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Taxation *in* Australia

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Julie Abdalla, FTI

Ten things I hate about your R&D claim
Llewellyn Wood

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Invitation to write

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

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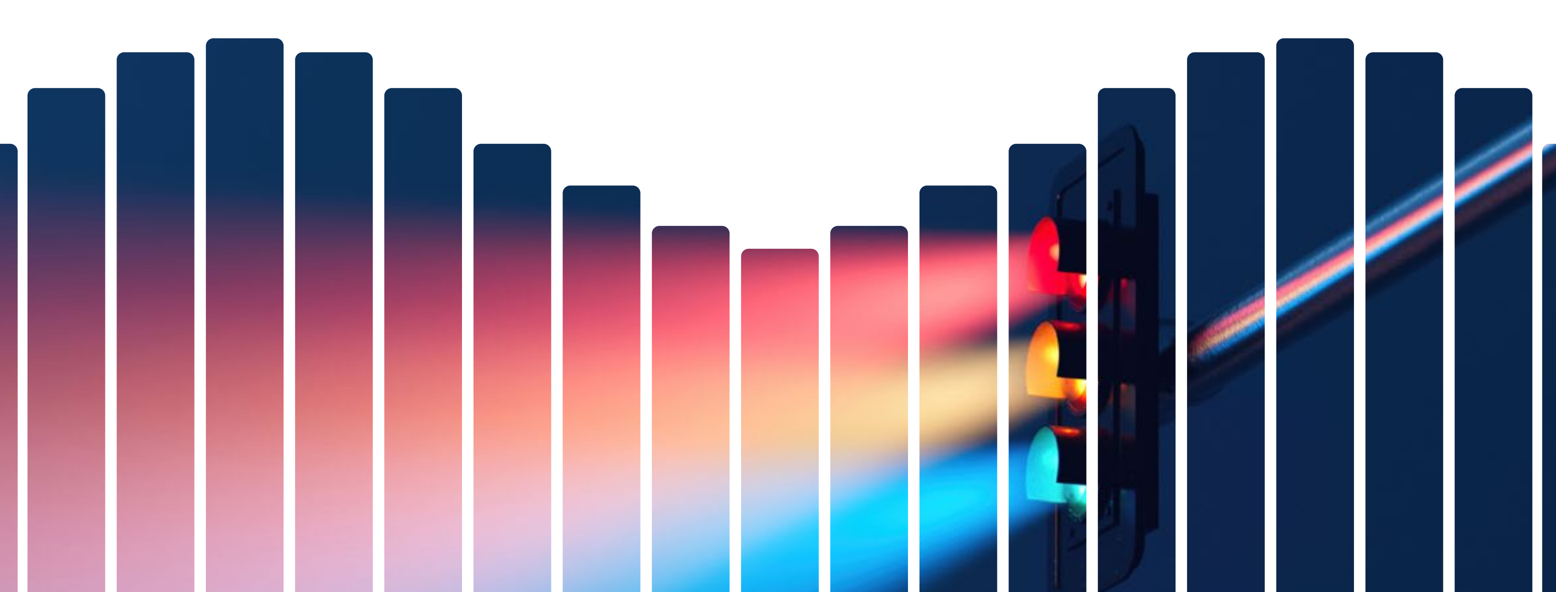

Tax News – at a glance

by TaxCounsel Pty Ltd

February – what happened in tax?

The following points highlight important federal tax developments that occurred during February 2024. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 412 (at the item number indicated).

Individual tax rates revamp

Amending legislation has been introduced into parliament which will give effect to the government's announced changes to the so-called stage 3 tax cuts for individual taxpayers that are to apply from 1 July 2024. **See item 1.**

Foreign investment fee increases

Amending legislation (the Foreign Acquisitions and Takeovers Fees Imposition Amendment Bill 2024) has been introduced into parliament that will triple the fees for acquiring established residential dwellings and double vacancy fees in the foreign investment framework. **See item 2.**

Royalties: software and intellectual property rights

The Commissioner has released a revised draft ruling which considers when an amount paid under a software arrangement is subject to royalty withholding tax, which turns on whether an amount paid is a royalty as defined in s 6(1) of the *Income Tax Assessment Act 1936* (Cth) and the various tax treaties (TR 2024/D1). **See item 3.**

Electric vehicles: home charging rate

The Commissioner has issued a final practical compliance guideline which sets out a practical administration approach to assist employers with FBT obligations, and individual taxpayers who incur work-related car and motor vehicle expenses, to calculate electricity costs incurred when charging electric vehicles at residential premises, typically, the employee's or individual's home (PCG 2024/2). **See item 4.**

Depreciating asset: composite items

The Commissioner has released a final ruling that considers the issues that arise where an asset consists of a number of components and it is necessary to determine whether the larger asset is itself a depreciating asset or whether one or more of its components are separate depreciating assets (TR 2024/1). **See item 5.**

Work-related deductions not substantiated

The AAT has affirmed a decision of the Commissioner to disallow claims by an individual taxpayer for work-related car expenses, other work-related expenses and gifts because of a lack of receipts and tax invoices to substantiate the expenses and a lack of specificity in a vehicle logbook (*Copley and FCT* [2024] AATA 8). **See item 6.**

Sale of land a taxable supply

The AAT has held that the sale by an individual taxpayer of a parcel of subdivided land was made in the course, or furtherance, of an enterprise carried on by him and that, therefore, the sale was a taxable supply for the purposes of GST (*Lance and FCT* [2024] AATA 11). **See item 7.**

President's Report

by Todd Want, CTA

Be active in shaping your legacy

President Todd Want encourages members to be proactively involved in contributing to a legacy of tax excellence.

We often hear that small business is the engine room of the Australian economy. That's not just a marketing slogan. I come from a family of small business owners, and I have seen firsthand the effort they put into their business and the impact they have on their local community.

I chose to play my part in this vital sector of our economy and lives through tax practice. Most of our members have made that same decision. Hence, you know as well as I do that, if small businesses are the engine room, their tax practitioners are the mechanics.

Last month, I was pleased to attend the Private Business Tax Retreat and get to know more of our members working in the SME space. Sixty-five per cent of our Institute members are SME or microbusiness practitioners and I'm always looking for chances to better understand the opportunities and challenges that the Institute can support them in navigating.

Serving today's membership of more than 9,000 tax practitioners is the Institute's key priority, including through advocacy work, education, producing resources, and events.

We're proactively working to further centre member voices in our organisation. We're building new avenues for members to share their feedback, ideas and experiences. And we're working harder than ever to ensure that members see their feedback actioned in real, concrete ways.

At the Private Business Tax Retreat, I encouraged members to be proactively involved in local events and activities, driven by their state councils. I'd like to repeat that here for all of our members around the country.

Your state council will be forming local working groups to better engage members, and to bring local ideas, opinions and challenges forward on a national stage. This is an opportunity for you to be more actively engaged in not only receiving support from the Institute, but also in helping to shape the kind of support on offer. The more you put in, the more you get out.

Building your legacy as a member

We're also thinking about the longevity of the Institute, our profession and our tax system.

Everyone involved in the Institute is building a rich legacy, whether through speaking up and making a difference in advocacy spaces, assisting with organising or presenting at CPD events, contributing to the body of tax knowledge in our journals and Tax Knowledge Exchange, or in a thousand other ways. As we increase local member engagement, it's our goal that more and more members are contributing to this legacy. It's something our community can be proud of for years and decades to come.

As an organisation, it's our job to invest in the sustainability of that legacy. That means continuing to keep our technology, resources and products modern and future focused.

We're investing in projects like our website, new Tax Knowledge Exchange platform, Tax Academy micro-credentials, and many more behind the scenes to future-proof the Institute, ensuring that we'll not only be here for another 80 years to come, but that we'll be relevant and useful to practitioners like you and leading the tax conversation.

Protecting our legacy also means maintaining a reputation that our members are proud of. It means being proactive about our impact in the wider economic, social and political landscape.

A sustainable tax system is a vital part of a sustainable future for the tax profession and an enduring Tax Institute. It's also very different from the system we have today.

Tax reform is a cause that the Institute has championed for many years now. We have become an important voice in the tax reform conversation, bringing attention to the challenges faced by our members and the wider tax profession.

I'm proud of the progress we've made so far, but there is still a long way to go. We're committed to seeing this through, and to ensuring that tax practitioners' voices are heard as we make changes for a better future.

CEO's Report

by Scott Treatt, CTA

Shaping changes to our tax system

Scott Treatt on your vital role in shaping how our tax system changes.

In his President's Report this month, Todd wrote to you about the value of building a legacy as a member of The Tax Institute and our role in maintaining that legacy. Part of that, as he writes, is the legacy of a sustainable tax system.

We have been working towards that legacy for many years now. Some of you may be sick of hearing the words "tax reform", but the push towards tax reform and your voice in that conversation are just as important as ever.

In fact, recent changes to the tax and superannuation systems that have either been made or proposed only highlight why your active participation is still so sorely needed.

Last year, penalties against promoters of tax schemes were increased and regulatory powers were strengthened. In the superannuation sector, we saw the proposed introduction of Div 296 into the *Income Tax Assessment Act 1997* (Cth) to levy an additional tax at the rate of 15% on earnings on total superannuation balances above $3m, consultation on the payday super measures, and amendments to the NALE provisions.

SME practitioners have had their eye on the Administrative Appeals Tribunal's decision in *Bendel v FCT*, which departs from the Commissioner's long-held views in TR 2010/3 (withdrawn), PS LA 2010/4 (withdrawn), PCG 2017/3 and TD 2022/11.

In international tax, we've seen the announcement of a multinational tax integrity and tax transparency package, proposed to apply from 1 July 2023, and the implementation of the OECD's Pillar 2 rules, from 1 January 2024.

Significant payroll tax changes affecting general medical practitioners have been made in several states and the High Court held that s 7(1) of the *Zero and Low Emission Vehicle Distance-based Charge Act 2021* (Vic) is invalid, which is likely to have significant implications for the states' ability to collect revenue from low emission vehicles. The Federal Treasurer announced at the end of last year that state and federal governments would work together to develop further options for zero emission vehicles user charging, so there is likely more change on the horizon in this area.

There have been many changes to tax policy and legislation. However, these changes are piecemeal and lack a cohesive vision. They are not reform and lack the kind of whole system vision – or, arguably, any long-term vision – needed for genuine reform.

Help us drive the conversation

That's where The Tax Institute and you, as a member, come in.

In order to make future changes to our tax system meaningful, we must speak up and help to give them direction. The Institute remains active in policy spheres, helping to shape the conversation around these changes as they are discussed, planned and implemented. Our Senior Tax Counsel – Tax & Legal, Julie Abdalla, FTI, has appeared before the Senate on numerous occasions to present the Institute and its members' view on various issues relating to changing tax policy or law. Our submissions continue to attract consideration from government agencies and attention in the media.

In these forums, we represent your voice and views. To do so, we need your active participation in our advocacy efforts. No one knows what's better for the tax profession and the tax and superannuation systems than members of The Tax Institute, who are at the coalface every day.

In his report, Todd has encouraged members to be actively involved in the activities and events being organised by our state councils. I'd like to add encouragement to be involved in the tax policy and advocacy activities of the Institute.

The best way to do this is by speaking up. Send us feedback on issues in TaxVine. Write articles for our journals detailing your analysis of policy changes (or potential changes). Talk to your local state council representatives and share your views. Attend events and engage in discussions on these emerging issues.

Your voice is our voice. So tell us what to say.

Associate's Report

by Abhishek Shekhawat, ATI

Designing better integrity provisions

Integrity provisions need to be appropriately designed to ensure that they operate efficiently yet fairly, a difficult balancing act to achieve.

Integrity provisions play an important role in our tax and superannuation systems. They address any unintended outcomes in the drafting or interaction of existing areas of the law and reduce the incentive for participants to "game" the system and receive an unplanned or otherwise notably unreasonable reduction in tax liability.

However, poorly drafted integrity provisions have the potential to adversely affect taxpayers to a disproportionate degree, so it is important to ensure that adequate time is spent by legislators in the design and consultation process to draft "good" integrity provisions. Proper consideration of how to draft integrity provisions is becoming more pronounced given the steady rise in the number of legislated or announced measures seeking to introduce new, or expand the scope of existing, integrity measures in recent years. This includes measures seeking to:

- treat distributions that are sourced from capital-raising activities unfrankable;
- deny deductions for intangible assets connected to a low-tax, or no-tax, jurisdiction;
- expand the scope of Pt IVA of the *Income Tax Assessment Act 1936* (Cth);
- expand the scope of the promoter penalty regime in Div 290 of Sch 1 to the *Taxation Administration Act 1953* (Cth); and
- tax large businesses under Pillar Two, including the domestic minimum tax income inclusion rules.

Designing "good" integrity provisions is a difficult task. It can be a challenge to achieve the right balance between addressing the underlying mischief without:

- creating excessive compliance burdens that outweigh the potential mischief;
- exceeding the intended scope and impacting commercial or low-risk transactions;
- adversely or disproportionately impacting one group of taxpayers over another; and
- resulting in unintended outcomes, such as excessively limiting overseas businesses from entering into commercial arrangements to invest in Australia, given our historically high reliance on imported capital.

This raises the question of how to design an effective integrity provision and achieve the right balance, a difficult challenge for legislators. Below are a few key factors that need to be considered during this process.

Understanding the extent of the problem

There is a perception that some integrity provisions are introduced as a knee-jerk reaction to a small number of actual or likely cases. Ideally, integrity provisions should not be enlivened as their purpose is to deter certain behaviour. It is therefore important to undertake a thorough analysis of the extent of the current or potential mischief had the new provision not been introduced.

A widescale problem may justify more obligations or restrictions on taxpayers. However, this should not be the default position. It is appropriate in some cases for an integrity provision to target a specific behaviour or arrangement of concern, some of which may have a low-tax value but which may result in a large impact on the revenue where a high number of taxpayers are involved. Consulting on the underlying modelling and assumptions, and obtaining additional data and insights from the profession, allows for a more accurate identification of the scope of the issue.

Utilising existing data

New integrity provisions often have the impact of imposing more reporting obligations on taxpayers. At times, the extent of these obligations can disproportionately outweigh the underlying mischief and disproportionately increase the costs for the impacted class of taxpayers. Where possible, utilising data (including data from existing reporting obligations) can go a long way to reducing that burden. The impact of practical administration, and limiting the increase in new obligations where possible, should be at the forefront when considering each measure.

Meaningful consultation

Providing adequate periods with meaningful consultation can be one of the most effective ways to identify and rectify any concerns, better ensuring that the measure achieves its intended purpose. Consultation can allow for:

- the gathering of information regarding the actual prevalence of arrangements of concern;
- a detailed understanding of the scope of the practical impact on taxpayers; and
- designing alternative solutions that achieve the same outcome without unduly burdening taxpayers.

Meaningful consultation can also expedite the legislative process, with the community and the profession's concerns being thoroughly considered before the introduction of a Bill. Lawmakers and the community will be provided with greater comfort that a proposed measure will be effective yet fair.

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Tax News – the details

by TaxCounsel Pty Ltd

February – what happened in tax?

The following points highlight important federal tax developments that occurred during February 2024.

Government initiatives

1. Individual tax rates revamp

Amending legislation has been introduced into parliament which will give effect to the government's announced changes to the so-called stage 3 tax cuts for individual taxpayers that are to apply from 1 July 2024.

Under the amendments, from 1 July 2024 in the case of individual resident taxpayers:

- the 19% tax rate is to be reduced to 16%;
- the 32.5% tax rate is to be reduced to 30%;
- the threshold above which the 37% tax rate applies is to be increased from $120,000 to $135,000; and
- the threshold above which the 45% per cent tax rate applies is to be increased from $180,000 to $190,000.

