-25 ... 99
s 26-55 ... 61, 74
s 26-102 ... 147, 148, 617
s 26-102(1) ... 148
s 26-102(1)(b) ... 624
s 26-102(2) ... 620
s 26-102(8) ... 621
s 26-102(9) ... 621
s 35-10(2) ... 416
s 35-10(2A) ... 416
s 40-25(7) ... 414
s 40-27 ... 616
s 40-80 ... 461
s 40-80(1) ... 461
s 40-82 ... 363
s 40-82(4) ... 358
s 40-82(4A) ... 358
s 40-95(4) ... 459
s 40-95(5) ... 459
s 40-755 ... 292–294
s 40-755(4) ... 292
s 40-760 ... 293
s 40-880 ... 229, 409, 413–416, 514, 597
s 40-880(2) ... 413, 415, 416
s 40-880(2)(a) ... 413
s 40-880(2)(a) to (c) ... 414
s 40-880(2)(b) ... 413
s 40-880(2)(c) ... 413, 414
s 40-880(2A) ... 358, 415
s 40-880(2B) ... 415
s 40-880(3) ... 414, 415
s 40-880(4) ... 415
s 40-880(5) ... 415
s 40-880(6) ... 416
s 40-880(7) ... 414
s 40-880(8) ... 416
s 40-880(9) ... 416
s 40-885 ... 416
s 50-1 ... 382
s 50-5 ... 382
s 50-45 ... 345
s 70-100 ... 603
s 83A-10(2) ... 346, 514, 597
s 83A-20 ... 369
s 83A-25(2) ... 684
s 83A-33 ... 369, 685
s 83A-35 ... 685
s 83A-45(5) ... 685
s 83A-105(4) ... 684
s 83A-115(4) to (6) ... 346, 597
s 83A-120(4) to (7) ... 346, 597
s 83A-120(4)(c) ... 685
s 83A-120(6) ... 685
s 83A-120(7) ... 685
s 85-10 ... 416
s 86-15(2) ... 623
s 100-45 ... 171
s 102-5 ... 624
s 103-25 ... 370
s 104-5 ... 170
s 104-10 ... 430
s 104-25 ... 159
s 104-35 ... 98
s 104-75 ... 38
s 104-75(5) ... 39
s 104-75(6)(a) ... 39
s 104-160(1) ... 324
s 104-160(5) ... 324
s 104-170 ... 37, 324
s 104-170(5) ... 324
s 104-215(5) ... 324
s 104-230(1) ... 324
s 104-230(2) ... 320, 322
s 104-230(2)(a) ... 320–322
s 104-230(2)(b) ... 320–322
s 104-230(5) ... 324
s 104-230(6) ... 321, 324
s 104-230(8) ... 321, 322, 324
s 104-230(10) ... 323, 324
s 104-500 ... 324
s 106-5 ... 463
s 106-5(1) ... 603
s 106-5(3) ... 463
s 106-50 ... 39
s 108-5 ... 463
s 108-5(2)(b) ... 370
s 108-7 ... 463, 601, 602
s 109-55 ... 324
s 110-45(3) ... 68
s 112-20 ... 178
s 115-25 ... 623
s 115-100 ... 623
s 115-110 ... 36
s 115-115 ... 620
s 115-200 to 115-230 ... 12
s 115-210(1) ... 12
s 115-215(3) ... 11, 13, 36, 39
s 115-220 ... 11, 13, 35
s 115-225 ... 13
s 115-228 ... 43
s 116-20 ... 68
s 116-50 ... 68
s 118-20 ... 603
s 118-110(3) ... 616
s 118-115 ... 96, 289
s 118-120 ... 96, 289
s 118-130(1) ... 289
s 118-130(2) ... 289
s 118-130(3) ... 289
s 118-140 ... 620
s 118-145 ... 290
s 118-178 ... 616
s 118-192 ... 620
s 118-195 ... 288, 291, 691, 695
s 118-195(1) ... 289, 290
s 118-197 ... 288, 290
s 118-200 ... 291, 691, 695
s 118-565(1)(h) ... 159
s 121-20(1) ... 465
s 121-20(4) ... 465
s 121-20(5) ... 465
s 122-40(3) ... 324
s 122-55 ... 324
s 122-60 ... 324
s 124-90(4) ... 324
s 124-780 ... 69
s 124-780(1)(a)(i) ... 159
s 124-780(2)(a) ... 69
s 124-780(3)(c) ... 69
s 124-780(4) ... 159
s 124-780(5) ... 159
s 124-800 ... 324
s 124-800(2) ... 324
s 126-5 ... 616
s 128-10 ... 324, 695
s 128-15 ... 691
s 128-15(2) ... 324
s 128-15(4) ... 324, 351, 691, 693
s 128-20 ... 291
s 128-50 ... 601
s 130-40 ... 157
s 134-1 ... 157
s 134-1(4) ... 157
s 137-10 ... 95
s 137-10(1) ... 96, 98
s 137-10(2) ... 96
s 137-10(2)(a) ... 95
s 137-10(3) ... 96
s 137-15 ... 95–97
s 137-20 ... 95, 97
s 137-25 ... 95
s 149-10 ... 323
s 149-15(1) ... 323
s 149-15(3) ... 323
s 149-30 ... 318
s 149-30(1) ... 318, 323
s 149-30(3) ... 324
s 149-30(4) ... 324
s 149-35 ... 318
s 149-35(2) ... 324
s 152-10 ... 359, 369
s 152-10(1)(c)(i) ... 358
s 152-10(1)(c)(ii) ... 359
s 152-10(1)(d) ... 525
s 152-10(1A) ... 369
s 152-10(1AA) ... 358, 360, 525
s 152-10(1B) ... 369
s 152-15 ... 359, 360, 369, 525
s 152-35 ... 369, 525
s 152-40 ... 360, 369, 525
s 152-40(3) ... 362, 525
s 152-40(4)(e) ... 525
s 152-47 ... 525
s 152-70 ... 361
s 160-10 ... 59
s 160-20 ... 358
s 160-35 ... 63
s 160-35(1)(e) ... 63
s 165-10 ... 45
s 165-12 ... 45
s 165-12(7) ... 46
s 165-13 ... 50
s 165-13(2) ... 49
s 165-165 ... 46, 324
s 165-210 ... 49, 50
s 165-211 ... 50
s 166-5 ... 49
s 166-5(3) ... 47
s 166-175 ... 62
s 202-45 ... 26
s 230-210 ... 726
s 230-255 ... 726
s 230-315 ... 726
s 230-395 ... 726
s 230-455(4)(a) ... 358
s 230-455(7) ... 726
s 245-40(e) ... 460
s 275-10 ... 532
s 275-115 ... 726
s 275-120 ... 726
s 275-145(1)(a) ... 726
s 276-10 ... 726
s 276-20 ... 726
s 292-100 ... 370
s 295-95(2) ... 177
s 295-95(2)(b) ... 178
s 295-160 ... 436
s 295-190 ... 436
s 295-385(8) to (10) ... 562
s 295-387 ... 561
s 295-387(3) ... 561
s 295-545 ... 384
s 295-550 ... 148, 178, 326, 384, 386, 387, 436
s 295-550(1) ... 384, 385
s 295-550(2) ... 384–386
s 295-550(3) ... 384, 385
s 295-550(3)(a) ... 386
s 295-550(3)(a) to (f) ... 386
s 295-550(4) ... 326, 327, 384, 386
s 295-550(5) ... 199, 201, 326, 384–386
s 295-550(5)(a) ... 199
s 295-550(5)(b) ... 199
s 295-550(5)(c) ... 199
s 302-10 ... 481–483
s 302-10(2)(b) ... 481
s 302-140 ... 483
s 302-145 ... 483
s 302-195 ... 483, 719
s 302-195(1)(d) ... 480
s 302-200 ... 483
s 307-205 ... 74
s 328-110 ... 16, 360, 369
s 328-115 ... 16, 92, 360
s 328-115(1) ... 16
s 328-120 ... 302
s 328-120(3) ... 365
s 328-125 ... 361, 365, 369
s 328-125(1) ... 369
s 328-125(2) ... 359
s 328-125(2)(b) ... 369
s 328-125(4) ... 359, 361
s 328-130 ... 361, 369
s 328-175 ... 358
s 328-180 ... 117, 363
s 328-210 ... 363
s 328-285 ... 363, 367
s 328-285(2) ... 358
s 328-357 ... 358
s 328-430 ... 358
s 328-435 ... 369
s 355-100 ... 116, 407
s 355-115 ... 115
s 355-115(3) ... 115
s 355-225(1)(b) ... 117
s 355-305 ... 116
s 355-310 ... 117
s 355-315(2) ... 116
s 355-315(3) ... 116
s 355-405 ... 407
s 355-440 ... 116
s 355-440(2) ... 116
s 355-445 ... 116
s 355-445(2) ... 116
s 355-446 ... 116
s 355-447 ... 116
s 355-448 ... 116
s 355-449 ... 116
s 355-450(1) ... 116
s 355-465 ... 117
s 355-466 ... 117
s 355-467 ... 117
s 355-468 ... 117
s 355-475(1) ... 117
s 701-1 ... 68, 324
s 701-5 ... 324
s 705-57 ... 170, 322, 324
s 705-65 ... 324
s 707-120(1) ... 62
s 707-140 ... 62