The following table sets out the comparative individual tax rates that apply to residents for 2023–24 and 2024–25.

Thresholds in 2023–24 ($)	Rates in 2023–24 (%)	New thresholds in 2024–25 ($)	New rates in 2024–25 (%)
0–18,200	Tax free	0–18,200	Tax free
18,201–45,000	19	18,201–45,000	16
45,001–120,000	32.5	45,001–135,000	30
120,001–180,000	37	135,001–190,000	37
>180,000	45	>190,000	45

Amendments are also being made to the rates of tax payable by non-resident individual taxpayers and to the rate of tax on the amount of working holiday taxable income.

Also, the Medicare levy low income thresholds are being increased as from the 2023–24 income year.

The amending Bills are the Treasury Laws Amendment (Cost of Living Tax Cuts) Bill 2024 and the Treasury Laws Amendment (Cost of Living — Medicare Levy) Bill 2024.

2. Foreign investment fee increases

Amending legislation (the Foreign Acquisitions and Takeovers Fees Imposition Amendment Bill 2024) has been introduced into parliament that will triple the fees for acquiring established residential dwellings and double vacancy fees in the foreign investment framework.

Schedule 1 to the amending Bill contains amendments to the *Foreign Acquisitions and Takeovers Fees Imposition Act 2015* (Cth) to update the fee cap, the maximum fee that can be imposed by the regulations, to $7m.

Amendments to the relevant indexation provisions that apply to the fee cap are also being made. The amendments will enable the tripling of fees for acquiring established residential dwellings and the doubling of vacancy fees in the foreign investment framework. These changes are giving effect to an announcement that was made by the government on 10 December 2023.

Schedule 2 to the amending Bill will amend the regulations to triple the fees for giving notice in relation to the acquisition of established dwellings, and double the vacancy fees for established and new residential dwellings acquired on or after 7.30 pm on 9 May 2017. Schedule 2 also updates the relevant indexation provisions to be consistent with the changes to the Act in Sch 1.

The amending Bill is to commence on either 1 April 2024 or the day after that Bill receives royal assent, whichever occurs later.

Another amending Bill (the Treasury Laws Amendment (Foreign Investment) Bill 2024) contains an amendment to the *International Tax Agreements Act 1953* (Cth) (the Agreements Act) to clarify any uncertainty associated with the interaction between certain taxes, such as foreign investment fees and similar state and territory property taxes, and double tax agreements implemented domestically by the Agreements Act.

The amendment will ensure that such taxes prevail in the event of any inconsistency with the Agreements Act. The amendment is to apply retrospectively for a period of six years. This time limitation broadly aligns with statute of limitation periods under state and territory legislation.

More particularly, the amendment is to apply to taxes (other than income taxes and FBT) payable on or after 1 January 2018 and taxes (other than income taxes and FBT) payable in relation to tax periods (however described) that end on or after 1 January 2018.

The Commissioner's perspective

3. Royalties: software and intellectual property rights

The Commissioner has released a revised draft ruling which considers when an amount paid under a software arrangement is subject to royalty withholding tax, which turns on whether an amount paid is a royalty as defined in s 6(1) of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) and the various tax treaties (TR 2024/D1).

The focus of TR 2024/D1 is on payments for the use of, or the right to use, copyright or other like property or rights. However, such payments may also be for the use of, or the right to use, other intellectual property (IP) rights, or otherwise fall within the definition of a "royalty". This will also affect the characterisation of the payment.

TR 2024/D1 does not consider:

- whether or not the payment constitutes assessable income under s 6-5 ITAA36 (ordinary income) or s 15-20 of the *Income Tax Assessment Act 1997* (ITAA97) (Cth) (royalties);
- the application of the transfer pricing rules in Div 815 ITAA97; or
- the potential application of Pt IVA ITAA36 to software arrangements involving payments for the use of, or the right to use, any IP right.

TR 2024/D1 applies to cross-border payments made under a software arrangement by an Australian resident, or a non-resident, which is related to or connected with a permanent establishment in Australia.

Where a tax treaty applies, the royalty definition in that tax treaty is given primacy over the domestic tax law definition of a royalty. The domestic tax law definition of a royalty is inclusive and covers amounts that would fall within the ordinary meaning of a royalty consistent with Australian case law. As a consequence, the domestic tax law meaning of royalties is broader than the standard tax treaty definition (which is exhaustive). It follows that, where an amount is a royalty under a standard tax treaty definition, it will also be a royalty under the domestic tax law definition and royalty withholding tax will apply at the rate provided for in that tax treaty.

The character of payments in relation to a software arrangement for, or that results in, the use of, or the right to use, software in Australia, depends on all of the facts and circumstances of the particular case, including the terms of any agreement between the parties and the conduct of the parties in relation to the software arrangement.

An amount may be a royalty even if it is not paid periodically and howsoever the payment is described or computed. For example, payments made under an agreement need not be described as being for, or being calculated with reference to, the use of, or the right to use, specified IP rights.

The following payments are characterised as a royalty where they are paid as consideration for one or more of the following:

1. the grant of a right to use IP, regardless of whether that right is exercised, for example, the grant of the right to reproduce a computer program, regardless of whether or not that right is exercised;
2. the use of an IP right (para (a) of the standard tax treaty definition), for example, the use of a copyright right consists of doing an act in respect of a copyright work that is the exclusive right of the copyright holder, such as authorising the communication of a computer program;
3. the supply of know-how in relation to an IP right referred to in (1) and (2) above (para (b) of the standard tax treaty definition);
4. the supply of assistance furnished as a means of enabling the application or enjoyment of the supply; and/or
5. the sale by a distributor of hardware with embedded software, where the distributor is granted or uses rights in the IP of the software.

The following payments are not royalties:

1. consideration that is wholly for the grant of a right to distribute copies of a computer program, without the use of, or the right to use, the copyright or another IP right;
2. consideration for the transfer of all rights relating to the copyright in software;
3. payments from a distributor that are consideration wholly for the acquisition of hardware with embedded software, provided that the distributor does not use, and is not granted the right to use, any copyright or another IP right in the embedded software;
4. payments from a distributor that are consideration wholly for the acquisition of physical carrying media on which software is stored, provided that the distributor does not use, and is not granted the right to use, any copyright or another IP right in the embedded software; and
5. consideration for the provision of services that are unrelated to any IP right referred to in para (a) of the standard tax treaty definition or any knowledge or information mentioned in para (b) of the standard tax treaty definition.

The enquiry under the standard tax treaty definition and the domestic tax law definition of a royalty is often expressed as whether or not the payment is paid "as consideration for" certain things. In this context, "consideration" is what moves the payment and is something of value given in exchange for it. "Consideration" does not have its technical meaning in contract law.

Where a payment is consideration for several things, only some of which fall within the standard tax treaty definition, the payment is a royalty to the extent that it is "for" the things that are within that definition. That is, the payment must be a royalty to at least some extent, even if it is also for other things that are not within the definition of a royalty.

If an undissected amount is paid as consideration for matters all of which are sufficiently connected with the things mentioned in the definition of a royalty, the whole amount of the payment will be taken to be a royalty in the first instance. However, it does not necessarily follow that, because an amount is paid as consideration for several things, it is paid only in part for each of them. For example, this will be the case where any IP rights granted are inseparable, from a practical and business point of view, from any other things for which the consideration is paid.

In certain cases, apportionment may be required to ascertain the extent to which any payment is a royalty. Apportionment is to be done on a fair and reasonable basis considering all of the relevant facts and circumstances of the particular case.

4. Electric vehicles: home charging rate

The Commissioner has issued a final practical compliance guideline which sets out a practical administration approach to assist employers with FBT obligations, and individual taxpayers who incur work-related car and motor vehicle expenses, to calculate electricity costs incurred when charging electric vehicles at residential premises, typically, the employee's or individual's home (PCG 2024/2).

It is the employer's or individual's choice to either use the methodology outlined in PCG 2024/2 or determine the cost of the electricity by determining its actual cost. The choice is per vehicle and applies for the whole income or FBT year. However, it can be changed by the employer or individual from year to year.

PCG 2024/2 does not apply to an electric vehicle that is a plug-in hybrid vehicle which has an internal combustion engine. This is because such vehicles operate on a combination of petrol-driven and electricity-driven kilometres. The methodology provided in PCG 2024/2 is a shortcut method which applies the electric vehicle home charging rate (EV home charging rate) only to vehicles that are solely fuelled by electric power.

PCG 2024/2 also does not apply to electric motorcycles or electric scooters.

Where a zero emissions vehicle has the functionality to accurately report the percentage of a vehicle's total charge based on the type of charging location, electric vehicle charging costs can include both home charging and commercial charging station costs. This is because the extent to which the vehicle has been charged at home (that is, its home charging percentage) can be accurately determined. The total number of relevant kilometres used to calculate home charging costs must be adjusted by applying the home charging percentage to arrive at the relevant kilometres for the purpose of PCG 2024/2.

If electric vehicle charging costs are incurred at a commercial charging station and the home charging percentage cannot be accurately determined, the taxpayer can choose to either: (1) use the EV home charging rate, but only if the commercial charging station cost is disregarded; or (2) use the commercial charging station cost, but only if the EV home charging methodology set out in PCG 2024/2 is not applied. Further, all necessary records such as receipts must be kept to substantiate the claim, as per normal record-keeping rules.

5. Depreciating asset: composite items

The Commissioner has released a final ruling that considers the issues that arise where an asset consists of a number of components and it is necessary to determine whether the larger asset is itself a depreciating asset or whether one or more of its components are separate depreciating assets (TR 2024/1).

Identifying the relevant depreciating asset is important for working out its effective life and, therefore, the rate at which deductions can be claimed. A depreciating asset that is the composite item as a whole may have an effective life that is different to the effective life of any individual component or components. This identification enquiry may also be relevant when testing an asset's eligibility for certain immediate tax write-offs and concessions.

TR 2024/1 also sets out the Commissioner's views on whether an "interest in an underlying asset" for the purposes of s 40-35 ITAA97 (jointly held depreciating assets) requires an entity to have an interest in all parts of a composite item that is itself a depreciating asset, or whether an interest in any part of the asset is enough.

A "composite item" is an item that is made up of a number of components that are each capable of separate existence. Section 40-30(4) ITAA97 directs an objective consideration of whether a particular composite item is itself a depreciating asset, or whether one or more of its components are separate depreciating assets – it is a question of fact and degree to be determined in the circumstances of the particular case.

TR 2024/1 sets out guidelines that are intended to assist in identifying the relevant depreciating asset. No one principle is determinative. Every enquiry requires the exercise of judgment in the prevailing factual circumstances. A composite item may be a single depreciating asset in one taxpayer's circumstances but not in another's.

For a component (or more than one component) of a composite item to be a depreciating asset, it is necessary that the component is (or components are) capable of being separately identified and recognised as having commercial and economic value.

Purpose or "functionality" is generally a useful guide to the identification of an item. The main principles that are taken into account when determining whether a composite item is a single depreciating asset, or more than one depreciating asset, are:

- the depreciating asset will ordinarily be an item that performs a separate identifiable function, having regard to the purpose it serves in its business context;
- an item may be identified as having a discrete function, and therefore as a depreciating asset, without necessarily being self-contained or used on a standalone basis;
- the greater the degree of physical or functional integration of an item with other component parts, the more likely the depreciating asset will be the composite item;
- when the effect of attaching an item to another item (which itself has its own independent function) varies the function or operational performance of that other item, the attachment is more likely to be a separate depreciating asset; and

- when various components are purchased (whether via one or multiple transactions) to function together as a system and are necessarily connected in their operation, the depreciating asset is usually the system (the composite item).

The relevant function considered in this context is the actual function that the item is to serve in the particular taxpayer's income-producing activity. Any theoretical function to which the item could be put in other circumstances is irrelevant.

To determine whether a composite item is a single depreciating asset or more than one depreciating asset, the relative functions of the entire item, against its components, need to be considered in the circumstances in which they are used.

A single depreciating asset is not necessarily the smallest possible component which can be identified within a composite item. Several components or parts of a composite item which work together with other components may be parts of a larger functional item, particularly where those components are integrally linked.

An item may be considered a separate depreciating asset notwithstanding that it performs some wider or commercially more "complete" function in combination or conjunction with other items that are themselves separate depreciating assets.

The fact that an item cannot operate on its own and has no commercial utility unless linked or connected to another item or items, does not preclude it from being a separate depreciating asset. Where such items are designed to be used in a range of settings or in conjunction with a wide range of equipment or systems, and are not acquired with other items as part of a system, this may indicate that they are separate depreciating assets.

An absence of a fixed physical connection between separate components of a composite item tends to indicate that each separate component is a depreciating asset.

Where an element of a system is purchased or installed at a different time to the system (irrespective of its intended operation within a system) and has a separate identifiable function, that element may be a separate depreciating asset.

Modifications

A modification or an alteration to an existing depreciating asset can itself be a separate depreciating asset. Such modifications can be of varying degrees.

Where:

- an addition or attachment substantially alters a depreciating asset (the original depreciating asset);
- the original depreciating asset continues to perform its function; and
- the addition or attachment serves its own function,

the addition or attachment is likely to be a separate depreciating asset from the original depreciating asset.

A modification which restructures or adds new components to an existing depreciating asset will result in the asset being merged into a new depreciating asset where the new depreciating asset has a different purpose or performs a different function from the original depreciating asset.

Examples

TR 2024/1 contains a number of examples that illustrate the propositions made in the ruling.

Recent case decisions

6. Work-related deductions not substantiated

The AAT has affirmed a decision of the Commissioner to disallow claims by an individual taxpayer for work-related car expenses, other work-related expenses and gifts because of a lack of receipts and tax invoices to substantiate the expenses and a lack of specificity in a vehicle logbook (*Copley and FCT*[1]).

The AAT held that the taxpayer had not met the burden (under s 14ZZK of the *Taxation Administration Act 1953* (Cth)) of proving that the Commissioner's notices of assessment were excessive or otherwise incorrect and what they should have been. In the absence of corroborating evidence supporting the expenses claimed, such as tax invoices which met the requirements of s 900-115 ITAA97 (written evidence from supplier), the evidence of a taxpayer that they have incurred the expenses is unlikely to be sufficient to meet the burden. Similarly, letters from the taxpayer's accountant stating that the taxpayer paid the expenses personally, that the expenses were incurred in the operation of the taxpayer's business, and asserting that the Commissioner was provided with sufficient evidence, were insufficient in assisting the taxpayer to meet the burden.

The taxpayer did not keep adequate receipts and records to support the expenses that he claimed and to apportion personal and business usage. He therefore failed to meet the substantiation requirements. The way that the taxpayer structured his employment and his corporate entities further added to the confusion as to who incurred the expenses.

The AAT observed that several expenses were likely to have been incurred in the gaining of the taxpayer's assessable interest as a real estate agent. Those expenses were a real estate licensing fee and Landgate fees. However, there was insufficient substantiation because those charges only appeared on bank statements.

7. Sale of land a taxable supply

The AAT has held that the sale by an individual taxpayer of a parcel of subdivided land was made in the course or furtherance of an enterprise carried on by him and that, therefore, the sale was a taxable supply for the purposes of GST (*Lance and FCT*[2]).

The land (known as Sutton Farm) comprised a single parcel of land of approximately 1.47 hectares and was acquired by the taxpayer in June 2013 for $1,600,000. The taxpayer

sold Sutton Farm for $4,250,000 under a contract for sale dated 24 November 2020 which was completed on 3 February 2021. On the first page of the sale contract, the box adjacent to the statement "GST is NOT applicable to this Contract" had been ticked. The taxpayer did not report the sale of the property in his BAS for the month of February 2021.

The AAT found that the taxpayer was not a reliable witness and, therefore, his evidence about his plans for Sutton Farm for the purposes of a family living arrangement could not be accepted. There were numerous inconsistencies and shortcomings in his claims. Critically, the AAT did not accept the taxpayer's evidence that Sutton Farm was to be subdivided into four lots, all of which were to be used by him and his family (including one of the subdivided lots to be used as a memorial). There was no independent corroboration of the taxpayer's claims to this effect and his claims were inconsistent with documents that were before the AAT.

Even though the AAT accepted that the taxpayer had intended, at some stage, to live in the heritage homestead located in the centre lot of Sutton Farm, it found that the taxpayer had also intended to subdivide Sutton Farm and sell off the subdivided lots in order to be able to afford to refurbish the homestead and repay his loans.

Critically, the AAT found that the evidence showed that the taxpayer engaged in an enterprise of developing Sutton Farm to enhance its value and make a profit by way of selling it as subdivided lots. That enterprise entailed a series of activities to develop Sutton Farm, including rezoning, negotiations with the Council for the local development plan, pursuing the closure and amalgamation of the pedestrian access way, obtaining subdivision approval, and completing electricity, water and sewerage works.

The AAT concluded that the series of activities undertaken by the taxpayer constituted an "enterprise" for the purposes of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GSTA99), namely, "in the form of a business". Further, that conclusion was also supported by the words "in the form of" which appear in the definition of "enterprise".

The taxpayer's development works were in "the form of a business", in particular, because of the scale of the operations that he was involved in, including the rezoning and subdividing of Sutton Farm, as well as the amount of capital invested by him in the purchase of the property and development works. This was regardless of whether or not he was in the business of being a property developer. Moreover, the local structure plan that the taxpayer lodged with the Council proposed that Sutton Farm was to be subdivided into four lots, with plans for further subdivision into approximately 15 lots. The taxpayer, as noted, also completed sewerage, water and electrical works. All of these activities were undertaken by the taxpayer over a period of some seven years, which enhanced the value of Sutton Farm.

The sale of Sutton Farm was a commercial transaction as it was undertaken "in the course or furtherance" of the "carrying on" of an enterprise. This was because the sale was for the purpose of achieving the goal of realising the value that had been added to Sutton Farm. "Carrying on" an enterprise is also broadly defined in s 195-1 GSTA99 to include doing anything in the course of the termination of the enterprise. It followed that, even if the ultimate sale of Sutton Farm was the result of the taxpayer giving up on the enterprise that he had commenced with respect to the development of Sutton Farm, the supply made on the sale of Sutton Farm nonetheless occurred in the course of him terminating the enterprise.

The AAT also held that the taxpayer's activities could be characterised as a series of activities "in the form of an adventure or concern in the nature of trade" for the purposes of the definition of enterprise in the GSTA99.

The inevitable further issue

A practical consequence of the decision of the AAT in this case is that there would be income tax implications for the taxpayer.

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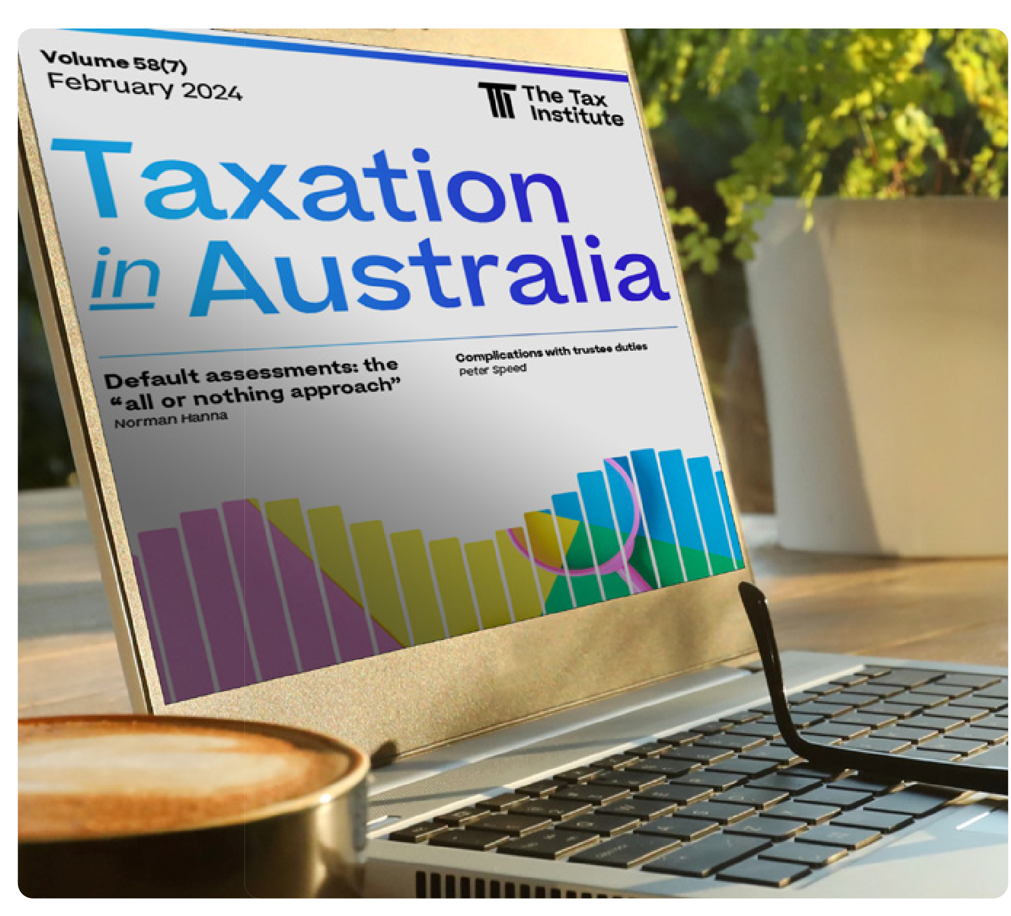
1 [2024] AATA 8.

2 [2024] AATA 11.



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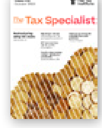

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Tax Tips

by TaxCounsel Pty Ltd

CGT: dwelling acquired by deceased estate

There is a special CGT main residence provision that potentially applies where a dwelling is acquired by the trustee of a deceased estate.

Background

The CGT main residence exemption provisions contain a number of special rules that apply where a dwelling owned by an individual becomes an asset of the individual's estate on their death. For example, there are special rules that apply in relation to a dwelling that was owned by a deceased individual and which passes to an individual beneficiary.[1]

There is also a provision (s 118-210 ITAA97) which operates where the trustee of a deceased estate acquires an ownership interest in a dwelling under the deceased's will. Where the conditions for its operation are met, the provision will apply; the operation of the section is not dependent on a choice being made. This article considers the operation of this provision. For convenience, the provision is referred to as the post-death dwelling acquisition rule.

There are several basic conditions that must be met for the post-death dwelling acquisition rule to apply.

What the section says

Section 118-210 ITAA97, which provides for the post-death dwelling acquisition rule, provides as follows:

"118-210 Trustee acquiring dwelling under will

(1) This section applies if you are the trustee of a deceased estate and, under the deceased's will, you acquire an ownership interest in a dwelling for occupation by an individual.

(2) If a CGT event happens to the interest in relation to the individual and you receive no money or property for it:

(a) a capital gain or capital loss you make from the event is disregarded; and

(b) the first element of the dwelling's cost base and reduced cost base in the hands of the individual is its cost base and reduced cost base in your hands at the time of the event; and

(c) the individual is taken to have acquired it when you did.

(3) If:

(a) you receive money or property for the CGT event happening or the event happens in relation to another entity; and

(b) the dwelling was the main residence of the individual from the time you acquired the interest until the time of the event;

you do not make a capital gain or capital loss from the CGT event.

(4) However, if the dwelling was the main residence of the individual during part only of that period, you make a capital gain or capital loss worked out using the formula:

$$\text{CG or CL amount} \times \frac{\text{Non-main residence days}}{\text{Days in that period}}$$

where:

CG or CL amount is the capital gain or capital loss you would have made from the CGT event apart from this Subdivision.

non-main residence days is the number of days in that period when the dwelling was not the individual's main residence.

(5) Only these CGT events are relevant:

(a) CGT events A1, B1, C1, C2, E1, E2, E5, F2, K3, K4 and K6 (except one involving the forfeiting of a deposit); and

(b) a CGT event that involves the forfeiting of a deposit as part of an uninterrupted sequence of transactions ending in one of the events specified in paragraph (a) subsequently happening.

Note: The full list of CGT events is in section 104-5.

(6) However, this section does not apply if, just before the deceased's death, the deceased was an excluded foreign resident."

Ownership interest

The concept of an ownership interest for the purposes of the post-death dwelling acquisition rule takes the meaning of the term that is relevant for the purposes of the CGT main residence rules generally. For example, an ownership interest in a dwelling that is not a flat or home unit is a legal or an equitable interest in the land on which the dwelling is erected, or a licence or right to occupy it.[2]

The acquisition condition

The post-death dwelling acquisition rule applies if the trustee of a deceased estate acquires, under the deceased's will, an ownership interest in a dwelling for occupation by an individual (s 118-210(1) ITAA97). The concept of a trustee

for this purpose extends to a deceased's legal personal representative.[3]

"Under" the will

The Commissioner accepts that, in its context in s 118-210(1) ITAA97, the preposition "under" requires a connection between the trustee's acquisition of an ownership interest in a dwelling and the deceased's will (TD 1999/74). The connection required is not a strict one.

TD 1999/74 makes these points:

- a trustee acquires an ownership interest in a dwelling under the will of a deceased person for the purposes of s 118-210(1) ITAA97 if the interest is acquired in accordance with the terms of the will, or in accordance with the terms of the will as modified by any court order;
- the trustee also acquires an interest under the deceased's will if they acquire it in pursuance of the will or under the authority of the will;[4]
- the acquisition need not be in strict conformity with the will or expressly by force of the will but, if it is, the requirements of s 118-210(1) ITAA97 would, in any case, be satisfied; and
- if a trustee acquires an ownership interest in a dwelling in the course of the administration of an intestacy, the trustee does not acquire the interest "under the deceased's will" for the purposes of s 118-210(1) ITAA97 because there is no will.

No limit to number of dwellings

There is no limit to the number of dwellings that can qualify for the post-death dwelling acquisition rule. For example, a testator's will may provide for the trustee to acquire a dwelling for the testator's spouse and also provide for the sale of such a dwelling and the acquisition of a replacement dwelling. In such a case, the rule may potentially operate in relation to both of the dwellings.

The relevant CGT events

For the post-death dwelling acquisition rule to apply, one of the following CGT events must be involved (except one involving the forfeiture of a deposit):[5]

- CGT event A1: disposal of a CGT asset;
- CGT event B1: use and enjoyment before title passes;
- CGT event C1: loss or destruction of a CGT asset;
- CGT event C2: cancellation, surrender and similar endings;
- CGT event E1: creating a trust over a CGT asset;
- CGT event E2: transferring a CGT asset to a trust;
- CGT event E5: beneficiary becoming entitled to a trust asset;
- CGT event F2: granting a long-term lease;
- CGT event K3: asset passing to a tax-advantaged entity;
- CGT event K4: CGT asset starts being trading stock; or
- CGT event K6: pre-CGT shares or trust interest.

Forfeiture of deposit

A CGT event that involves the forfeiture of a deposit will also be a relevant CGT event, provided the forfeiture of the deposit is part of an uninterrupted sequence of transactions ending in one of the CGT events listed above subsequently happening (s 118-210(5)(b) ITAA97).

There is a specific CGT event that may happen where there is a forfeiture of a deposit. This is CGT event H1 which happens if a deposit paid to a taxpayer is forfeited because a prospective sale or other transaction does not proceed (s 104-150 ITAA97).

CGT event: no consideration

Where the circumstances are such that the post-death dwelling acquisition rule potentially applies, if a CGT event happens to the ownership interest in relation to the individual and the trustee receives no money or property for it:[6]

- any capital gain or loss made by the trustee is disregarded;
- the first element of the dwelling's cost base and reduced cost base in the hands of the individual is its cost base and reduced cost base in the trustee's hands at the time of the event; and
- the individual is taken to have acquired the dwelling when the trustee acquired it.

A typical circumstance in which s 118-210(2) ITAA97 would apply is where the dwelling is distributed in specie by the trustee to the individual.

Example 1

Stuart died on 18 April 2018. David is the executor of Stuart's will. In exercise of powers conferred on him by the will, David acquired a dwelling under a contract entered into on 5 March 2020 that is to be occupied by Stuart's daughter, Jane, who is then 20. Jane moved into the dwelling on 31 May 2020. Under the will, the dwelling is to pass to Jane on her attaining 24 on 22 August 2024. The dwelling so passes. Jane sells the dwelling on 17 November 2024. David's cost base and reduced cost base of the dwelling as at 22 August 2024 is $1.5m.

In these circumstances, no capital gain or capital loss will be made by David on the dwelling passing to Jane on 22 August 2024. Jane will be taken to have acquired the dwelling on 5 March 2020 and the first element of the cost base and reduced cost base of the dwelling in her hands will be $1.5m (the cost base and reduced cost base of the dwelling to David on 22 August 2024).

Example 2

Assuming the facts in example 1, if Jane were to later sell the dwelling, the main residence exemption would apply in the normal way in relation to any capital gain or

Example 2 (cont)

capital loss that she makes from the sale, subject to the assumptions that are required to be made in relation to: (1) her cost base and reduced cost base of the dwelling; and (2) her time of acquisition of the dwelling.

There is, however, an issue of whether, because Jane did not move into the dwelling until 31 May 2020, she would only be entitled to a partial exemption. It would seem arguable that the first practicable to move into a dwelling concession provided for by s 118-135 ITAA97 could potentially apply. That concession applies if a dwelling becomes an individual's main residence by the time it was first practicable for them to move into it after they acquired their ownership interest in it and treats the dwelling as being the individual's main residence from when they acquired the ownership interest until it actually became their main residence.

The effect of s 118-210(2)(c) ITAA97 is that Jane would be taken to have acquired her ownership interest in the dwelling on 5 March 2020 and, so, if 31 May 2020 was the first practicable time for her to move into the dwelling, the main residence exemption would be available to Jane from 5 March 2020.

As noted below, it would seem that the position would be otherwise if the trustee were to dispose of the dwelling and it is necessary to calculate a capital gain or loss that is made by the trustee.

Where the trustee receives money or property

Where the circumstances are such that the post-death dwelling acquisition rule potentially applies, if a CGT event happens to the ownership interest in relation to the individual and the trustee receives money or property for the CGT event happening or the event happens in relation to another entity, the trustee will not make a capital gain or loss from the CGT event if the dwelling was the main residence of the individual from the time the trustee acquired the ownership interest until the time of the event (s 118-210(3) ITAA97).

If, however, the dwelling was the main residence of the individual during part only of that period, the trustee will make a capital gain or capital loss worked out using the formula set out in s 118-210(4) ITAA97 (see above).

For the purposes of determining the number of non-main residence days in the numerator of the formula, there is a question of whether the CGT main residence provisions that may operate to treat a residence as being (contrary to fact) a taxpayer's main residence are relevant. The first practicable to move into a dwelling concession noted above would not be relevant because that concession only applies if a dwelling "becomes your main residence".

Another example of such a provision is the provision under which an individual may choose to treat a dwelling as continuing to be their main residence during a period of absence.[7]

It is thought that the better view is that such a deeming provision would not be relevant. Taking the absence concession, it can apply, by virtue of s 118-145(1), if a dwelling that was "your" main residence ceases to be "your" main residence. It is suggested that the word "your" in that context refers to the taxpayer who is claiming the main residence exemption. On the other hand, in the context of the post-death dwelling acquisition rule, the references to "you" are clearly references to the trustee.