s 707-145 ... 56
s 707-210(4)(c) ... 62
s 707-305(2) ... 63
s 707-305(3) ... 62
s 707-315 ... 63
s 707-320 ... 55, 63
s 707-320(1) ... 63
s 707-320(2) ... 63
s 707-320(3) ... 63
s 707-325(2) to (5) ... 63
s 711-65 ... 324
s 711-75 ... 324
s 721-15(1) ... 68
s 721-15(3) ... 68
s 727-15(8) ... 358, 359
s 775-70(1) ... 170
s 775-75(1) ... 170
s 775-80 ... 726
s 815-125 ... 494
s 815-130 ... 494
s 815-150 ... 28, 68
s 820-35 ... 359
s 855-5 ... 14
s 855-10 ... 12, 14, 39, 123, 124, 234
s 855-10(1) ... 11, 13, 35, 36
s 855-40 ... 14, 123
s 855-40(1) ... 12, 14
s 855-40(2) ... 36
s 900-30(3) ... 217
s 976-1 ... 27
s 995-1 ... 37, 324, 385, 387, 416, 601, 602, 685
s 995-1(1) ... 95, 98, 236

Judiciary Act 1903
s 55ZF ... 700

Land Tax Act 2005 (Vic) ... 441

Land Tax Management Act 1956 (NSW)
s 3A ... 43
s 9E(2)(c) ... 79

Law of Property Act 1936 (SA)
s 26 ... 568
s 29(1)(b) ... 269

Law of Property Act 2000 (NT)
s 10(1)(b) ... 269

Legal Practitioners Regulations 2014 (SA)
reg 28(2) ... 245

Legal Profession Uniform Law Application Act 2014 (Vic)
Sch 1
– Pt 2.1, Ch 2 ... 127

Legal Services Directions 2017
App B, cl 2(d) ... 700

Limitation Act 1969 (NSW)
s 54 ... 26
s 63 ... 26

Limitations of Actions Act 1958 (Vic)
s 5(1) ... 700

Monetary Units Act 2004 (Vic) ... 127

New Business Tax System (Alienation of Personal Services Income) Bill 2000 ... 623

New Business Tax System (Consolidation) Act (No. 1) 2002 ... 63

New Business Tax System (Entity Taxation) Bill 2000 ... 302

New Business Tax System (Simplified Tax System) Act 2000 ... 357

Patents Act 1990 ... 236
s 13 ... 236
s 18 ... 237
s 67 ... 236
s 68 ... 236
s 77 ... 236

Pay-roll Tax Assessment Act 2002 (WA)
Pt 2
– Div 2A, Subdiv 4 ... 685

Payroll Tax Act 1971 (Qld)
Pt 2
– Div 1C ... 685

Payroll Tax Act 2007 (NSW)
Pt 3
– Div 4 ... 685

Payroll Tax Act 2007 (Vic)
Pt 3
– Div 4 ... 685

Payroll Tax Act 2009 (NT)
Pt 3
– Div 4 ... 685

Payroll Tax Act 2009 (SA)
Pt 3
– Div 4 ... 685

Payroll Tax Act 2011 (ACT)
Pt 3
– Div 3.4 ... 685

Personal Property Securities Act 2009 ... 217

Planning and Environment Act 1987 (Vic) ... 440

Powers of Attorney Act 2014 (Vic) ... 258
s 7 ... 259
s 26 ... 259

Property Law Act 1958 (Vic)
s 53(1)(b) ... 268, 314
s 154A ... 77

Property Law Act 1969 (WA)
s 34 ... 568
s 34(1)(b) ... 269

Property Law Act 1974 (Qld)
s 11 ... 568
s 11(1)(b) ... 269

Real Property Act 1900 (NSW)
s 42 ... 568

Residential Tenancies Act 2010 (NSW)
s 40 ... 131

Social Security Act 1991 ... 96
s 23(1) ... 95
s 23(5A) ... 96
s 23(5B) ... 96
s 23(5C) ... 96
s 23(5D) ... 96

Stamp Duties Act 1920 (NSW) ... 307, 308

Stamp Duties Act 1923 (SA)
s 102C ... 309

Stamp Duties (Amendment) Act 1987 (NSW) ... 310

Stamp Duty Act 1978 (NT)
s 56S ... 309

State Revenue Legislation Further Amendment Act 2020 (NSW) ... 308

Statute of Frauds 1677 (UK) ... 312

Statute of Monopolies 1624 (England) ... 236
s 6 ... 236

Succession Act 2006 (NSW)
Ch 3 ... 39

Superannuation Guarantee (Administration) Act 1992
Pt 7 ... 149

Superannuation Industry (Supervision) Act 1993 ... 126, 329, 479, 490
s 17A ... 200, 648, 649, 720
s 17A(3)(a) ... 649
s 31 ... 174
s 35B ... 261
s 59(1A) ... 490
s 62 ... 180
s 66 ... 178, 179
s 71 ... 179
s 85 ... 180
s 103 ... 175
s 109 ... 176, 178, 180

Superannuation Industry (Supervision) Regulations 1994 ... 126, 482, 720
Div 13.3A ... 199
reg 6.17A ... 329, 490
reg 6.17A(7) ... 329
reg 6.21(1) ... 482
reg 6.21(2)(a) ... 482, 483
reg 6.22 ... 483
reg 7.08 ... 73, 74
reg 8.02B ... 174–176
reg 13.22B ... 179
reg 13.22C ... 179, 180
reg 13.22D ... 180

Superannuation Legislation Amendment Bill (No. 2) 1999 ... 384

Supreme Court (General Civil Procedure) Rules 2015 (Vic)
r 54.02 ... 316

Tax Agent Services Act 2009 ... 5, 218, 462, 677
s 50-5(1) ... 674, 676
s 70-5(1) ... 676

Tax Agent Services (Transitional Provisions and Consequential Amendments) Act 2009 ... 682

Tax Agent Services (Transitional Provisions and Consequential Amendments) Bill 2009 ... 682