Example 3

Robert died on 17 June 2019. Under his will, Robert made a bequest of $2.5m to the executor (Wayne) which is to be applied in acquiring a dwelling for his spouse (Alison) to live in. Wayne acquired a dwelling for this purpose on 8 May 2020 for $2.3m. Alison moved into the dwelling on 15 June 2020 and lived in the dwelling until 16 July 2024 when she vacated the dwelling to live with one of her children. Wayne then sells the dwelling on 25 September 2024 (CGT event A1) for $2.9m. Wayne, as the trustee of Robert's will, would not make a capital gain calculated on the basis that the periods (1) 8 May 2020 to 14 June 2020 and (2) 17 July 2024 to 25 September 2024 were non-main residence days for the purposes of applying the formula in s 118-210(4). It would seem that it would not be possible for the first practical to move in concession to apply for period (1) or for the absence concession to apply for period (2).

Will drafting

As a general comment, where a will is being drafted and it is envisaged that the post-death dwelling acquisition rule may be relevant, the executor should be provided with the greatest flexibility that is consistent with the testator's intentions.

Excluded foreign resident

The post-death dwelling acquisition rule discussed above does not apply if, just before the deceased's death, the deceased was an excluded foreign resident.[8]

An individual is an excluded foreign resident, at a particular time, if:

- they are a foreign resident at that time; and
- the continuous period ending at that time for which they have been a foreign resident is more than six years.[9]

The excluded foreign resident rule applies generally in relation to CGT events that happen after 7.30 pm on 9 May 2017, subject to transitional provisions.

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References

1 S 118-195 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97). The general CGT deceased estate provisions are contained in Div 128 ITAA97.

2 S 118-130 ITAA97.

3 See the definition of "trustee" in s 6(1) of the *Income Tax Assessment Act 1936* (Cth).

4 *Evans v Friemann* [1981] FCA 85.

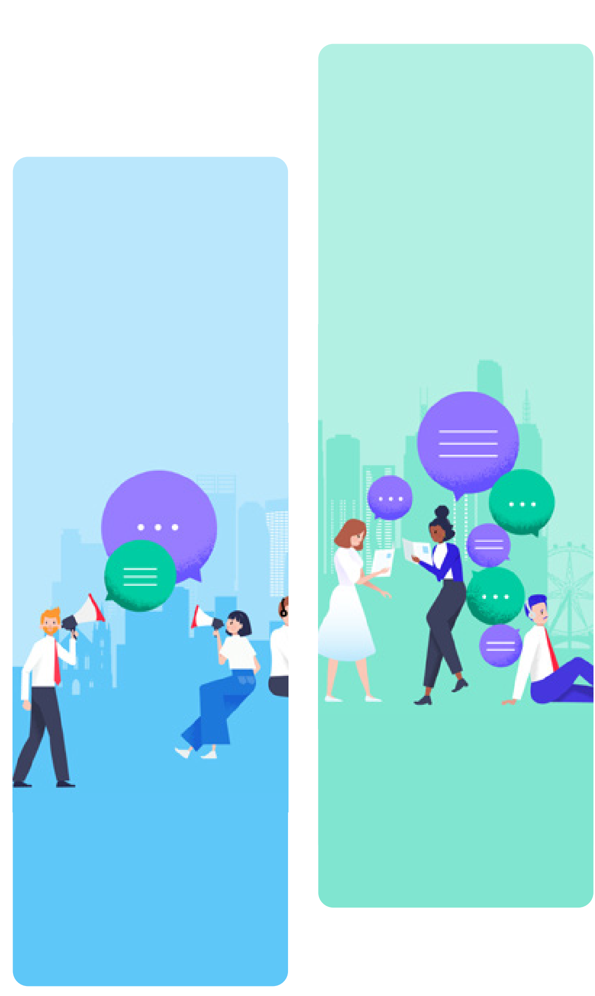
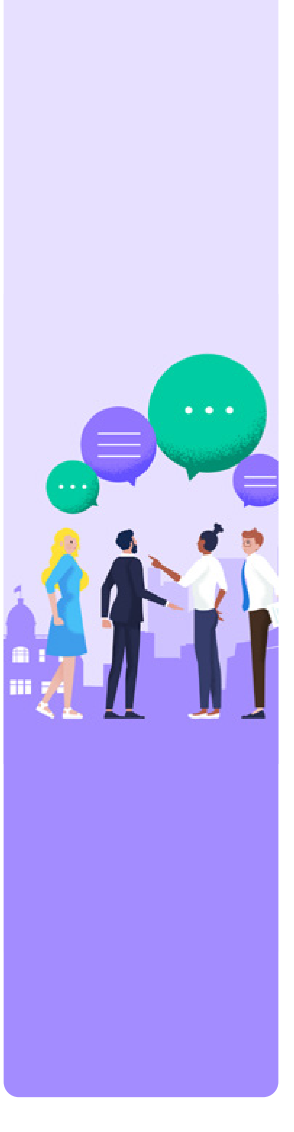
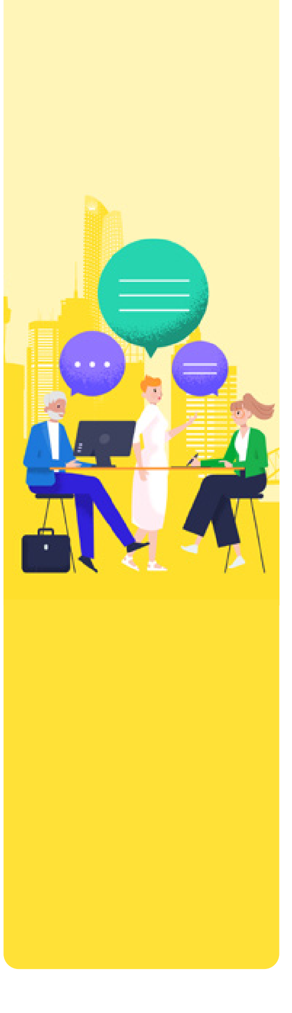
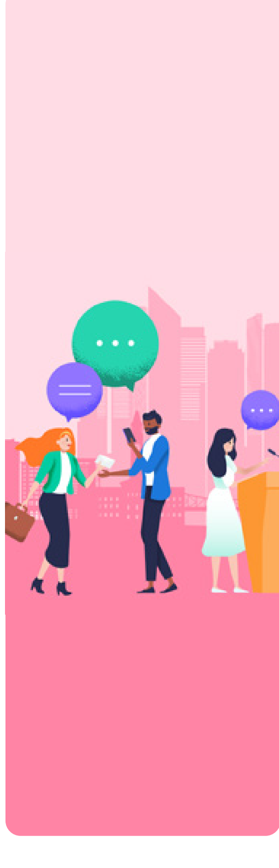
5 S 118-210(5)(a) ITAA97.

6 S 118-210(2) ITAA97.

7 S 118-145 ITAA97.

8 S 118-210(6) ITAA97.

9 S 118-110(4) ITAA97.

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Mid Market Focus

by Helena Yuan, HLB Mann Judd

Family trust elections: risks and pitfalls

An interposed entity election is a crucial part of understanding the full cost of making a family trust election and avoiding potential pitfalls.

Introduction

Corporate beneficiaries are regularly used as part of family wealth protection and wealth distribution strategies in Australia.

The most well-published tax issue associated with using corporate beneficiaries is the ATO's view on the application of Div 7A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) on unpaid present entitlements owing to corporate beneficiaries. This well-known issue is outside the scope of this article.

Instead, this article will take you through some of the other tax risks and pitfalls associated with making distributions to a corporate beneficiary by a discretionary trust with a family trust election (FTE) in place. These tax risks and pitfalls tend to not be at the top of a trustee's or adviser's mind when considering the use of a corporate beneficiary.

Family trust election and family group

The reasons for making an FTE are generally well understood. However, an FTE can be a double-edged sword. A discretionary trust with an FTE in place confines the trustee to making distributions only to family members of the individual who was elected to be the primary individual in the FTE. An FTE can only be made once for a trust and can be revoked only in very limited circumstances.

A distribution by the trustee to a beneficiary who is outside the primary individual's family group will attract family trust distribution tax (FTDT). The FTDT rate is the individual's top marginal rate plus Medicare levy (currently, the FTDT is 47%). The punitive tax rate, coupled with an unlimited timeframe for the Commissioner to raise an FTDT assessment, can result in a costly distribution if the trustee does not carefully consider whether a beneficiary is a member of the primary individual's family group for tax purposes.[1] As illustrated in this article, an eligible beneficiary within the trust deed may not necessarily be a member of the chosen individual's family group.

An FTE not only constrains the trust in its distributions, but it also has a follow-on effect to companies that are deemed to be entities owned by the primary individual's family,[2] or to companies that have made an interposed entity election (IEE).[3] Effectively, these companies will need to consider whether a recipient of a trust distribution or company distribution is a member of the primary individual's family group. Failure to do so may inadvertently trigger an FTDT liability. An interest-free or low-interest loan may also attract FTDT. The same constraints also apply to other trusts within the primary individual's family group. However, they are outside the scope of this article.

This article considers a few situations where a corporate beneficiary (a company) is a member of the primary individual's family group. But, first, let's look at the legislation.

Section 272-90, Sch 2F ITAA36 provides that a company may become a member of a primary individual's family group in either of the following two categories:

1. the company is covered by an IEE (s 272-90(4)); or
2. the company is owned by a family (s 272-90(5)).

Company owned by a family

First, let's consider the situations where a company is owned by the family of the primary individual.

The key condition in s 272-90(5) is that the primary individual, or one or more members of the primary individual's family (including trusts) – either by themselves or as a group – must have fixed entitlements, directly or indirectly, to 100% of the income and capital of the company.

It follows that, if there is less than 100% fixed entitlements to either income *or* capital of the company, the company could not be said to be "owned" by the family for the purposes of the ITAA36.

We will compare the companies in example 1 and example 2 and consider whether either of them is an entity owned by the *family*.

Example 1

Sunshine Family Trust has a valid FTE, effective from 1 July 2022. The FTE nominated Jennie as the primary individual, thus, the FTE constrains the trustee to only make a distribution to Jennie and members of Jennie's group, without incurring FTDT.

Jennie and Joe are siblings and they are the only shareholders in Breezy Pty Ltd. The company has only ordinary shares on issue, and Jennie and Joe each own their respective ordinary shares beneficially. This class of shares gives shareholders rights to dividends and return of capital, as well as voting rights.

As Jennie and Joe are siblings, between them, they are taken to have fixed entitlements to 100% of the income *and* capital of Breezy Pty Ltd. We would reach the same

conclusion regardless of whether Jennie and Joe had equal shareholdings in the company.

In this example, Breezy Pty Ltd is considered as an entity owned by the family under s 272-90(5). Sunshine Family Trust can make a distribution to Breezy Pty Ltd without incurring FTDT. Furthermore, Breezy Pty Ltd would be able to distribute dividends to Jennie and Joe individually without attracting FTDT.

Example 2

In addition to the facts in example 1, we now know that Joe is married to Emily and they are the shareholders of Turbine Pty Ltd which has the following share structure at incorporation:

Shareholders	Ordinary shares	Class A shares	Class B shares
Emily	100 shares, beneficially held	1 share, beneficially held	None
Joe	100 shares, beneficially held	None	1 share, beneficially held

Each class of shares has the following rights:

Rights	Ordinary shares	Class A shares	Class B shares
Voting right at all meetings	✓	✓	✓
Right to participate in any dividend payable on the class of shares held	✓	✓	✓
Right to participate in any division or distribution of any surplus assets or profits equally with all other members having similar rights	✓	✓	✓

Furthermore, the company constitution also allows dividends to be paid by Turbine Pty Ltd:

- in respect of the shares of any class or classes to the exclusion of any other class or classes; and/or
- at different rates in respect of any class or classes of shares.

Let's look at whether Sunshine Family Trust can distribute income to Turbine Pty Ltd without attracting FTDT.

The only shareholders of Turbine Pty Ltd are Emily and Joe. Joe is a member of Jennie's family group because Joe is Jennie's sibling,[4] and Emily is also a member of Jennie's family group. At first glance, the only persons who hold an entitlement to the income and capital of Turbine Pty Ltd are within the bounds of Jennie's family group. It would appear that collectively they hold 100% of the fixed entitlement to Turbine Pty Ltd's income and capital, although Turbine Pty Ltd can pay dividends to any class(es) to the exclusion of any other classes and at different rates.

However, a private ruling issued by the Commissioner[5] in July 2020 ruled that, where a company has discretionary power to pay dividends to one class of shares to the exclusion of the other classes of shares, each shareholder is taken to have nil% fixed entitlement to the income of the company. As such, that company could not satisfy the conditions for an entity owned by the family.

If one accepts the Commissioner's position in that private ruling, Turbine Pty Ltd would *not* be an entity owned by Jennie's family group because Emily and Joe each is taken to have nil% fixed entitlement to the income of the company. The consequence is that Sunshine Family Trust cannot distribute income to Turbine Pty Ltd without attracting FTDT if nothing more is done.

Examples 1 and 2 illustrate that, while a discretionary power to distribute dividends by the company may be an attractive feature due to the potential flexibility in income distribution, according to the ATO, this feature may potentially expose trust distributions to such a company to the punitive FTDT.

However, there is another way for a company to become a member of the primary individual's family group. Let's now look at a company that is covered by an IEE.

Company covered by an IEE

A company that is not automatically an entity "owned" by the family can nevertheless become a member of the primary individual's family group if the company makes an IEE with respect to the family trust making the distribution.

Among other requirements, a company can make an IEE only if it passes the "family control test" in the way described in s 272-87, Sch 2F ITAA36.

The bar for passing "family control" is lower than that for "family owned". There are two conditions in the family control test that are applicable to companies.[6] A company can pass the family control test if it satisfies either of the two conditions.

The first condition requires shareholders who are members of the primary individual's family group, including the primary individual, to have between themselves and for their own benefit fixed entitlement to a greater than 50% share of the income of the company.

The second condition of the family control test requires shareholders who are members of the primary individual's family group, including the primary individual, to have between themselves and for their own benefit fixed entitlement to a greater than 50% share of the capital of the company.

"Fixed entitlement to share of income or capital" of a trust, of a company or of a partnership is defined in the legislation.[7]

It is worth noting that a share of the capital of a company refers to the shares "carrying the right to receive the whole or part of any distribution of the paid-up share capital of the company".[8]

Example 3

Continuing with the facts in example 2, applying the first condition of the family control test will not improve the outcome. Emily and Joe – either individually or collectively – do not have a greater than 50% share of the income of Turbine Pty Ltd so the company will *not* pass the first condition of the family control test.

As described above, accepting the Commissioner's position in the private ruling, Emily and Joe each would be taken to have nil% fixed entitlement to the income of Turbine Pty Ltd because Turbine Pty Ltd has discretionary power to pay dividends to one class of shares to the exclusion of the other classes of shares.

We will look at the second condition of the family control test for a company in example 4, with an additional piece of information.

Example 4

Continuing with the facts in example 3, we now consider the second condition of the family control test, along with an additional piece of information. We now know that Turbine Pty Ltd's company constitution provides that:

> Repayment of capital – Regardless of any other provision in this Constitution, on a winding up or a reduction of the capital of the Company the amount paid up on the shares in each class then issued will be repaid to the holders of those shares in the following order of priority:
>
> (a) Ordinary Shares;
>
> (b) A Class Shares;
>
> (c) B Class Shares.

Emily, being a shareholder of ordinary and class A shares, and Joe, being a shareholder of ordinary and class B shares, individually would have a fixed entitlement of up to a 50% share of the paid-up capital of Turbine Pty Ltd in the event of a return of capital to shareholders.