Tax Laws Amendment (2006 Measures No. 1) Act 2006 ... 413

Tax Laws Amendment (2006 Measures No. 4) Bill 2006 ... 124

Tax Laws Amendment (2007 Measures No. 4) Bill 2007 ... 234

Tax Laws Amendment (2010 Measures No. 1) Act 2010 ... 682

Tax Laws Amendment (2011 Measures No. 5) Act 2011 ... 36

Tax Laws Amendment (2011 Measures No. 5) Bill 2011 ... 124

Tax Laws Amendment (Improvements to Self Assessment Act) (No. 2) 2005 ... 488

Tax Laws Amendment (Research and Development) Act 2015 ... 111, 115

Tax Laws Amendment (Research and Development) Bill 2013 ... 111

Taxation Administration Act 1953 ... 459
Pt IVC ... 172, 570, 696, 697, 700
s 8C ... 700
s 8E ... 700
s 14ZZC ... 700
s 14ZZK(b) ... 94
s 14ZZN ... 700
s 14ZZO(a) ... 700
s 14ZZO(b) ... 700
s 14ZZO(b)(i) ... 700
Sch 1
– Pt 4-25
– Div 288 ... 285
– Div 370 ... 574
– Subdiv 12-H ... 43
– Subdiv 14-E ... 155
– Subdiv 284-E ... 229, 230
– s 12-35 ... 477
– s 12-175 ... 299, 302
– s 12-180 ... 299, 302
– s 12-280 ... 99
– s 14-201(1)(e) ... 68
– s 14-210(2) ... 68
– s 14-225 ... 68
– s 14-225(2) ... 69
– s 14-225(3) ... 69
– s 45-130(1A) ... 358
– s 260-5 ... 700
– s 284-75 ... 677
– s 284-75(1) ... 678
– s 284-75(5) ... 679, 680
– s 284-75(6) ... 679-681
– s 284-224 ... 574
– s 353-10 ... 431, 432, 484–486
– s 353-10(1) ... 700
– s 353-25 ... 431, 432
– s 357-85 ... 323
– s 388-60 ... 69
– s 388-75 ... 69

Taxation Administration Act 2001 (Qld)
s 69(1)(b) ... 700

Taxation Laws Amendment Bill (No. 4) 2003 ... 26

Taxation Laws Amendment Bill (No. 5) 1986 ... 233

Treasury Laws Amendment (2017 Enterprise Incentives No. 1) Act 2019 ... 51, 52

Treasury Laws Amendment (2018 Superannuation Measures No. 1) Act 2019 ... 148

Treasury Laws Amendment (2018 Superannuation Measures No. 1) Bill 2019 ... 385

Treasury Laws Amendment (2019 Measures No. 3) Act 2020 ... 430

Treasury Laws Amendment (2019 Tax Integrity and Other Measures No. 1) Act 2019
Sch 3 ... 624

Treasury Laws Amendment (2020 Measures No. 6) Act 2020 ... 407
Sch 1 ... 369

Treasury Laws Amendment (2021 Measures No. 2) Act 2021 ... 283

Treasury Laws Amendment (2021 Measures No. 4) Act 2021 ... 95
s 2 ... 98

Treasury Laws Amendment (2021 Measures No. 4) Bill 2021 ... 6, 98

Treasury Laws Amendment (2021 Measures No. 7) Bill 2021 ... 458

Treasury Laws Amendment (A Tax Plan for the COVID-19 Economic Recovery) Act 2020 ... 6, 118, 369, 407
Sch 3 ... 369
Sch 7 ... 369

Treasury Laws Amendment (A Tax Plan for the COVID-19 Economic Recovery) Bill 2020 ... 111, 113, 115, 116, 120

Treasury Laws Amendment (Cost of Living Support and Other Measures) Act 2022 ... 596

Treasury Laws Amendment (Enhancing Superannuation Outcomes For Australians and Helping Australian Businesses Invest) Act 2022 ... 513

Treasury Laws Amendment (Enhancing Superannuation Outcomes For Australians and Helping Australian Businesses Invest) Bill 2021 ... 561

Treasury Laws Amendment (Enhancing Tax Integrity and Supporting Business Investment) Bill 2022 ... 459

Treasury Laws Amendment (Enterprise Tax Plan Base Rate Entities) Act 2018 ... 15

Treasury Laws Amendment (Enterprise Tax Plan Base Rate Entities) Bill 2017 ... 18

Treasury Laws Amendment (Enterprise Tax Plan No. 2) Bill 2017 ... 17

Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018 ... 120

Treasury Laws Amendment (Reducing Pressure on Housing Affordability Measures) Act 2019 ... 610

Treasury Laws Amendment (Reducing Pressure on Housing Affordability Measures) Bill 2019 ... 624

Treasury Laws Amendment (Reducing Pressure on Housing Affordability Measures No. 2) Bill 2018 ... 623

Treasury Laws Amendment (Research and Development Incentive) Bill 2018 ... 111, 112, 114, 115

Treasury Laws Amendment (Research and Development Tax Incentive) Bill 2019 ... 111–115, 120

Treasury Laws Amendment (Streamlining and Improving Economic Outcomes for Australians) Bill 2022
Sch 3 ... 513

Treasury Laws Amendment (Tax Concession for Australian Medical Innovations) Bill 2022 ... 513
Treasury Laws Amendment (Tax Integrity and Other Measures) Act 2018 ... 369
Treasury Laws Amendment (Tax Relief So Working Australians Keep More Of Their Money) Act 2019 ... 477
Treasury Laws Amendment (Tax Relief So Working Australians Keep More Of Their Money) Bill 2019 ... 18
Trustee Act 1893 (NT)
s 27 ... 136
Trustee Act 1898 (Tas)
s 32 ... 136
Trustee Act 1925 (ACT)
s 70 ... 136
Trustee Act 1925 (NSW) ... 71
s 70 ... 136
Trustee Act 1936 (SA)
s 36 ... 136
Trustee Act 1958 (Vic)
s 41 ... 136
s 48 ... 136
Trustees Act 1962 (WA)
s 77 ... 136
Trusts Act 1973 (Qld)
s 80 ... 136
Valuation of Land Act 1960 (Vic) ... 440
Venture Capital Act 2002
Pt 2 ... 541
Windfall Gains Tax and State Taxation and Other Acts Further Amendment Act 2021 (Vic) ... 440
s 3 ... 442
s 59 ... 442

Rulings and other materials

Accounting Professional & Ethical Standards Board
APES 110 Code of Ethics for Professional Accountants ... 127
Attorney-General's Department
Legal Services Directions 2017
– Appendix B ... 486
Australian Accounting Standards Board
AASB 2 ... 685
AASB 23 ... 305
Australian Taxation Office
CGT Determination 33 ... 464, 465
CIS 2013/01 ... 380
CIS 2016/03 ... 380–382
GSTD 2021/D2 ... 7
GSTR 2003/13 ... 603, 604
GSTR 2004/6 ... 603
GSTR 2006/7 ... 155
ID 2003/589 ... 460
ID 2004/807 ... 601, 602
ID 2007/60 ... 14, 124
ID 2010/82 ... 29
ID 2011/93 ... 232, 234
ID 2011/101 ... 324
ID 2011/104 ... 25
ID 2011/107 ... 324
ID 2013/53 ... 726
IT 2340 ... 715
IT 2503 ... 551
IT 2530 ... 317–319
IT 2639 ... 545, 547, 548
IT 2660 ... 101, 102
LCR 2016/8 ... 562
LCR 2019/1 ... 52
LCR 2019/3 ... 52
LCR 2019/5 ... 16, 17
LCR 2019/D3 ... 178, 179, 200
LCR 2021/2 ... 148, 199–201, 384, 385, 436, 437, 573
LCR 2021/3 ... 407
PBR 88506 ... 483
PBR 1011623239706 ... 430
PBR 1011681715552 ... 483
PBR 1012563986561 ... 324
PBR 1051228325810 ... 324
PBR 1051421869428 ... 41
PBR 1051574799355 ... 52
PBR 1051635988256 ... 321
PBR 1051639379151 ... 324
PBR 1051792738625 ... 324
PBR 1051795970990 ... 52
PBR 1051798578303 ... 183
PBR 1051799006782 ... 324
PBR 1051799609838 ... 324
PBR 1051825845637 ... 324
PBR 1051838730781 ... 483
PBR 4120039511517 ... 292
PBR 5010062000175 ... 324
PCG 2016/1 ... 545, 551
PCG 2016/16 ... 387
PCG 2018/9 ... 44
PCG 2019/5 ... 288, 290, 291
PCG 2020/5 ... 149, 178, 385
PCG 2021/3 ... 217
PCG 2021/4 ... 404, 406, 407, 543, 545–551, 626–632, 637, 638
PCG 2021/D1 ... 477
PCG 2022/D1 ... 512, 514, 515, 701, 712
PS LA 2006/2 (GA) ... 26
PS LA 2007/20 ... 692
PS LA 2010/4 ... 31, 515, 519, 520, 573
PS LA 2011/4 ... 700
PS LA 2011/6 ... 700
PS LA 2011/27 ... 571
PS LA 2011/29 ... 22
PS LA 2012/5 ... 681
PS LA 2021/D1 ... 149
PS LA 2021/D2 ... 284
PS LA 2022/1 ... 516
QC 19749 ... 436
QC 21546 ... 561
QC 26343 ... 182, 183
SMSFD 2008/3 ... 329, 330
TA 2017/1 ... 536
TA 2018/2 ... 101
TA 2021/2 ... 283, 284, 353, 354, 371–373
TA 2021/4 ... 346
TA 2022/1 ... 515
TD 13 ... 605
TD 13W ... 602
TD 94/69 ... 483
TD 2000/31 ... 290, 464, 602
TD 2001/26 ... 430
TD 2006/78 ... 523, 524
TD 2011/16 ... 25
TD 2012/21 ... 717
TD 2013/12 ... 483
TD 2013/22 ... 73
TD 2017/23 ... 232, 234
TD 2017/24 ... 232, 234
TD 2018/13 ... 25
TD 2018/15 ... 98
TD 2019/14 ... 39–42, 716
TD 2019/14EC ... 41
TD 2019/D6 ... 14, 36, 123, 124, 232
TD 2019/D7 ... 36, 37, 232
TD 2021/5 ... 6, 7
TD 2021/6 ... 92
TD 2021/7 ... 347
TD 2021/9 ... 407
TD 2021/D1 ... 16, 92
TD 2021/D2 ... 347
TD 2021/D3 ... 347
TD 2021/D4 ... 347
TD 2021/D5 ... 345
TD 2022/1 ... 460
TD 2022/2 ... 597
TD 2022/3 ... 597
TD 2022/4 ... 597
TD 2022/5 ... 596
TD 2022/6 ... 596
TD 2022/7 ... 596
TD 2022/8 ... 597, 646
TD 2022/D1 ... 519–521
TD 2022/D2 ... 513
TR 93/12 ... 99–101, 202–204
TR 95/13 ... 674
TR 96/26 ... 93, 477, 671
TR 97/22 ... 345
TR 98/17 ... 612
TR 1999/9 ... 50, 51, 62, 321
TR 1999/16 ... 324
TR 2001/7 ... 618
TR 2001/8 ... 618
TR 2003/5 ... 382
TR 2004/9 ... 55
TR 2004/15 ... 165, 172
TR 2004/18 ... 319, 322, 324
TR 2004/D25 ... 38, 298, 302
TR 2005/12 ... 30
TR 2006/7 ... 326, 327, 384, 386, 387
TR 2007/2 ... 59
TR 2008/9 ... 177
TR 2010/3 ... 27, 515, 519, 520, 573
TR 2010/8 ... 22
TR 2011/6 ... 413–415
TR 2012/D1 ... 298, 302
TR 2014/D1 ... 646
TR 2017/D5 ... 646
TR 2018/5 ... 44, 172
TR 2018/6 ... 37–39, 312, 315, 316
TR 2018/7 ... 645
TR 2019/1 ... 16, 32, 523
TR 2019/6 ... 382
TR 2019/D5 ... 477
TR 2020/2 ... 292, 293
TR 2021/2 ... 92, 93, 671
TR 2021/4 ... 217
TR 2021/5 ... 407
TR 2021/D1 ... 477
TR 2021/D2 ... 618
TR 2021/D4 ... 99–102, 202–204, 235, 239
TR 2021/D5 ... 147, 148
TR 2021/D6 ... 345
TR 2022/D1 ... 512, 514, 515, 701, 702, 705–707, 712, 713
Chartered Accountants Australia and New Zealand
CR 3 – Public Practice Regulations ... 127
Double tax agreements
Australia–UK
– art 3(1) ... 347
– art 5 ... 233
– art 12 ... 236
– art 25(1) ... 347
OECD
Model Tax Convention on Income and on Capital
– art 7 ... 101
– art 12 ... 101
– art 12(2) ... 101
– art 13 ... 101, 685
– art 15 ... 684
– art 16 ... 684
Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ... 230
Revenue NSW
Revenue Ruling DUT 051 ... 308
Revenue Ruling G 014 ... 79
Tax Practitioners Board
TPB(PN) 5/2022 ... 461

Cases

A
Abuthman v FCT [2007] FCA 1026 ... 700
Addy v FCT [2021] HCA 34 ... 347, 404
Advanced Holdings Pty Ltd as Trustee for The Demian Trust v FCT [2020] FCA 1479 ... 426
Advanced Holdings Pty Ltd as Trustee for The Demian Trust v FCT [2021] FCAFC 135 ... 149, 427
Aid/Watch Incorporated v FCT [2010] HCA 42 ... 381
Alcan (NT) Alumina Pty Ltd v Commr of Territory Revenue [2009] HCA 41 ... 121, 487, 706, 707, 710
Allen and FCT [2021] AATA 2768 ... 219
Allen (Trustee), in the matter of Allen's Asphalt Staff Superannuation Fund v FCT [2011] FCAFC 118 ... 384
Allzams Trust and FCT [2021] AATA 2767 ... 219
Alves v Hodgson (1797) 7 TR 241 ... 310
Ambulance Service (NSW) v DCT (2002) 50 ATR 496 ... 708
Amerind, Re; Carter Holt Harvey Woodproducts Australia Pty Ltd v The Commonwealth [2019] HCA 20 ... 38
ANZ Executors & Trustee Co Ltd v McNab [1999] 3 VR 666 ... 430
Application of NSFT Pty Ltd [2010] NSWSC 380 ... 430
AS Skyes (dec'd) and the Trustee Act, Re [1974] 1 NSWLR 597 ... 430
Ash v Ash [2016] VSC 577 ... 258, 259
Aston (Aust) Properties Pty Ltd v Commr of State Revenue (Taxation) [2012] VCAT 48 ... 71
Aussiegolfa Pty Ltd (Trustee) v FCT [2018] FCAFC 122 ... 40
Austotel Pty Ltd v Franklins Selfserve Pty Ltd (1989) 16 NSWLR 582 ... 566, 568
Australia and New Zealand Banking Group Ltd v Konza [2012] FCAFC 127 ... 700
Australian Competition and Consumer Commission v ACN 099 814 749 Pty Ltd [2016] FCA 403 ... 121
Australian Council for Overseas Aid v FCT (1980) 33 ACTR 16 ... 380
Australian Prudential Regulation Authority v Derstepanian [2005] FCA 1121 ... 385
Australian Securities and Investments Commission v Macdonald (No. 11) [2009] NSWSC 287 ... 430
Australians for Indigenous Constitutional Recognition Ltd v Commr of the Australian Charities and Not-for-profits Commission [2021] FCA 435 ... 382
Automotive Invest Pty Ltd and FCT [2022] AATA 673 ... 677, 678, 681
Automotive Invest Pty Ltd v FCT (Gosford Classic Car Museum) [2022] FCA 281 ... 677, 678, 681
AWB Ltd v Cole (No. 5) [2006] FCA 1234 ... 432
AWF Prop Co 2 Pty Ltd v Ararat Rural City Council [2020] VSC 853 ... 77
B
Baden's Deed Trusts, Re [1969] 2 Ch 388 ... 430
Balasubramaniyan; FCT v [2022] FCA 374 ... 674
Balcaskie Investments Pty Ltd v Chief Commr of State Revenue [2017] NSWCATAD 21 ... 39
Bamford; FCT v [2010] HCA 10 ... 298, 384, 642, 643
Barry v Borlas Pty Ltd [2012] NSWSC 831 ... 430
BCI Finances Pty Ltd (in liq) v FCT (No. 3) [2014] FCA 958 ... 486
Behrndt and FCT [2021] AATA 1769 ... 93
Belfield v Belfield [2012] NSWCA 416 ... 258, 259
Ben Nevis (Holdings) Ltd v Commrs for HM Revenue & Customs [2013] EWCA Civ 578 ... 310
Boensch v Pascoe [2019] HCA 49 ... 44
Bosanac; FCT v [2021] FCAFC 158 ... 221–223
Bosanac (No. 7); FCT v [2021] FCA 249 ... 221–223
Brandi; FCT v (unreported, Federal Court, Victorian Registry, 30 October 2017, No. VID1183/2017) ... 433
British Mexican Petroleum Co Ltd v Jackson (1932) 16 TC 570 ... 233
Broadbeach Properties Pty Ltd; DCT v [2008] HCA 41 ... 700
Browne v Dunn (1893) 6 ER 67 ... 644
Bullock v Unit Construction Co Ltd [1959] Ch 315 ... 121
Burton v FCT [2019] FCAFC 141 ... 230, 232, 234, 302