Turbine Pty Ltd should be able to satisfy the second condition of the family control test on the basis that Emily and Joe – between themselves and for their own benefit – would have a greater than 50% fixed entitlement to distribution of the capital of Turbine Pty Ltd.

Therefore, Turbine Pty Ltd would be able to pass the family control test, and it could make an IEE with respect to the Sunshine Family Trust when one is required.

Disadvantages of making an IEE

Making an IEE can come at a cost. Similar to making an FTE, trustees and their advisers must carefully consider the longer-term disadvantages of making an IEE in order to avoid potential traps.

This is because an IEE can be revoked only in limited circumstances, and the effect of a company making an IEE with respect to a trust that has an FTE in place is that the company would be limited in making distributions only to members of the individual nominated in the trust's FTE.

The following two examples illustrate potential hidden traps when making an IEE.

Example 5

Continuing with the facts in the first four examples, Turbine Pty Ltd has now made an IEE in respect of the Sunshine Family Trust in an earlier year to avoid a potential FTDT liability on a distribution from the Sunshine Family Trust.

As Emily and Joe have now sold their shares in Turbine Pty Ltd to a third-party purchaser, a distribution from Turbine Pty Ltd to the new shareholders may be subject to FTDT.

Example 6

Turbine Pty Ltd is still owned by Emily and Joe in the same way as described in example 2, but it has made an interest-free loan to Jewel Pty Ltd. Jewel Pty Ltd is wholly owned by Bobby who is a friend of Joe. Bobby is otherwise not related to Jennie, Emily or Joe. The interest forgone on this loan may also expose Turbine Pty Ltd to FTDT.

Conclusion

Trust taxation is a complex area, and using companies as beneficiaries dials up the level of complexity from a tax perspective. When making a trust distribution, trustees and their advisers must carefully consider the trust deed, as well as the hidden traps in the FTE and IEE if one is made.

Helena Yuan
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Higher Education

The three secrets to success

The Dux of Corporate Tax for Study Period 1, 2023 describes his career in tax and how setting priorities is key to juggling work and study.

Vincent Oldani
Tax Manager
MGI Joyce-Dickson, ACT

Tell us about your career in tax

I graduated from a French business school with a finance major and spent most of my career in Luxembourg. My first job in 2006 was with the international corporate tax team of KPMG, and then I became a finance/tax specialist with the investment fund division of Macquarie Bank. I moved to Australia for family reasons and joined the tax team of MGI Joyce-Dickson in Canberra.

I moved into a tax advisory role with MGI in early 2021. The Australian tax system is complex and different from what I was used to back in Europe. I figured out that the best way to learn quickly was to undertake the Chartered Tax Adviser Program with The Tax Institute. It was so helpful in structuring and expanding my tax knowledge that I decided to go for one more subject!

What have you gained by taking the Corporate Tax subject?

I learned a lot about corporate tax topics that are often outside of the usual reach of a tax accountant and yet critical to tax advisory, such as the company loss utilisation rules, the debt/equity tests, the capital reduction/share buy-back rules, the consolidation mechanics, the CGT roll-overs etc. Some topics, like the module on R&D incentives, are a bit more specialised but they have also proved extremely useful for some of my clients.

The technical content from the subject is useful on a daily basis. I often go back to the module notes to confirm my understanding of a specific topic as the explanations and the given examples are helpful to quickly grasp some mechanisms which may not be that clear from reading the tax legislation or commentaries.

What about the CTA Program?

I have no specialisation in my current tax advisory role, and I am supposed to be able to cover any question on any area of the Australian tax law. I have learned a lot in a short period of time, but directly on the job, bit-by-bit, rather than in a structured way. Following the CTA program really gives me this excellent structured understanding, which is key for me to join the dots in what I am learning at my work. Studying with The Tax Institute was an excellent smooth online experience.

Do you have any tips for others on managing study while working?

The first secret is to set your priorities right. The important before the urgent. I mean what is important, long and difficult (for instance, your studies!) should be at least started, set into motion, before you get to the never-ending routine of the urgent problems.

My second secret is to avoid the serial timewasters like addictive TV series (cancel your subscriptions!) and to leave your smartphone in a different room. Then you find out that there is enough time for your work, your family, your studies, and even for your hobbies.

Last but certainly not least, it is very helpful to have an employer that supports your studies by granting you some days to prepare for your exams. I am very thankful to my employer for that.

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The changing face of tax practitioner obligations

by Julie Abdalla, FTI, Senior Counsel – Tax & Legal, The Tax Institute

There have been a number of recent significant changes to the regulatory framework governing registered tax agents and registered BAS agents. The changes range from amended reporting requirements to new obligations being added to the Code of Professional Conduct, coupled with changes to the penalties associated with misconduct. The changing governance framework has caused significant concern among members of the profession. However, it is important to carefully analyse each measure and determine what they mean for tax practitioners. In this article, we briefly look at the historical landscape of the changes, examine the key measures introduced in the first tranche, and analyse their impact on the tax profession and the tax system.

Genesis for change

Over the course of the past two years, the government has made several announcements regarding a plethora of changes impacting the regulatory framework within which registered tax agents and BAS agents (tax practitioners) operate. Despite the government framing many of the key changes as a response to the PwC matter that has dominated newsfeeds since it came to light in early 2023, many of the proposed and enacted changes emanate from the 2019 review of the Tax Practitioners Board (the James review).

The James review was announced on 5 March 2019 in response to existing concerns that the more than 10-year old framework within which the tax profession operates would benefit from improvements and change. The James review was tasked with:[1]

- examining the legislative framework to ensure that the *Tax Agent Services Act 2009* (Cth) (TASA) is operating as intended;
- examining the governance framework and the Tax Practitioners Board (TPB) governance arrangements and whether they are fit for purpose and operate as intended;
- considering whether the TASA supports the TPB in responding to known and emerging issues;
- examining whether the powers and functions of the TPB are sufficient to enable the objects of the legislative framework to be met; and
- considering ways to improve the regulatory environment.

After extensive consultation, the final paper was tabled on 31 October 2019. It made 28 recommendations, including improving the independence of the TPB, amending the legislative framework and Code of Professional Conduct (the Code), and improving the integrity of the rules governing tax practitioners. The recommendations were based on existing and known issues within the tax profession, such as de-registered tax practitioners continuing to provide services under the supervision of, or through, a registered tax practitioner.

The James review recognised that every regulatory framework benefits from regular scrutiny and updates. As technology and work practices change, it is important for the supporting framework to also adapt, allowing modern approaches to address modern issues.

The government's response, released on 27 November 2020, supported 20 of the 28 recommendations made in the James review. So far, nine of the recommendations in the James review have been implemented by the government over two tranches of legislative changes.

Passage of the first tranche of changes

The first tranche of measures was originally released to the public on 18 November 2022 in the form of an exposure draft of the Treasury Laws Amendment (Measures for Consultation) Bill 2022: Tax Practitioners Board Review. The exposure draft legislation proposed to:

- update the objects clause in the TASA;
- establish a special account for the TPB;
- impose new restrictions around tax practitioners using or working with disqualified entities;
- convert the three-yearly annual registration period to an annual registration period; and
- enable the Minister to make changes to the Code through delegated legislation.

The Tax Institute, in conjunction with other leading professional associations (the joint bodies), made a joint submission outlining the industry's concerns with the proposed approach. Broadly, the joint bodies are supportive of measures that increase the independence of the TPB from the ATO, and suggested improvements to better ensure that the proposed changes would achieve the optimal balance between ensuring public confidence in the operation of the tax system and minimising unintended outcomes or excessive burdens placed on the vast majority of the profession that strives to do the right thing.

The first tranche, introduced in Sch 3 to the Treasury Laws Amendment (2023 Measures No. 1) Bill 2023 (TLAB1), had a rocky path through the parliament due to the rigorous political debate that surrounded the proposed provisions. The TLAB1 was referred to the Senate Economics Legislation Committee (Senate Committee) on 9 March 2023, with the joint bodies making a subsequent submission before the Senate Committee's report was tabled on June 2023.

No material changes were made following the Senate Committee's report. However, significant changes were tabled in the Senate on 8 November 2023 by Greens Senator Barbara Pocock (the Greens' amendments). The Greens' amendments proposed restrictions to the appointments of Board members to the TPB and, more significantly, new breach reporting ("dob-in") provisions. These changes were not subject to any form of consultation, were not accompanied by any explanatory material, and took the profession by surprise. The Senate agreed to the Greens' amendments on 15 November 2023; the House of Representatives agreed to them on 16 November 2023; and the TLAB1 received royal assent on 27 November 2023 as the *Treasury Laws Amendment (2023 Measures No. 1) Act 2023* (TLAA1).

"Meaningful consultation is a crucial step in our legislative process as it allows … the opportunity to road-test potential changes …"

The joint bodies issued a media release on 15 November 2023, stating that:

> "… serious concerns remain that the amendments in their current form may have devastating impacts for any tax practitioner falsely accused of misconduct."

and that:

> "Poor tax law design and lack of consultation can often lead to poor or unintended outcomes for everyone involved, which is why the usual process of parliamentary consultation is in place and should have been followed in this case."

It is disappointing that the Greens' amendments to the TLAB1 were not first subject to any form of public consultation or scrutiny. Meaningful consultation is a crucial step in our legislative process as it allows tax practitioners, professional associations, and industry experts the opportunity to road-test potential changes to, among other things:

- identify issues and areas for improvement;
- ensure that there is a robust framework for administrative guidance; and
- ensure that the measure will operate as parliament intends.

Due to the lack of consultation, some key outstanding issues remain and need to be addressed. In the short term, an unreasonable burden is placed on the TPB to develop fair and balanced guidance due to the lack of guidance from the parliament. The first tranche of measures are discussed in greater detail below.

Disqualified entities

The TLAA1 introduces new restrictions and obligations regarding disqualified entities that, directly or indirectly, provide tax agent or BAS agent services. Broadly, an entity is a disqualified entity if they are neither a registered agent nor a qualified tax-relevant provider and, in the last five years, have:[2]

- been convicted of a serious taxation offence, a serious offence or an offence involving fraud or dishonesty;
- been penalised under the promoter penalty provisions;
- been an undischarged bankrupt or have gone into external administration;
- been subject to sanctions for a breach of the Code;
- had their registration terminated;
- had their application for registration or renewal rejected; or
- been found to have contravened the TASA.

Code item 15: use of disqualified entities to provide tax agent services

New Code item 15 requires tax practitioners to not use or employ the services of an entity to provide tax agent services on their behalf if:[3]

- they knew, or ought reasonably to have known, that the entity was a disqualified entity; and
- the TPB did not provide approval to use or employ the services of that entity under s 45-5 TASA.

The restriction is intended to be broad in scope, applying to a range of working relationships, including employees and contractors[4] and those who are "used" but do not receive a direct fee or reward.[5] However, the restriction is not intended to apply to disqualified entities that are used to provide peripheral services, such as administrative support.[6]

When announced, there was uncertainty regarding the scope of the phrase "knew, or ought reasonably to have known". On 18 December 2023, the TPB released for consultation draft information sheet TPB(I) D51/2023. The draft information sheet provides further guidance on this aspect. TPB(I) D51/2023 proposes to require tax practitioners to take a number of steps to meet this obligation, including:[7]

- undertaking proof of identity steps as set out in TPB(PN) 5/2022;
- discussing the requirements of Code item 15 and receiving written confirmation that one of the events

that results in an entity becoming disqualified has not occurred in the last five years;

- checking the TPB public register to verify whether the individual has been sanctioned or had their registration previously terminated (noting the current limits of the TPB public register not being able to display de-registrations that occurred more than 12 months ago);
- having a contract that requires the employed entity to notify the employing tax practitioner if they become a disqualified entity;
- ensuring that the contract allows for termination if the employed entity becomes a disqualified entity; and
- keeping records completed by the employed entity declaring that they have not been subject to a disqualifying event in the last five years, for a period of five years after the employed entity ceases to be used by the tax practitioner.

If finalised in its current form, this approach will require many tax practitioners to update their onboarding processes, new and existing employment contracts, and record-keeping procedures to ensure that they meet the TPB's minimum expected requirements. It is important for tax practitioners to revisit the finalised version of TPB(I) D51/2023 and implement any necessary changes in a timely manner.

Tax practitioners would be assisted in their onboarding processes if they were provided with access to a complete register which includes disqualified entities. Currently, while tax practitioners are likely to be apprehensive about ensuring that they do not employ or work with a disqualified entity, the current checks may not provide them with a satisfactory level of comfort, potentially resulting in some tax practitioners spending time researching cases and media articles to assure themselves that they have not engaged a disqualified entity. A centralised, and regularly updated, formal register would alleviate these concerns and provide comfort to tax practitioners and the TPB regarding the use of disqualified entities in a more efficient manner. We hope that the improvements to the TPB public register contained in tranche two (discussed below) will enable the TPB to provide this functionality in the medium to long-term.

If tax practitioners want to use the services of a disqualified entity, they must seek prior approval from the TPB, otherwise they will be in breach of Code item 15. An application to use or employ a disqualified entity is required to be made to the TPB in the approved form and accompanied by the following information:[8]

- the reasons why the entity is a disqualified entity, and the circumstances relating to those reasons;
- the role, proposed or actual, that the entity would perform when providing tax agent services on behalf of a tax practitioner;
- the extent to which the reasons the entity is disqualified are, or are not, relevant to the entity's ability to perform the proposed role to an appropriate standard of professional and ethical conduct; and
- any other evidence that the tax practitioner considers is relevant in assisting the TPB's decision.

It remains to be seen what approach the TPB will take when providing its approval for this purpose. The explanatory memorandum (EM) to the TLAA1 does not provide much guidance regarding whether the TPB is required to adopt a strict approach. Rather, the TPB is required to factor in a range of circumstances. This is likely to result in the TPB approaching each request on its own merits.

Code item 16: providing services in connection with disqualified entities

Under new Code item 16, tax practitioners must not provide tax agent services in connection with an arrangement with an entity that they know, or ought reasonably to have known, is a disqualified entity.[9] This Code item is intended to prevent arrangements where the disqualified entity is operating through the tax practitioner, covering arrangements where a disqualified entity benefits from an arrangement where the tax practitioner derives fees from providing tax agent services.[10] For example, this may occur in scenarios where the disqualified entity is acting as the controlling mind of the tax practitioner and continues their operations using the registered tax practitioner's credentials.[11]

Unlike Code item 15, tax practitioners cannot seek permission from the TPB to provide tax agent services in connection with an arrangement with disqualified entities. The difference in treatment exists as Code item 16 primarily covers scenarios where the disqualified entity provides the services themselves, rather than providing the services on behalf of the registered tax practitioner.

An "arrangement" is a defined term for the purposes of the TASA[12] and is broadly defined to mean "any arrangement, agreement, understanding, promise or undertaking, whether express or implied, and whether or not enforceable (or intended to be enforceable) by legal proceedings".[13] Draft guidance issued by the TPB indicates that the application of this broad definition when determining whether an "arrangement" exists will:

- be approached on a case-by-case basis;[14] and
- extend to arrangements that may not constitute an enforceable arrangement, provided there is a "level of mutual commitment" that each party will act in a particular manner.[15]

The TPB is of the view that Code item 16 is not intended to apply to arrangements where the relevant services are administrative in nature, or unrelated to the provision of tax agent services.[16] The TPB proposes to require that tax practitioners use their professional judgment when determining whether the service is administrative or unrelated to tax agent services.[17]

When determining whether tax practitioners knew or ought reasonably to have known that the other entity was

a disqualified entity, the TPB proposes to require that tax practitioners follow the same criteria as that set out in TPB(I) D51/2023. That is, the tax practitioner is expected to undertake the same checks, have the same contractual powers and requirements, and keep the same records for five years after the arrangement ends. Tax practitioners will need to review their existing arrangements and ensure that they meet the TPB's requirements.

Reporting obligations of disqualified entities

Disqualified entities are required to report their status before they enter into a contract, or before the contract is renewed or extended, with a tax practitioner to provide services on their behalf or enter into an arrangement with a tax practitioner to provide tax agent services.[18] Failure to do so may result in a civil penalty of 250 units for an individual or 1,250 penalty units for a body corporate.[19]

Entities are also required to notify tax practitioners on behalf of whom they are providing tax agent services, or with whom they are in an arrangement regarding the provision of tax agent services, if they become a disqualified entity. This must be reported within 30 days of the period the entity knew, or ought reasonably to have known, of their disqualified status. A transitional rule allows disqualified entities an extended period ending 30 days from 1 January 2025 to provide the relevant notice if:[20]

- immediately before 1 January 2024, a tax practitioner employs or uses a disqualified entity (who has a disqualified status as of 1 January 2024) to provide tax agent services on their behalf;
- immediately before 1 January 2025, a tax practitioner employs or uses a disqualified entity to provide tax agent services on their behalf; and
- the disqualified entity has not already notified the tax practitioner of their disqualified status.

The EM to the TLAA1 does not provide guidance on when the tax practitioner knew, or ought reasonably to have known, the entity became a disqualified entity. However, it is unlikely that the TPB will adopt a similar approach as in TPB(I) D51/2023 on this issue. Rather, it is likely that disqualified entities will be required to make that judgment based on facts known to them, with a possible understanding that a reasonable person would be involved in, or seek to confirm the outcome of, any case or investigation against them. We await further guidance from the TPB in this regard.

The Greens' amendments

The details of the two measures introduced through the Greens' amendments are discussed below. As mentioned above, these measures were not subject to consultation. This raises concerns over the implementation and administration of these obligations as the tax community has not been able to provide its feedback or views on any issues, or propose more efficient and fairer ways to achieve the appropriate outcomes.

Breach reporting measures

Tax practitioners are required to notify the TPB, in writing, if they have reasonable grounds to believe that another tax practitioner has undertaken actions that would constitute a significant breach of the Code.[21] A breach is a significant breach if it:[22]

- constitutes an indictable offence, or an offence involving dishonesty, under an Australian law;
- results, or is likely to result, in material loss or damage to another entity (including the Commonwealth);
- is otherwise significant, including taking into account any one or more of the following:
  - the number or frequency of similar breaches by the agent;
  - the impact of the breach on the agent's ability to provide tax agent services; and
  - the extent to which the breach indicates that the agent's arrangements to ensure compliance with the Code are inadequate; or
- is a breach of a kind prescribed by the regulations.

Tax practitioners are also required to:

- report their own actions that they reasonably believe constitute a significant breach of the Code;[23] and
- notify all of their clients of TPB orders regarding a breach of the Code.[24]

The breach reporting measures raise some concerns regarding their practical application. At the forefront, there are widely held concerns about the serious ramifications for tax practitioners who are incorrectly reported to the TPB. The impact is agnostic whether the report was made with anti-competitive or malicious intent, or in good faith but based on incomplete or incorrect information. Reports received by the TPB are likely to be investigated, causing significant disruptions and stress on the party being investigated. These issues may be exacerbated by the proposed increase in the TPB's investigation time from six months to 24 months,[25] contained in the second tranche of measures.

On the other hand, tax practitioners who report a breach are not protected by the whistleblower provisions or other provisions. This may deter some practitioners if they are obliged to report a suspected breach of a particularly litigious entity. These issues need further consideration to ensure that the breach reporting measures operate as intended. At this stage, given the measures are already legislated, a post-implementation review may be the most effective way to achieve this.

The breadth of what constitutes a significant breach may mean that a large range of events fall within the scope of the breach reporting measures, some of which may be outside of what was intended by the policymakers. The TPB is expected to provide guidance and a reasonable approach to significant breaches.

There is also uncertainty regarding some of the terms used in the definition of "significant breach". In particular, further guidance is required regarding:

- what constitutes an "offence involving dishonesty";
- the relevant threshold for "material loss or damage"; and
- actions or conduct that would meet the threshold of an "otherwise significant" breach of the Code.

Further guidance will be required from the TPB to assist tax practitioners in better understanding their obligations. The lack of prior consultation and guidance in the EM accompanying the TLAB1 places the TPB in a difficult position as it lacks a robust framework to assist it in designing meaningful guidance and in administering the breach reporting provisions as intended.

Appointments to the TPB

When appointing an individual to the Board of the TPB, the Minister must be satisfied that the individual is a "community representative".[26] A community representative is defined to mean an individual who is not any of the following:[27]

- a partner in a partnership or an executive officer of a company (director, secretary or senior manager within the meaning of the *Corporations Act 2001* (Cth)) that is a prescribed tax agent;
- a former partner in a partnership that is currently a prescribed tax agent, if the individual is receiving regular and ongoing benefits, or has within the last six months received a material benefit, from the partnership; or
- a former executive officer of a company that is currently a prescribed tax agent if either of the following apply:
  - the individual is receiving regular and ongoing benefits, or has within the last six months received a material benefit, from the company; or
  - the individual holds shares in the company.

A prescribed tax agent in the definition above means a company or partnership that is a registered tax agent and has more than 100 employees. The limit of 100 employees does not appear to be restricted to only those employees who provide tax agent services; it likely also includes administrative and other staff. In effect, this requirement will prevent partners or executives from not only larger firms, but also mid-sized firms, from being appointed to the Board of the TPB.

Representation of a broad cross-section of the industry on the Board of the TPB is important. It is somewhat ironic that the requirement of community representation excludes such a broad sector of the community. The TPB needs a diverse mix of representatives from large, mid-, and small-sized firms that provide tax agent services across a range of markets and issues. Without adequate representation, the Board of the TPB will not have the depth and range of expertise to understand the context of matters before it and make the right decisions, especially since most cases need to be considered on their merits.

Code item 17: Minister to amend the Code

New Code item 17 empowers the Minister to specify additional Code obligations.[28] The additional Code obligations, made in the form of a legislative instrument, may elaborate or supplement any aspect of the Code.[29] Additional Code obligations must not be inconsistent with the Code, or reduce any existing obligations.[30] New Code item 17 is intended to create a proactive, agile regime that allows the Minister the power to respond to developments in a timely manner.[31] Consultation is intended to be undertaken for any proposed changes.[32]

On 10 December 2023, the Assistant Treasurer and Minister for Financial Services, the Hon. Stephen Jones MP, released for consultation the Tax Agent Services (Code of Professional Conduct) Determination 2023 (the draft instrument). The draft instrument supplements a range of existing obligations and introduces a few new ones, including:

- requiring tax practitioners to uphold and promote the ethical standards of the profession;
- adding further Code obligations against making false or misleading statements;
- requiring the maintenance of confidentiality in dealings with the government and government bodies;
- not using information received confidentially from the government or government bodies to make a profit;
- keeping complete and accurate records regarding tax agent services provided to clients;
- ensuring that those providing tax agent services on their behalf maintain the relevant skills and records;
- maintaining adequate control procedures to ensure that the Code is followed; and
- keeping clients informed of all relevant changes.

The leading professional associations, including The Tax Institute, made a joint submission to the Treasury regarding the draft instrument. The joint bodies agreed with the need for a strong and robust Code to ensure that there is public trust and confidence in the operation and administration of the tax and superannuation systems. However, we are of the view that there is scope to refine the proposed drafting to ensure that it is better targeted and does not result in any unintended consequences. We await the registration of the draft instrument and hope that our suggested changes are adopted, better ensuring that the draft instrument is effective at achieving its stated objectives.

Other changes

A range of other minor changes have been made to the TASA and tax practitioners' obligations. Key among these is the change from a three-yearly registration to an annual registration from 1 July 2024.[33] To better accommodate this change, the TPB's maximum time to review an application has been reduced from six months to four months. It remains to be seen whether other commitments connected

to the three-yearly cycle, such as the existing continuing professional education requirements, will also be amended to reflect the new annual registration period.

A special account has been created for the TPB,[34] allowing the TPB to receive funding from the Commonwealth that is separate from the funding received by the ATO. Although seemingly procedural and minor, this is an important change that will better ensure the independence of the TPB from the ATO. This is important for tax practitioners as it should lead to:

- better targeted services to assist tax practitioners to meet their obligations; and
- greater confidence that the TPB is operating independently from the ATO.

Finally, the first tranche of changes also amended the objects clause of the TASA to incorporate the supporting of public trust and confidence in the integrity of the tax profession and tax system.[35] The changes reflect the government's view that the TPB's role has matured to include upholding the integrity of the tax system as an objective. One might question whether the TPB should be tasked with this, or whether the ATO is better suited to ensuring public trust and confidence in the tax system.

What's next?

Although the first tranche contains a significant number of changes to the framework governing tax practitioners, further changes are in the pipeline. A second tranche of proposed amendments, contained in the Treasury Laws Amendment (Tax Accountability and Fairness) Bill 2023 (TAF Bill), has been introduced into the parliament and is currently before the Senate Committee. The TAF Bill proposes to:

- reform the promoter penalty provisions contained in Div 290 of Sch 1 to the *Taxation Administration Act 1953* (Cth) (TAA);
- extend the protections offered by the whistleblower provisions contained in Pt IVD TAA;
- make changes to the operation of the TPB, including by:
  - increasing the maximum timeframe for TPB investigations from six months to 24 months;
  - amending the rules governing the information that can be published on the TPB public register, and the period for which it can be displayed; and
  - amending the TPB's delegation powers; and
- amending the information-sharing provisions to ensure that important information regarding breaches of confidentiality can be shared between government agencies, Minsters and prescribed professional associations.

Separately, the Treasury recently released a consultation paper concerning the TPB's powers to sanction tax practitioners. The consultation paper sought views on the expansion of the TPB's sanction powers to ensure that it has the appropriate range of tools to address tax practitioners who do not comply with the Code. A submission by the joint bodies, including The Tax Institute, in response to the consultation paper can be found on our website.

Final thoughts

Further changes are likely to come, as many of the recommendations from the James review that were accepted by the government are yet to be implemented. The tax practitioners' governance framework appears to be a continually evolving landscape in the short term. As always, the Tax Policy & Advocacy team at The Tax Institute will continue to advocate for a better system; one that strikes the appropriate balance between fairness, simplicity and efficiency.

Despite the plethora of changes, tax practitioners should remember that the vast majority of the profession is committed to doing the right thing and upholding the integrity of both the profession and the tax system. Although the changes will require tax practitioners to adapt their processes and record-keeping, the vast majority of them will not be notably impacted by the changes. Hiccups may arise in the implementation of some of the changes. However, the Tax Policy & Advocacy team will continue to work with the profession, the TPB, and the government to ensure that these issues are promptly addressed and the framework achieves its intended purpose.

Julie Abdalla, FTI
Senior Counsel – Tax & Legal
The Tax Institute

References

1 Terms of reference for the James review. For further information, see https://treasury.gov.au/review/review-tax-practitioners-board-terms-reference.

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3 S 30-10(15) TASA.

4 Para 3.30 of the EM to the TLAA1.

5 Para 3.32 of the EM to the TLAA1.

6 Para 3.31 of the EM to the TLAA1.

7 Table 2 of TPB(I) D51/2023.

8 Para 27 of TPB(I) D51/2023 (reflecting the requirements set out in s 45-5(6) TASA).

9 S 30-10(16) TASA.

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13 S 995-1 of the *Income Tax Assessment Act 1997* (Cth).

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Ten things I hate about your R&D claim

by Llewellyn Wood, Associate Lawyer, Cartland Law

I have written this article based on some of my personal views and observations from reviewing and supporting various R&D claims. I have seen the 10 issues discussed in claims that were unsuccessful and, in my view, many of these issues were avoidable. It is often not the underlying claim or R&D project that causes an unsuccessful claim. The issues discussed below are intertwined, but most relate back to the point of claimants maintaining good records. Poor record-keeping is often the leading cause of disappointment to many claimants. This is not necessarily a piece designed for sophisticated claimants and advisers. It is hoped that it will help those unfamiliar with the R&D tax incentive to understand some of the fundamental requirements in claiming the incentive, and to help them have as smooth a claim as possible.

Introduction

The Australian Government offers a generous incentive to support Australian companies to conduct R&D activities in Australia. The ATO can refund up to 45% of eligible R&D expenditure. Such an attractive proposition leads many to think that they can make unsubstantiated or illegitimate claims for the refund without consequences. Most claimants have bona fide claims, but they may, in their rush to obtain the refund, make errors. If they are asked to verify their claim by the ATO, this can lead to stress and unnecessary costs and delays. What's more, during the current economic difficulties, some claimants are rushing to get their claims in early and this may lead to unnecessary mistakes.

In the late 2010s, there were many illegitimate claims relating to R&D projects focusing on cryptocurrencies. Now AI and ChatGPT related claims are popular for many claimants. No doubt, the ATO will be focusing in on people making claims related to such projects.

Given that a claimant is essentially asking the Australian taxpayer to subsidise their R&D activities, it is right that the claimant show that they are entitled to their refund.

I have written this article in the hope that it will be a starting point for claimants and their advisers in improving their R&D claims.

Based on previous experience (on both sides of the fence), these are the 10 things that I hate about your R&D claim.

I hate your records

I hate your R&D records. Records for R&D need to be more detailed than records for general deductions.

One common reason that an R&D claim may be denied is because the records do not sufficiently support the expenditure or the claim. Your records must show that the expenditure was incurred and that it has a sufficient nexus to your registered R&D activities. Keep this phrase in mind:[1]

> "Incurred on your registered R&D activities."

While you may have the most innovative R&D project in the world, if your records do not demonstrate what you and your team have been doing, any refund claimed may be denied.

For all business operators, there is a general obligation to keep and maintain business records.[2] This also applies to businesses conducting R&D. However, the standard of record-keeping for R&D purposes is set higher than for business-as-usual purposes.

Administrative Appeals Tribunal decisions on this issue highlight that the standard of records and record-keeping is higher for R&D notional deductions than ordinary deductions. On this point, the AAT has stated:[3]

> "135. It is clear that eligible companies intending to claim the R&D tax offset must maintain adequate contemporaneous records which substantiate the carrying on of claimed R&D activities and the incurring of expenditure in relation to those activities. Moreover, as the R&D tax offset claim involves an election or choice, the records must include sufficient particulars which show the basis on which the election or choice has been made. As substantiation of expenditure is involved, the records should show what time has been spent on the R&D activities in respect of which the tax offset is claimed. It follows that the applicant's ordinary business records should be sufficient for a relevant independent third party (such as the Tribunal) to be able to readily verify the amount of the expenditure on R&D activities and the relationship of the expenditure to those activities. The applicant should also maintain records or documentation to support the apportionment of expenditure between R&D activities and other business activities, such as time sheets or time cards, which are capable of reasonably straight-forward analysis."

For example, if you hire a technician, they should keep a timesheet of the hours that they worked on R&D activities and the hours that they worked on non-R&D activities. The timesheet should explain what they were doing during those hours. If the claimant is reviewed, the ATO is likely to ask you to provide up to three months' worth of timesheets.

The Department of Industry, Science and Resources also expects you to maintain contemporaneous records.[4]

When assessing a claim, a person should ask themselves:

- Are the records contemporaneous?
- Is the basis for apportionment easily identified by the records?
- Would an independent third party (not necessarily an expert in the technology) easily understand the records?