Butlin v Butlin [1966] HCA 4 430
Byrnes v Kendle [2011] HCA 26 316
Bywater Investments Ltd v FCT [2016] HCA 45 .... 36, 120, 165

C
Cam & Bear Pty Ltd v McGoldrick [2018] NSWCA 110 ....175, 181
Campbell and FCT [2019] AATA 2043 481
Cantor Management Services Pty Ltd v Booth [2017] SASCFC 122 .... 329, 491
Carter; FCT v [2022] HCA 10 ....598, 639, 716
Carter Holt Harvey Woodproducts Australia Pty Ltd v The Commonwealth [2019] HCA 20 38
Carter v FCT [2020] FCAFC 150 ....599, 644
Carvell and FCT [2021] AATA 3627 347
Cecil Investments Pty Ltd, Re [2021] NSWSC 211 429
Cerrah and Tax Practitioners Board [2022] AATA 7 462
Certain Lloyd's Underwriters Subscribing to Contract No. IH00AAQS v Cross [2012] HCA 56 14
Charles Marshall Pty Ltd v Grimsley [1956] HCA 28 223
Chevron Australia Holdings Pty Ltd v FCT [2017] FCAFC 62 493
Chief Commissioner of Stamp Duties (NSW) v Buckle [1998] HCA 4 491
City of Swan v McGraw-Hill Co Inc [2014] FCA 1271 486
Clark; FCT v [2011] FCAFC 5 .... 315, 316, 716
Clark and FCT [2021] AATA 2446 150
Clark v FCT [2007] FCA 1426 700
Clark v Inglis [2010] NSWCA 144 427
Clay v Clay [1999] WASCA 8 269
Clay v James [2001] WASC 18 ....315, 316
Clough Ltd v FCT [2021] FCA 108 416
Clough Ltd v FCT [2021] FCAFC 197 ....408, 409, 413
Colonial First State Investments Ltd v FCT [2011] FCA 16 387
Commercial Nominees of Australia Ltd; FCT v [1999] FCA 1455 315
Commissioner of Inland Revenue v Ward 69 ATC 6050 33
Commissioner of State Revenue v Lend Lease Funds Management Pty Ltd [2011] VSCA 182 314
Commissioner of State Revenue v Rojoda Pty Ltd [2020] HCA 7 605
Commissioner of State Revenue (Vic) v Danvest Pty Ltd [2017] VSCA 382 605
Commissioner of State Revenue (Vic) v The Optical Superstore Pty Ltd [2019] VSCA 197 477
Consolidated Media Holdings Ltd; FCT v [2012] HCA 55 487
Corporate Affairs Commission (NSW) v Yuill [1991] HCA 28 707
CPG Group Pty Ltd v DCT [2019] VSC 146 700
CPT Custodian Pty Ltd v Commr of State Revenue [2005] HCA 53 .... 386, 491
Craven v Bradley [2021] VSC 344 ....349–351, 425
CUB Australia Holding Pty Ltd v FCT [2021] FCAFC 171 285
Cuesuper Pty Ltd, Re [2009] NSWSC 981 201

D
Dalco; FCT v [1990] HCA 3 699
Daniele v Shire of Swan (1998) 20 WAR 164 461
Darrelen Pty Ltd v FCT [2010] FCAFC 35 386
Davies and FCT [2009] AATA 297 367
De Vonk; FCT v (1995) 133 ALR 303 700
Dempsey and FCT [2014] AATA 335 623
Denlay v FCT [2011] FCAFC 63 484
DHJPM Pty Ltd v Blackthorn Resources Ltd [2011] NSWCA 348 567
Dion Investments Pty Ltd, Re [2013] NSWSC 1941 428
Dion Investments Pty Ltd, Re [2014] NSWCA 367 .... 316, 428
Dion Investments Pty Ltd, Re [2020] NSWSC 1661 ....71, 429
Donoghue; FCT v [2015] FCAFC 183 ....433, 484
Donovan v Donovan [2009] QSC 26 329
Doueihi v Construction Technologies Australia Pty Ltd [2016] NSWCA 105 567
Drake Personnel Ltd v Commr of State Revenue [2000] VSCA 122 477
Draper v Official Trustee in Bankruptcy [2006] FCAFC 157 316
Duke Group Ltd (in liq) v Arthur Young (Reg) (No. 3) (1990) 55 SASR 11 461
Dyda Pty Ltd v Commr of State Taxation (SA) [2018] SASC 156 40

E
East Finchley Pty Ltd v FCT [1989] FCA 481 488
Eichmann v FCT [2020] FCAFC 155 ....147, 362, 487, 523
Esquire Nominees Ltd v FCT [1973] HCA 67 121
Esso Australia Resources Ltd v FCT [1998] FCA 1655 14
Esso Australia Resources Ltd v FCT [1999] HCA 67 434
Esso Australia Resources Ltd v Plowman [1995] HCA 19 486
Everett; FCT v [1980] HCA 6 548
Executors of the Estate of the late Peter Fowler and FCT [2016] AATA 416 524
Extra Nominees Pty Ltd v Comptroller of Stamps (Vic) (1990) 21 ATR 3664 316

F
Farrar v Commr of Stamp Duties (1975) 5 ATR 364 254
Fell v Fell [1922] HCA 55 430
Finch v Telstra Super Pty Ltd [2010] HCA 36 134
First Provincial Building Society Ltd v FCT [1995] FCA 1101 414
Fischer v Nemeske Pty Ltd [2015] NSWCA 6 33
Fischer v Nemeske Pty Ltd [2016] HCA 11 427
Fundy Settlement v Canada [2012] 1 SCR 520 120

G
Galland; FCT v [1986] HCA 83 548
Gallieni & Gallieni [2012] FamCAFC 205 430
Ganter v Whalland [2001] NSWSC 1101 14
Gartside v IR Commrs [1968] AC 553 134
Gentsis v Forty-first Advocate Management Pty Ltd [2004] VSC 398 316
Giumelli v Giumelli [1999] HCA 10 568
Glencore International AG v FCT [2019] HCA 26 433
Glencore Investment Pty Ltd; FCT v [2020] FCAFC 187 492–494
Global Citizen Ltd and Commr of the ACNC [2021] AATA 3313 .... 285, 379–382
Goldsworthy Mining Ltd v FCT [1975] HCA 3 461
Goulding v James [1997] 2 All ER 239 316
Government of India, Ministry of Finance (Revenue Division) v Taylor [1955] AC 491 307
Grant v Downs [1976] HCA 63 434
Guardian AIT Pty Ltd ATF Australian Investment Trust v FCT [2021] FCA 1619 ....410, 488, 512, 514, 701, 702, 704, 705, 711
Gulland; FCT v ("Three Doctors Case") [1985] HCA 83 705
GYBW and FCT [2019] AATA 4262 386

H
Hagan v Waterhouse (No. 2) (1992) 34 NSWLR 400 269
Hancock v Rinehart [2015] NSWSC 646 315
Harding v FCT [2019] FCAFC 29 623
Harman v Secretary of State for the Home Department [1983] 1 AC 280 484
Harris v Rothery [2013] NSWSC 1275 259
Hearne v Street [2008] HCA 36 484
Hepples v FCT (1990) 22 FCR 1 320
Hertz Corp v Friend 559 US 77 (2010) 120
Hill v Zuda Pty Ltd [2021] WASCA 59 ....126, 329, 490
Holmden's Settlement Trusts, Re [1968] AC 685 316
Holt's Settlement Trusts, Re [1969] 1 Ch 100 316
Hraichie and FCT [2021] AATA 2773 218
Huang; DCT v [2021] HCA 43 408
Huang v DCT [2020] FCAFC 141 310
Hunger Project Australia; FCT v [2014] FCAFC 69 .... 379–381, 708, 710
Hunter Douglas Ltd v FCT 82 ATC 4550 233

I
Ian Mark Collins & Mieneke Mianno Collins ATF The Collins Retirement Fund and FCT [2022] AATA 628 598
ICI Australia Ltd v FCT [1996] FCA 617 320
Idlecroft Pty Ltd v FCT [2005] FCAFC 141 .... 487, 488
In the Will of Docker (1976) 12 ALR 521 44
International Nickel Australia Ltd v FCT [1977] HCA 49 233
Ioppolo v Conti [2013] WASC 389 649
Ioppolo v Conti [2015] WASCA 45 649
ISPT Nominees Pty Ltd v Chief Commr of State Revenue [2003] NSWSC 697 316

J
Jenkins v Ellett [2007] QSC 154 429
John Holland Group Pty Ltd v FCT [2015] FCAFC 82 473

K
K & S Lake City Freighters Pty Ltd v Gordon & Gotch Ltd [1985] HCA 48 487
K7 Developments Pty Ltd v Abbotsford Estates Pty Ltd [2021] VSC 422 152
Kafataris v DCT [2008] FCA 1454 38
Kafataris v DCT [2015] FCA 874 316
Karas; DCT v [2012] VSC 143 485
Karger v Paul [1984] VR 161 134
Kauter v Hilton [1953] HCA 95 ....269, 316
Khoury v Government Insurance Office of NSW [1984] HCA 55 147
Kinsela v Caldwell [1975] HCA 10 71
Knight v Knight [1840] EngR 862 70
Kong and FCT [2021] AATA 2775 218
Korda v Australian Executor Trustees (SA) Ltd [2015] HCA 6 316

L
La Mancha Africa SARL v FCT [2021] FCA 1564 ....409, 484–486
Lacey & Lacey [2020] FamCAFC 73 ....425, 426
Lane; FCT v [2020] FCAFC 184 44
Lapalme, Re; Daley v Leeton [2019] VSC 534 430
Legal Practice Board v Computer Accounting and Tax Pty Ltd [2007] WASC 184 127
Legend International Holdings Inc (in liq), Re [2018] VSC 789 310
Livingspring Pty Ltd v Kliger Partners [2007] VSC 443 427
London and FCT [2022] AATA 644 673
Lonsdale Sand & Metal Pty Ltd v FCT [1998] FCA 155 26
Lygon Nominees Pty Ltd v Commr of State Revenue [2007] VSCA 140 715

M
Malek and FCT [1999] AATA 678 480
Marley v Rawlings [2015] AC 129 430
Marsella v Wareham (No. 2) [2019] VSC 65 134
Maughan v FCT (1942) 66 CLR 388 381
McCarthy and FCT [2021] AATA 1511 9
McCarthy v Saltwood Pty Ltd [2020] TASSC 19 427
McCurry v FCT [1998] FCA 512 9
McDonald; FCT v 87 ATC 4541 ....601, 602
McGowan & Valentini Trusts, Re [2021] VSC 154 ....70, 267–269, 312, 315, 316
McPhail v Doulton [1970] UKHL 1 254
Mercanti v Mercanti [2016] WASCA 206 136
Meyerstein, Re [2009] VSC 564 71
Miller v Cameron (1936) 54 CLR 572 136
Milroy v Lord [1862] EWHC Ch J78 269
Mobbs and FCT [2022] AATA 201 516
Moreton Resources Ltd v Innovation and Science Australia [2019] FCAFC 120 541
MP Metals Pty Ltd v FCT (1967) 117 CLR 631 121
Municipal Council of Sydney v Bull [1909] 1 KB 7 310
Munro v Munro [2015] QSC 61 .... 329, 491
Mussalli v FCT [2021] FCAFC 71 8

N
N & M Martin Holdings Pty Ltd v FCT [2020] FCA 1186 ....11, 12, 35–37, 123
Narumon Pty Ltd, Re [2018] QSC 185 ....329, 490
Naval, Military and Airforce Club of South Australia Inc v FCT [1994] FCA 1123 320
Nelson v Nelson [1995] HCA 25 223
Newton; FCT v (1957) 96 CLR 578 ....706, 708, 709, 712
Newton v FCT (1958) 98 CLR 1 .... 701, 702, 704, 705
North Australian Contracting Pty Ltd and FCT [2022] AATA 223 516
NSFT Pty Ltd, Application of [2010] NSWSC 380 430

O
Ogilvie v Adams [1981] VicRp 92 26
O'Grady v Northern Queensland Co Ltd [1990] HCA 16 416
Origin Energy Ltd v FCT (No. 2) [2020] FCA 409 416
Oswal; FCT v [2012] FCA 1507 44
Oswal v FCT (No. 4) [2016] FCA 666 486
Owies Family Trust, Re [2020] VSC 716 134–136

P
Paciocco v ANZ Banking Group Ltd (2016) 258 CLR 525 409
Parramatta City Council v Brickworks Ltd [1972] HCA 21 461
Paul v Constance [1977] WLR 527 269
Perpetual Executors and Trustees Association of Australia Ltd v Wright [1917] HCA 27 316
Perpetual Trustee Co Ltd v FCT [1931] HCA 20 381
Perpetual Trustee Co Ltd v Thomas [1903] NSWStRp 58 269
Perrin v Morgan [1943] AC 399 430
Perry v Nicholson [2017] QSC 163 329
Peter Greensill Family Co Pty Ltd (trustee) v FCT [2020] FCA 559 ....11, 12, 35–38, 124, 230, 232, 234, 302, 487
Peter Greensill Family Co Pty Ltd (trustee) v FCT [2021] FCAFC 99 ....11, 44, 123, 124
Planche v Fletcher (1779) 1 Doug 251 310
Prestige Motors Pty Ltd as trustee of the Prestige Toyota Trust; FCT v 98 ATC 4241 ....487, 488, 705, 706, 709–713
PricewaterhouseCoopers; FCT v (Federal Court, unreported, Victorian Registry, 2 June 2020, No. VID 364/2020) 433