The policy rationale is justified. If you are going to ask the Australian taxpayer to incentivise or financially support your R&D, it is fair enough that you have sufficient documentation supporting the claim and expenditure.

I hate that you want the ATO to understand your R&D

I hear complaints all the time along the lines of the ATO not understanding the technology, the activities or the science. The reality is the ATO probably won't understand your project or your technology, and it doesn't have to either.

The R&D tax incentive is a dual-administered regime by two Australian Government departments:

1. AusIndustry, which:
   a. deals with the registration of R&D projects and activities;[5]
   b. has the technical background to understand the R&D; and
   c. makes the determinations about technology and whether the activities meet the definition of R&D; and
2. the ATO, which deals with the refund of the money and makes sure that expenditure is incurred on registered R&D activities.

I really hate it when claimants, their lawyers and their tax agents complain that the ATO officers don't understand the technology or science that forms the basis for the R&D activities and claim. The ATO officers are not required to do so. That is AusIndustry's job, and such complaints are not helpful to the ATO or to a client.[6]

The ATO officers aren't qualified engineers or scientists. If you were an engineer or scientist, I suspect you wouldn't work as a case officer at the ATO.

The ATO officers only need to see that the expenditure you have claimed has been incurred on your registered R&D activities.

Timesheets and records of research or records of experimentation should reflect what the claimant is doing. If this is not easily discernible, the records are probably not good enough.

As stated above, the records should be easily discernible to any independent third party, including an AAT member.[7] Again, AAT members are unlikely to be engineers or scientists. Costs of bringing in expert witnesses at the AAT may also be expensive. The most cost-effective method for a claimant is to ensure that their records are sound in the first place. Therefore, the records need to clearly show how the costs of expenditure were incurred on the R&D activities.

I hate your R&D advisers

First, most R&D advisers are professionals, and I don't actually hate them. However, there is always a minority of advisers that cause headaches (these are the ones I don't like). I hate it when a claimant seeks advice from an inexperienced or unqualified R&D adviser. Even worse, I hate it when clients seek advice from R&D promoters. I also hate it when clients attempt to navigate this themselves. A claimant should always use the services of a qualified or registered R&D adviser.

You should ask questions about your R&D adviser's experience and capabilities.

All advisers should be qualified and registered with a regulatory body.[8]

If you rely on a tax agent, that tax agent must be registered with the Tax Practitioners Board (TPB). The TPB also offers registration for agents to work exclusively as R&D advisers.[9]

You can also seek advice from a lawyer who is experienced in giving R&D advice, provided the lawyer is registered to practice, and you should make sure that your lawyer understands the R&D tax incentive.

AusIndustry will also ask whether you have sought the services of a professional R&D adviser independent of your ordinary tax agent.[10] You should be truthful when completing this part of your application.[11]

There are a lot of unregistered R&D advisers out there. There are also some unscrupulous registered R&D advisers. Both promise high refunds or "cashbacks" or use a similar phrase. Often, they will charge their fee as a percentage of the refund that you receive. In such cases, it is in their interest to inflate the claim, albeit illegitimately. A few of them operate in Australia and some operate overseas, and claimants sometimes never meet their R&D adviser, even via video call.

Illegitimate advisers:

- tend to use template-supporting documents, leading to many registration documents and claims looking very similar (despite the claimants not knowing each other);
- leave their details (author of a document) embedded in the properties of electronic documents; and
- often disappear at the first sign of trouble and will never help you if you are reviewed. This will leave you on your own dealing with the ATO and, if the claim is false, leave you bearing the costs of any penalties imposed and no refund.

A legitimate R&D adviser, tax agent or lawyer will:

- be qualified and have professional registrations and professional indemnity insurance;
- provide you with a costs agreement or terms of engagement and an invoice based on their work performed (such as providing advice or preparing documents) or a fixed fee rather than based on a percentage of the refund you receive;

- be able to provide you with assistance if you are reviewed; and
- tell it to you straight if you try to make an incorrect claim or are about to make a mistake.

If you are a tax agent and your client has instructed you to lodge an R&D claim with their tax return, you should always ask for the AusIndustry application and examine the document. If you have any queries that can't be answered by your client, you should seek independent advice.

If you are examined by the ATO, the ATO will ask why you chose your R&D adviser, including what qualifications and experience they may have. They may also ask this about your tax agent. This goes to your behaviour if errors are identified in your claim. If you are seen as choosing an unqualified adviser, or not making reasonable enquiries about that adviser, the ATO may conclude that you were reckless[12] in your actions and reckless in your claim. The ATO may also consider that you do not have a reasonably arguable position.

Always seek the advice of a qualified, experienced and registered adviser.

I hate your period of review

The *Income Tax Assessment (1936 Act) Regulations 2015* (Cth) state that the limited amendment period or period of review for an R&D claim is four years, regardless of the size or turnover of the entity making the claim (many don't know this and assume that the period of review is two years). Your records must be kept for a minimum of four years.[13]

The ATO may make an amendment to your tax return up to four years after you have lodged it; this is not restricted to the R&D component and includes your entire tax return.

The period of review starts on the later of:

- the day you lodge your tax return; or
- the day after the ATO issues you with a notice of assessment.

If the ATO suspects fraud, there is an unlimited period of review (although this is unlikely).[14]

AusIndustry has the power to examine R&D applications and registrations:

- if AusIndustry cancels a registration or issues you with an adverse finding, you have the right to have this decision reviewed:[15]
  - first, internally by AusIndustry;
  - second, by the AAT; and
  - third, by the courts;
- if ultimately the finding is not in your favour (and your R&D registration is cancelled), AusIndustry will inform the ATO of this outcome;
- this might be well outside the four-year limited amendment period;
- in this case, the four-year limited amendment period will not apply and the ATO may amend your tax return and deny your claim for the R&D tax offset;[16] and
- the ATO has two years after it has received notice from AusIndustry to amend your tax return and deny your claim.[17]

There is nothing you can do other than retaining your records for at least four years (longer if your R&D registration is being reviewed).

I hate your overseas activities

I hate that you try to claim expenditure incurred on overseas activities. Unless you have an advanced overseas finding, your R&D must be conducted in Australia (if you want to claim).

In most cases, to claim the expenditure, the R&D activities need to have taken place solely in Australia.[18]

There are some exemptions that allow the R&D activities to be undertaken overseas and still qualify as eligible expenditure, including:

- where, solely or partially, the R&D activities are conducted overseas, with a positive advanced overseas finding issued by AusIndustry;[19]
- if the R&D is conducted for a foreign entity and the conditions are met;[20] and
- if the R&D is conducted *via* a permanent establishment but not *for* a permanent establishment.[21]

Advanced overseas findings

An R&D entity will need to apply to AusIndustry for a finding about an activity being conducted, or proposed to be conducted, outside of Australia if it wants to claim the expenditure as a notional deduction.

An overseas finding has a number of requirements, including the requirement that the activities are covered by an advanced finding, that is, a finding before the activities are undertaken.[22]

Section 28C states:[23]

> "(1) The Board[24] must, on application by an R&D entity for a finding under this subsection about an activity, do one or more of the following:
>
> (a) find that all or part of the activity is an activity (the ***overseas activity***) that meets the conditions in section 28D;"

Section 28D states:[25]

> "(1) The first condition is that the overseas activity is covered by a finding under paragraph 28A(1)(a) or (b) (findings that activities are R&D activities)."

Section 28A relates to advanced findings about the nature of activities and states:[26]

> "(1) The Board must, on application by an R&D entity for a finding under this subsection about an activity, do one or more of the following:
>
> (a) find that all or part of the activity is a core R&D activity;

(b) find that all or part of the activity is a supporting R&D activity in relation to one or more specified core R&D activities for which the entity has been or could be registered under section 27A[27] for an income year;"

The legislation leads us on a bit of a path for this, but essentially it states that, if you wish to claim R&D expenditure on R&D activities, it is necessary that you have in place an advanced overseas finding.

AusIndustry also adopts the view that an overseas finding is an advanced finding because the activity must be a core or supporting activity.[28]

There are additional criteria for the granting of advanced overseas findings.[29]

This goes back to the point that, if you want Australian taxpayers to fund your R&D, the money should be spent in Australia.

There is an interesting possible loophole in that the legislation states that:[30]

> "… a finding under subsection (1) comes into force at the start of the income year in which the application for the finding is made;"

This suggests that it might be possible to commence the overseas activities before the finding is issued and still have the activities covered. For example, overseas activities may take place in July, and a positive finding is granted later in January, indicating that the July activities will be covered by the finding and hence claimable.

Anecdotally, it has been suggested that it is possible for a claimant to lodge a claim for their R&D expenditure without their overseas expenditure included in the claim, and then once they have obtained an advanced overseas finding, amend the tax return to include the overseas expenditure.

I am not a huge fan of amending claims. I have seen refunds paid out, then subsequent amendments made to the claim which triggered an ATO examination.

Income tax perspective

From an ITAA97 perspective, the legislation is very clear and unambiguous, and it is not possible to read an alternative interpretation into the legislation. If the R&D has not been conducted in Australia, and you do not have a positive advanced overseas finding from AusIndustry, you cannot claim the expenditure for R&D.

Even if you meet the criteria for an advanced overseas finding, but don't have the finding itself, you cannot claim expenditure incurred on overseas activities; anyone who says different is wrong.

In the past, the ATO has allowed administrative concessions to permit claims for minor incidental overseas expenditure (such as attending some conferences or ordering a small part from overseas), but it has not allowed this for some time. It was always at the sole discretion of the ATO and has no basis in any law. The ATO would only allow this if the rest of your claim had met all of the other required conditions.

In *TDS Biz Pty Ltd v FCT*,[31] the claimant argued that an advanced overseas finding was not necessary to order parts from overseas, stating that:

> "22. … it did not require a finding under s 28C of the IRD Act because it did not undertake any R&D activities outside Australia, pointing to the distinction between the core R&D activities carried out in Australia, and the purchase of parts and components outside of Australia that were required for the dominant purpose of the Australian activities, which it describes as not being R&D activities at all."

The claimant had also relied on secondary interpretations of the legislation. However, the court found that the claimant had misunderstood those interpretations and that any secondary interpretation was not a substitute for what is clear legislation.

The court also found:

> "24. Additionally, supporting R&D activities do not necessarily have to involve any actual research and development if other criteria are met as set out in s 355-30(2), reproduced above. So long as supporting R&D activities are directly related to core R&D activities, they may extend to activities that are not themselves core R&D activities as listed in s 355-25(2) or to activities that produce goods or services, or to activities directly related to producing goods or services, provided they are undertaken for the dominant purpose of supporting core R&D activities.
>
> 25. To the extent that expenditure takes place on any overseas activities capable of falling within one of the two categories of R&D activities – core R&D activities or supporting R&D activities – that will only be able to be the subject of a claim for a tax offset if those overseas activities are also covered by a finding in force under s 28C(1)(a) of the IRD Act that those activities cannot be conducted in Australia, meeting all four conditions in s 28D for such a finding … At all times, the issue was eligibility to claim a tax offset for the overseas component of the expenditure, for which a s 28C(1)(a) finding was required."

The issue in *TDS Biz* wasn't whether it should be granted an overseas finding but whether it was required to obtain one in the first place.

The case also supports the view that the purchasing of parts constitutes a supporting activity.

Advanced overseas findings are only available from AusIndustry and you should obtain this finding before you incur the expenditure. If you spend the money first and then ask for a finding, AusIndustry may not give you a back-dated finding.

AusIndustry overseas findings can be intense and they involve a full examination of your proposed overseas activities. You will need to show that it is not possible for your R&D activities to take place in Australia. Cost factor alone is not sufficient grounds to obtain a positive overseas finding from AusIndustry.

I hate your R&D application

I hate that you have a poorly written R&D application. One of the biggest red flags for the ATO is a poorly written AusIndustry application.

Your R&D registration is the second document that the ATO will examine (after your tax return).

While you are limited in what you can register as your core activities,[32] you should explain your hypothesis or what you intend to research, or have researched or developed, and broadly speaking the nature of the activities that you will be undertaking.

You should then register your supporting activities. There are fewer restrictions with these but you need to explain how those activities support your core activities; this is where you can be more specific and detail what your experimentations will be. You can also use this as an opportunity to include additional expenses.

If you fail to properly register your supporting activities, the ATO may not be convinced that that the activities you undertake are genuinely in support of your core activities. It may then decide to deny any claim for those activities.

The application is critical and you should take your time to get this right.

If you make a mistake, always seek advice and lodge an amendment to your R&D registration before you lodge your R&D claim.

I hate that you think you can claim everything

I hate that you have registered an activity with AusIndustry and assume that everything registered is R&D. I hate that you think you can claim all expenditure.

Many claimants obtain their registration from AusIndustry and assume that everything they spend is claimable. This is not always true.

Some claimants also make the assumption that the registration of their R&D activity means that their R&D activities satisfy the criteria under the legislation.

AusIndustry has limited staff and budget when compared to the ATO. Sometimes, all that AusIndustry will be able to verify is that the claimant details on the application form are correct.[33]

With around 13,500 applications each year, AusIndustry does not have the capacity to examine every single registration in such detail and make a finding that the activities are R&D activities. This leads to most applications being registered.

When an application or registration is selected for further examination by AusIndustry, a complete review of the R&D activities will take place.

The issue of whether an item of expenditure is claimable is left to the ATO to examine.

The ATO is reluctant to make determinations of whether something is R&D, but will make a decision as to whether you have spent the money on the R&D activities. Therefore, you need to show that your expenditure has a sufficient nexus to your registered R&D activities.

You also need to show that the expenditure was "at risk". This means that the expense has been incurred without you knowing whether the expenditure would make a return.

If you are to receive some form of consideration, regardless of the results for the R&D expenditure, the expenditure is not claimable.[34]

Many claimants ran into trouble when they claimed their employees' salaries as R&D and received JobKeeper for those salaries at the same time. The ATO disallowed expenditure on salaries to the extent that they were supported by JobKeeper payments.[35]

Also, if your activities look like business-as-usual activities, you may find the ATO referring the registration back to AusIndustry for review. If something isn't R&D, you shouldn't register the activity.[36]

AusIndustry may investigate after registration has been issued, although it won't usually do this unless it has a tip-off (often from the ATO).

If AusIndustry cancels your registration, the ATO has an unlimited period of amendment to give effect to that decision.

I hate your lack of payments to associates

I hate that you haven't paid your associates.

At the end of 2023, the ATO released TA2023/4 regarding activities undertaken by associates – this has always been problematic in the R&D program.[37]

For most expenses, you don't actually have to pay the expense immediately in order to claim the expense. For example, if you hire an independent contractor to do some R&D work for you, and they invoice you on 20 June but you don't actually pay them until 2 July, you can claim that expense in either financial year (but not both years) for R&D purposes.[38] This acts on the condition that you actually intend to pay them. This should be reflected in the end of year financial statements, eg in the creditors account. The ATO may ask you to verify that you have paid this amount.

Payment for R&D has its general legal meaning in income tax law, which includes constructive payment. This means that payment is satisfied when the R&D entity applies or deals with the amount in any way on the other's behalf, or as the other directs.[39]

It is common for claimants to hire or contract some of the R&D work to their director, shareholder or other associate. There is nothing wrong with this. However, in order to claim your associate's salary, wages or fees as a notional deduction, you must actually pay them the market value for their services.

You must also report superannuation payments and PAYG (where necessary). During a review or audit, the ATO will analyse your BAS and compare it to your other lodgments.