Project Blue Sky Inc v Australian Broadcasting Authority [1998] HCA 28 ....121, 487

Q

Qantas Airways Ltd; FCT v [2014] FCAFC 168 .... 473, 671
Qantas Airways Ltd and FCT [2014] AATA 316 671
Quikfund (Australia) Pty Ltd v Airmark Consolidators Pty Ltd [2014] FCAFC 70 121

R

Raftland Pty Ltd as trustee of the Raftland Trust v FCT [2008] HCA 21 268
Raftland Pty Ltd v FCT [2006] FCA 109 313
Raftland Pty Ltd v FCT [2008] HCA 21 488
Ramsden v Dyson [1866] LR 1 HL 129 568
Razzy Australia Pty Ltd v Commr of State Revenue [2021] VSC 124 ....196, 198
Reid v Commr of State Revenue [2021] QCAT 322 700
Rennie Produce (Aust) Pty Ltd (in liq); DCT v [2018] FCAFC 38 484
Rivers Developments Pty Ltd and FCT [2022] AATA 887 672
Royal Lion Capital Pty Ltd and FCT [2021] AATA 3049 218
Rubino Investments Pty Ltd as trustee for the Rubino Family Trust v Chief Commr of State Revenue [2018] NSWCATAD 133 ....268, 269, 313
Ruscoe & Walker [2001] FamCA 268 430
Ryan Wealth Holdings Pty Ltd v Baumgartner [2018] NSWSC 1502 ....175, 181

S

Saunders v Vautier [1841] EngR 629 ....315, 316
Secretary, Department of Social Security v James (1990) 95 ALR 615 316
Sharpcan Pty Ltd; FCT v [2019] HCA 36 416
Shell Energy Holdings Australia Ltd; FCT v [2022] FCAFC 2 461
Shi; DCT v [2021] HCA 22 485
Sibai v FCT [2021] FCA 1353 700
Singapore Telecom Australia Investments Pty Ltd v FCT [2021] FCA 1597 699
Skeats' Settlement, In re; Skeats v Evans (1889) 42 Ch D 522 259
SNF (Australia) Pty Ltd; FCT v [2011] FCAFC 74 493
Soar v Ashwell [1893] UKLawRpKQB 142 269
Song v FCT [2018] FCA 840 432
Soo v Soo [2016] NSWSC 1666 430
Southern Global Group Pty Ltd and FCT [2021] AATA 3968 ....347, 348
Spence v FCT [1967] HCA 32 601
Spencer v The Commonwealth of Australia (1907) 5 CLR 418 349
SPIC Pacific Hydro Pty Ltd v Chief Commr of State Revenue [2021] NSWSC 395 76–79
SPIC Pacific Hydro Pty Ltd v Chief Commr of State Revenue (No. 2) [2021] NSWSC 486 76–79
State Grid International Australia Development Co Ltd [2022] FCA 139 700
State of Norway's Application (No. 2), Re [1990] 1 AC 723 310
Staughton, Re; Grant v McMillan [2017] VSC 359 430
Stein v Sybmore Holdings Pty Ltd [2006] NSWSC 1004 430
STNK and FCT [2021] AATA 3399 286
Stockton v FCT [2019] FCA 1679 623
Stone v Kramer [2021] NSWSC 1456 566–568

T

Tax Practitioners Board v Hacker (No. 4) [2021] FCA 940 217
Tax Practitioners Board v Stroe [2022] FCA 482 675
Thiess v Collector of Customs [2014] HCA 12 487
Thornton v Shoe Lane Parking Ltd [1970] EWCA Civ 2 254
Thoroughbred Racing Pty Ltd v FCT [2013] FCA 1300 700
"Three Doctors Case": FCT v Gulland [1985] HCA 83 705
Tierney v Wood (1854) 52 ER 377 316
Tikva Investments Pty Ltd v FCT [1972] HCA 68 602
Tingari Village North Pty Ltd and FCT [2010] AATA 233 524
Todd v Todd [2021] SASC 36 .... 349, 351, 424, 425
Toohey, R v; Ex parte Meneling Station Pty Ltd [1982] HCA 69 320
Townson v Tickell (1819) 106 ER 575 717
Treasury Wine Estates Ltd v Maurice Blackburn Pty Ltd [2020] FCAFC 226 486
Triway Superannuation Fund and FCT [2011] AATA 302 262
Trustee for MH Ghali Superannuation Fund and FCT [2012] AATA 527 ....326, 327, 385, 387
Trustee for the Whitby Trust and FCT [2019] AATA 5637 644
Trustees of the Property of John Daniel Cummins v Cummins [2006] HCA 6 222

U

Unilever Australia Securities Ltd; FCT v 95 ATC 4117 233
Unit Construction Co Ltd v Bullock [1960] AC 351 ....120, 121

V

Versaci v Rechichi [2019] VSC 747 316
Virgin Australia Airlines Pty Ltd v FCT [2021] FCA 523 ....7, 473
Virgin Australia Regional Airlines Pty Ltd; FCT v [2021] FCAFC 209 ....410, 477
Virgin Blue Airlines Pty Ltd v FCT [2010] FCAFC 137 477
VL Finance Pty Ltd v Legudi [2003] VSC 57 26

W

Waltons Stores (Interstate) Ltd v Maher (1988) 164 CLR 387 567
Wareham v Marsella [2020] VSCA 92 ....134, 136
West v Weston Matter No. 4365/96 [1998] NSWSC 419 71
Whiddon and FCT [2022] AATA 197 517
Wilstead No. 5 Pty Ltd v Smyth [2020] VSC 651 428
Women's Life Centre Inc and Commr of the ACNC [2021] AATA 500 382
Wooster v Morris [2013] VSC 594 ....330, 649
Word Investments Ltd; FCT v [2008] HCA 55 ....345, 380
Wyndham v Egremont [2009] EWHC 2076 316
WYPF and FCT [2021] AATA 3050 219

Y

YPFD and FCT [2014] AATA 9 .... 219, 523

Authors

A

Abdalla, J
Tax Counsel's Report
- Federal Budget 2022-23 594
- Incentivising innovation: patent box regime 146
- Reflections on 2021 and the path forward 344
- The sharing economy reporting regime 458

Abraham, T
A Matter of Trusts
- Landholder duty aggregation 196

Ananda, A
Tax Counsel's Report
- ATO client verification requirements 5

B

Backhaus, S
Superannuation
- NALE and NALI: tax impact on contributions 436
- NALI: history and overview 384

Banton, S
Superannuation: top five litigation risks 174

Bembrick, P
Mid Market Focus
- When is an asset "active" for CGT purposes? 523

Bender, P
Trust disclaimers: FCT v Carter 639
Trust law: vesting and resettlement issues 312

Bertram, K
Commissioner of Taxation's access powers 431

Brandon, G
Mid Market Focus
- Employee share schemes – another instalment 683
- Restructuring: racing to IPO with blinkers on 156

Briglia, P
A Matter of Trusts
- Fixed trusts and NALI 326

Brumm, L
Corporate tax compliance and the RTP schedule 304

Bubb, A
Five ways that tax litigation is different 696

Burgess, M
Tax and estate planning in 2022: the year ahead 423

Burns, A
Mid Market Focus
- Environmental protection activities 292

Butler, D
Superannuation
- A guide to SMSF succession planning: part 1 648
- A guide to SMSF succession planning: part 2 719
- Are SMSF wills really "safer" than BDBNs? 490
- Contribution reserving: hurdles and risks 73
- NALE and NALI: tax impact on contributions 436
- NALI: history and overview 384
- New choice simplifies ECPI claims 561
- SMSF deeds: how does your supplier rate? 125
- SMSF wills versus BDBNs 329
- SMSFs: pros and cons of adding a member 260
- SMSFs with units in unit trusts and NALI 199

C

Cartland, A
Tomorrow's tax practice: part 1 185
Tomorrow's tax practice: part 2 243

Chow, S
CCIVs: a more workable approach 374

Chye, J
Mid Market Focus
- Migrating funds to Australia: tax traps 353

Cullen, R
Alternative Assets Insights
- NSW wind farm: fixtures and valuation issues 76

D

Dean, M
Navigating transactions involving "pre-CGT" assets 317

Dever, B
Member Profile 468

Diamond, B
Alternative Assets Insights
- Victorian windfall gains and land tax amendments 440

Donaldson, S
Obituary, Roger Lyne Hamilton SC 388

Donlan, T
Successful Succession
- Family succession: encourage with caution 566
- Real and genuine consideration 134
- Trust a little bit of uncertainty 267

E

Elliott, J
Member Profile 226

F

Fettes, W
Superannuation
- A guide to SMSF succession planning: part 1 648
- A guide to SMSF succession planning: part 2 719
- Contribution reserving: hurdles and risks 73
- New choice simplifies ECPI claims 561
- SMSF wills versus BDBNs 329

Figot, B
Superannuation
- Are SMSF wills really "safer" than BDBNs? 490
- SMSFs with units in unit trusts and NALI 199

Freshwater, L
Superannuation death benefits: some discrete issues 479

G

Godber, P
President's Report
- A strategic course for the future 280
- A welcome chance to reconnect 214
- Challenges coming our way in different forms 144
- Recognising our tremendous volunteer efforts 86
- The year that's gone and the year ahead 342
- Things to fix in the tax system 2

Grieve, S
Commissioner of Taxation's access powers 431

H

Haines, A
Commissioner of Taxation's access powers 431

Healey, S
Tomorrow's tax practice: part 1 185
Tomorrow's tax practice: part 2 243

Hennebry, E
A Matter of Trusts
- Section 100A: "oh no not you again" 487

Houseman, N
Alternative Assets Insights
- Glencore decision impact statement 492

Huang, R
Alternative Assets Insights
– NSW wind farm: fixtures and valuation issues 76
Hurst, G
CEO's Report
– A busy time in tax 669
– Ending the year on a collaborative note 343
– Growing together through change 3
– Highlights of The Tax Summit 281
– Leadership with vision 457
– Ongoing challenges for our community 87
– Start here, start now 215
– Supporting you through change 511
– The home of tax 593
– The Tax Summit: challenge accepted 145
– Working towards our long-term vision 403

J
Jeremiah, R
A Matter of Trusts
– Certainty and establishing a trust 70
– Tax-effective succession of a family trust 715
Jiang, SW
Alternative Assets Insights
– NSW property tax reforms update 129
Jones, D
Mid Market Focus
– Company tax rates and base rate entities 15

K
Kazacos, A
Undeclared foreign income: the "stick" approach 371
Kew, S
Alternative Assets Insights
– TR 2021/D4: software draft ruling 202
Khoo, C
Alternative Assets Insights
– Glencore decision impact statement 492

L
Lanyon, V
Share sale and purchase agreements 64
Leibler, M
Tax and the rule of law 569
Liang, L
A Matter of Trusts
– CGT liability of foreign beneficiaries 123
– Taxation of employee remuneration trusts 645

M
Ma, M
Associate Tax Counsel's Report
– State Budgets: a mixed approach to tax reform 89
Mack, D
Alternative Assets Insights
– Corporate collective investment vehicles 263
– Tax elections: managed trusts 722
Mahir, E
Alternative Assets Insights
– Glencore decision impact statement 492
Malek, S
Alternative Assets Insights
– Victorian windfall gains and land tax amendments 440
Malone, R
Alternative Assets Insights
– TR 2021/D4: software draft ruling 202
Mavropoulos, B
Corporate tax residence: a hidden risk 119
McNamara, E
Navigating transactions involving "pre-CGT" assets 317
Monotti, W
A Matter of Trusts
– Appointors: the problem of incapacity 258
Montani, D
Allocation of professional firm profits: part 1 543
Allocation of professional firm profits: part 2 626
Murray, I
Public benevolent institution "relief" via advocacy 379
Muscat, P
Corporate tax compliance and the RTP schedule 304

N
Nguyen, A
R&D tax incentive amendments 111
Noolan, A
The dark corners of Div 7A 22

P
Papadakos, G
Alternative Assets Insights
– Victorian windfall gains and land tax amendments 440
Peiros, K
Successful Succession
– Real and genuine consideration 134

R
Raspin, I
Superannuation death benefits: some discrete issues 479
Rogers, J
Sancho Panza to the Commissioner's Don Quixote 484

S
Sangha, R
Don't lose your losses 45
Saville, S
Don't lose your losses 45
Schurgott, K
Trust hot topics 35
Sealey, M
Alternative Assets Insights
– NSW property tax reforms update 129
Shekhawat, A
Associate's Report
– Australia's rising property prices 282
– Electrifying the tax engine 216
– FBT on car parking: stuck in reverse 671
– Opening our eyes to s 100A 512
– On the horizon in 2022 404
Shepherd, P
Member Spotlight 608
Smyth, D
R&D tax incentive amendments 111
Smythe, C
NSW Duties Act: charging the land 307
Spencer, L
A Matter of Trusts
– Certainty and establishing a trust 70
– Tax-effective succession of a family trust 715
Stevenson, A
Member Spotlight 528

T
Tapiolas, L
Member Spotlight 688
TaxCounsel Pty Ltd
Tax News – what happened in tax?
– June 2021 6
– July 2021 91
– August 2021 147
– September 2021 217
– October 2021 283
– November 2021 345
– December 2021 406
– February 2022 459
– March 2022 513
– April 2022 595
– May 2022 672
Tax Tips
– Blackhole expenditure: some points 413
– CGT asset identification 463
– Discretionary trusts: CGT and non-resident beneficiaries 11
– Division 7A and UPEs: new ATO approach 519
– Granny flats and CGT 95
– GST contractual issues 152
– Jointly owned land 601
– Main residence exemption: deceased estates 288
– Presumption of advancement? 221
– Statement penalty safe harbour 677
– Wills and potential CGT 349
The Tax Institute
Charities and not-for-profits 419
Employment taxes 469
Incentives for innovation and infrastructure 529
Large business and international: part 1 163
Large business and international: part 2 227
Private wealth 689
Small and family business concessions 357
Streamlining the tax system for individuals 609
Taxation of SMEs 296
The case for reform 104
Treatt, S
The inherent disincentive of the Child Care Subsidy 553
Tse, J
Interview with Jerome Tse 402
President's Report
– Good tax policy is fair – for everyone 456
– Reflecting on the Federal Budget 2022-23 510
– Tax time and the rest of 2022 668
– The voice of the profession 592
Undeclared foreign income: the "stick" approach 371

W
West, M
Section 100A and tax purpose 701
Whelan, L
Mid Market Focus
– Are software charges subject to royalty withholding tax? 99
Woo, K
Alternative Assets Insights
– CCIV legislation passed 563
– Corporate collective investment vehicles 263
– Tax elections: managed trusts 722
Wood, A
Five ways that tax litigation is different 696
Wu, L
Introducing a patent box in Australia 235

Giving back to the profession

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