The payments to associates rule for R&D is clear. Do not use a clever way of paying your associate (if you are inexperienced), and do not use journal entries or loan accounts (if this is done incorrectly, you can be denied that expense). This has been tried and was unsuccessful in the following cases:

- in *FCT v Desalination Technology Pty Ltd* ,[40] two related entities (IDTG and DST):[41]
  - entered into a verbal agreement whereby:
    - IDTG would conduct R&D activities for DST(the taxpayer);
    - IDGT would invoice monthly for the R&D activities that it conducted;
    - DST was cashflow poor so most of the invoices were debited to an inter-company loan account (the "come and go" loan account);
    - the invoices would not be treated as trade creditor invoices, but treated as *fully paid when rendered* and the value of the invoices would be debited to the come and go loan account (so the company could avoid trading insolvent); and
    - once DST was in a position to pay, it would make payment;
  - once under review, the parties signed a written agreement and forwarded it to the ATO;
  - on appeal to the Full Court of the Federal Court, the court found:
    - there were contingencies attached to the come and go loan account;
    - despite appearing to be a timing of obligations, there was no obligation at all for DST to pay the invoices; and
    - on that basis, DST had not incurred the expenditure and was not eligible to claim the expenditure; and
- in *Sunlite Australia Pty Ltd v FCT*:[42]
  - Sunlite Australia Pty Ltd (Sunlite) was a corporate trustee of a trading trust;
  - the AAT found that Sunlite incurred R&D expenditure as trustee for the trust, and not in its own capacity. It was the trust, which the business owned and operated, which undertook the R&D work;[43]
  - Sunlite argued that incurring the expenditure by an entry in a loan account between the applicant in its own right and the applicant as trustee of the trust was no different to the applicant borrowing the money from a bank to pay for the R&D;[44]
  - the AAT did not agree with that, and distinguished factual scenarios between borrowing from a related entity and borrowing from a third-party bank;[45]
  - Sunlite did not appeal this finding in the Full Court of the Federal Court, but based its appeal on an interpretation of the law and not on findings of fact;
  - in the appeal to the Full Court, Sunlite sought to make the argument that the trustee and the trust should be considered as one entity;[46] and
  - the court ultimately did not agree with Sunlite's arguments and stated:[47]

  "47. All of which is to further expose the fundamental flaw of Sunlite's submission which ignores the terms of the legislation that require references to an entity that is a body corporate to be read as applying singularly to the body corporate acting in its own right and not to another entity (relevantly, the body corporate acting as trustee)."

While the present article is not intended to be a full analysis of *FCT v Desalination Technology Pty Ltd* or *Sunlite Australia Pty Ltd v FCT*, referring to these cases illustrates that payments between related parties (for R&D) are not satisfied by way of journal entry or inter-entity loans. If the ATO, AAT or the courts suspect that you are not definitively committed or obligated to paying those amounts, for example, by way of cash, it is likely that the claim for the R&D expenditure will be denied.

Do not issue nil-value or low-value shares in the company to your associates in consideration of payment. That won't work either.

Any payment must be an actual form of payment, that is, cash, bank transfers, cheques, promissory notes or other bills of exchange.

In addition, if you are not careful, you may end up having Div 7A, s 100A, GST or SGC issues.

Always seek advice on this before making any claim.

I hate that your refund was retained for too long

I point this one out as many claimants rely on their refund to fund the next stage of their R&D activities. It is therefore important to the claimant that the refund is paid to them in a timely manner.

The ATO has the right to examine a person's tax return, whether that is by review or audit. As you are claiming a refundable amount, the ATO may decide to conduct the examination before or after the refund is issued to you. In most cases, where the ATO has selected an R&D claim for review, any refund will be retained pending the outcome of the review. If you are able to support your claim, or most of your claim, early, most or all of your refund will be paid to you. If you cannot do this, your refund will be retained for a longer period of time.

Legislation authorises the ATO to retain all or a portion of your refund. This goes for R&D refunds, GST refunds and personal income tax return refunds.

When the ATO makes a decision to retain a refund, it must consider the following 10 factors:[48]

1. the likely accuracy of the notified information;
2. the likelihood that the notified information was affected by:
   a. fraud or evasion;
   b. the intentional disregard of a taxation law; or
   c. recklessness as to the operation of a taxation law;
3. the impact of retaining the amount on the entity's financial position;
4. whether retaining the amount is necessary for the protection of the revenue, including the likelihood that the Commissioner could recover any of the amount if the notified information were found to be incorrect after the amount had been refunded;
5. any complexity that would be involved in verifying the notified information;
6. the time for which the Commissioner has already retained the amount;
7. what the Commissioner has already done to verify the notified information;
8. whether the Commissioner has enough information to make an assessment relating to the amount;
9. the extent to which the notified information is consistent with information that the entity previously provided; and
10. any other relevant matter.

If the ATO finds that your claim is acceptable, it will release the refund to you.

If the ATO does not find that your claim, or a portion of your claim, is acceptable, it will not release that part of the refund to you. However, if any part of the claim is not found to be acceptable, the ATO may consider that you have made a false or misleading statement and that there is still as shortfall amount. This may lead to the ATO imposing penalties on you.

The ATO may also decide to make a partial release of your refund if it is satisfied that a portion of your claim is correct, and continue examining the remainder of your claim.

The decision to retain your refund is a separate decision to that of your eligibility to claim R&D. The decision to retain the refund is appealable to the AAT, but you will need to determine what factors the ATO has considered and whether it has given them full consideration.

You are allowed to make a freedom of information request regarding the decision, including any working papers that the ATO has relied on to retain your refund. If the ATO's papers are poorly drafted, an argument may be made that there has been insufficient consideration of the 10 factors above.

I hate the size of your claim

I hate that you try to make your claim small, so that the ATO will not review your claim.

The ATO reviews claims great and small, and a small claim can attract suspicion, especially if you are a new claimant.

The ATO will review a claim for $20,000 of refund.

The ATO will review a claim for $1m of refund.

Just because you are big or small, doesn't make you invisible. Make sure any claim is squeaky clean.

Conclusion

There are some bad R&D claims. However, there are a whole lot more claims that work extremely well. The difference between the two is that the latter get the basics right. Even in the more complex cases, it can be easy to overlook the basics. One of the basics is keeping and maintaining contemporaneous records of the R&D and how the expenses were incurred.

Getting the basics right can give you a lot of grace with the ATO if the claim has some complexity to it. While it might be easy to put the onus on the ATO for not understanding the claim, if the basis of the claim cannot be shown, there might be something wrong with the claim or the records.

Another basic to get right is making sure you receive advice from qualified advisers. There are a small number of unqualified promoters out there pushing R&D cashback scams. They take much of the glory but none of the risk. The old cliché, " if it looks too good to be true then it probably is", rings true in these cases.

As a last point, there are some things to dislike in R&D but there is a whole lot more to like. While it can seem complex and time-consuming at first view, understanding the benefits of getting it right can be rewarding.

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References

1 This isn't necessarily a legally supported quotation but I find it useful in practice.

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3 *Ozone Manufacturing Pty Ltd and FCT* [2013] AATA 420. This case considers the previous R&D legislative regime, but it is still relevant under the current legislation.

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6 In my opinion, it isn't a strong argument to state that the ATO does not understand the technology. When this argument is made, it can be a sign that professional advisers are not appropriately assisting their clients to ensure that the claim is supported as best as it can.

7 *Active Sports Management Pty Ltd and Industry Innovation and Science Australia* [2023] AATA 4078.

8 Ideally with the Tax Practitioners Board or as a legal practitioner.

9 *FCT v Perez* [2023] FCA 1221.

10 On the application form to register your R&D activities.

11 Often promoters will use templates or precedents when lodging R&D registration applications, leading to large volumes of applications looking

exactly the same. Both the ATO and AusIndustry have programs in place to determine when this happens and will likely know when a promoter has completed the application.

12 See, for example, s 284-90 of Sch 1 to the *Taxation Administration Act 1953* (Cth) (TAA53). "Reckless" is a word used in the legislation, and when examining a false or misleading statement, the ATO and the courts will refer to it. This also attracts a penalty of up to 50% of the shortfall amount.

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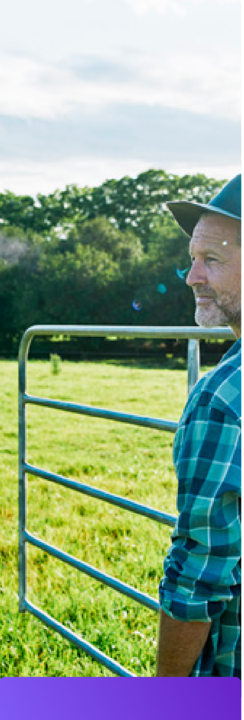

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Redefining the taxation of gifts

by Yicheng Ru, JD Candidate, University of Melbourne

This article examines the classification of gifts within the "assessable income" definition under s 6-5 of the *Income Tax Assessment Act 1997* (Cth), highlighting the challenges in aligning gift taxation with ordinary income due to the inherent diversity of gifts and the contexts of their receipt. The article scrutinises the enduring conundrum that gifts pose in tax law, given their divergence from typical income streams such as wages, bonuses and tips. The analysis extends to critique the current gift taxation rules measuring it against Hill J's embodiment of Adam Smith's taxation virtues of fairness, simplicity and efficiency. Conclusively, the article proposes a reformed approach to reconcile the taxation of gifts with the ideals of equity, simplicity and efficiency in the tax system, thereby contributing to the broader conversation on refining Australia's income tax structure.

Introduction

Section 6-5 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) plays a pivotal role in defining "assessable income" in Australia, stating that it includes "ordinary income". Typically, this encompasses familiar forms of income such as remuneration,[1] bonuses[2] and tips.[3] However, the classification of gifts within this framework has historically presented a unique challenge, prompting extensive legal debate and judicial interpretation. Unlike standard forms of income, gifts do not fit neatly into traditional categories, leading to complexities in their taxation.[4]

The difficulty in creating a universal formula for the taxation of gifts arises from their diverse nature and the varied contexts in which they are given. Windeyer J's observation that this issue represents a mixed question of fact and law underscores the complexity of integrating gifts into the paradigm of ordinary income.[5]

This article starts with an overview of the circumstances in which gifts can be treated as ordinary income. The analysis then concentrates on the fact that the existing approach of gift taxation may not satisfy the principles of fairness, simplicity and efficiency, as articulated by Justice Graham Hill[6] from Adam Smith's concept of a good tax system.[7] Lastly, this article proposes how to promote equity, simplicity and efficiency in gift taxation by following the principles of a good tax system. Through this proposed approach, the article contributes to the ongoing discourse on how best to integrate the taxation of gifts into Australia's broader income tax framework.

Gift scenario analysis

"Mere gifts" scenario

Kitto J distinguished between gifts and "mere gifts", describing the latter as unrelated to employment or occupation and without significance other than to benefit the donee.[8] "Mere gifts" are not "ordinary income" in its broader definition, which includes the notion that income "flows" from a source, such as capital.[9]

Gifts provided for personal attributes are not ordinary income.[10] A client who gave his accountant shares in his company was not ordinary income since the gift was not related to any earning activity of the taxpayer and was offered due to the close personal relationship between the two parties.[11] A similar decision was reached in *Scott v FCT*.[12] When a solicitor is fully remunerated for his services, the additional payment is a product of gratitude, indicating a personal gift.[13] Therefore, "mere gifts" fall outside the notion of ordinary income because they arise from personal qualities.[14]

Gift from service constitutes ordinary income

Nexus test

A "gift" earned directly or indirectly in the nature of a taxpayer's services is ordinary income.[15] A sufficient nexus must be established between the receipt and the services provided by the taxpayer to determine that the receipt is linked with personal services.[16] For the purposes of s 6-5 ITAA97, a nexus or connection between the gift received and the work performed is crucial for determining whether the gift is ordinary income.[17]

In *Brown v FCT*, a gratitude payment for introducing a potential client to the property developer was not a "mere gift".[18] It was found that a nexus was created since the taxpayer would only get the incentive if the purchase went through.[19] When it is evident that a nexus exists between the gift and the activity performed, it makes no difference whether a gift is given before, in the middle of, or after the performance.[20] In addition, it is also irrelevant whether the voluntary payment is in the course of current employment or past employment.[21]

When an employee receives additional money from a current employer's study scheme, the allowance is assessable as income since it is exclusively for the employee, with sufficient connection to the current service.[22] In *FCT v Dixon*, although the taxpayer had enlisted in the army, he was still connected with the firm and was able to receive the supplementary taxable "gift" as income for the daily expense.[23] However, if additional

retirement payments are to reduce pension inflation from a past employer, there is no substantial nexus because the payment is not a product of service but only linked to pension.[24]

Additionally, when third-party voluntary payments are incidental to a taxpayer's profession, they are considered assessable income, constituting ordinary income.[25] An award for "best and fairest" player is not a "mere gift" because it is connected with the taxpayer's occupation.[26] There are a number of other elements that assist in evaluating whether the nexus is substantial enough to characterise the "gift" as ordinary income, such as the donor's motive, recurrence and periodicity of payment, and the taxpayer's reasonable expectation of a gift.[27] Nevertheless, they are not determinative.[28]

Uncertainties

The sufficient nexus test must be "reformulated" case by case.[29] There are more complicated occasions for the court to decide how remote or proximate the nexus relates to services,[30] as shown in Diagram 1.[31] When the nexus is uncertain, the court needs to evaluate several determinative factors in each case to decide whether a gift is ordinary income.[32]

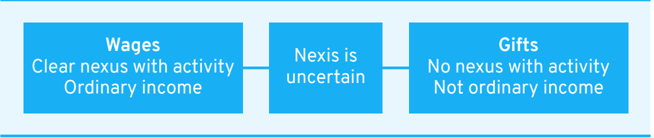
Inherent issues

The fundamentals of a reasonable tax system have not altered since Adam Smith wrote about his "four canons of taxation" in 1776.[33] Hill J articulated Adam Smith's "four maxims" into three core principles: equity, simplicity and efficiency.[34] These principles serve as crucial benchmarks for evaluating the effectiveness and fairness of any tax regime. However, when it comes to the existing system of taxing gifts under Australian tax law, there are significant challenges in aligning with these principles.

Equity

In 2019–20, income taxes contributed approximately 60% of overall government revenue, with 42% paid by individual taxpayers.[35] That is why several scholars followed Adam Smith to address the importance of fairness in the taxation system.[36] Currently, no theoretical consensus exists on what constitutes "income".[37] The requirement of a sufficient nexus, which determines if a receipt is derived from a service, can be demonstrated through specific instances but lacks a precise definition.[38] As Professor Parsons said, income tax without a single underlying principle "earns no respect".[39] Gift cases hinge on facts and degrees; therefore, they are never readily resolved.[40] People may find it challenging to willingly comply with tax rules that seem unclear or inconsistent. The lack of clear guidelines on the taxation of gifts may be perceived as inequitable.

Diagram 1. Income characterisation: service nexus analysis[41]



Simplicity

Understandably, the Australian tax system is designed to be complex in order to cope with the litigious few rather than compliant taxpayers, preventing abuse of legal loopholes.[42] However, focusing on legal correctness has led to complexity and unsatisfactory user experience.[43] The complexity of the tax law possibly encourages non-compliance because few individuals have the knowledge, resources and expertise to apply the law to their circumstances.[44] Specifically, gifts reveal a conspicuous deficiency: taxpayers concede benefit but argue no assessable income.[45]

People have trouble identifying whether a gift is ordinary income or not without clear guidance. The complexity of tax concepts can sometimes inadvertently lead even conscientious taxpayers to make mistakes, and the consequences of non-compliance can be a costly endeavour.[46] Therefore, the overly sophisticated gift concept and test discourage willing tax participation, undermining government revenue collection.

Efficiency

An efficient tax system raises and redistributes revenue with the least economic and administrative costs.[47] Income tax sometimes "has an excess marginal burden or the value destroyed for the dollar of revenue raised".[48] In the Henry review 2009, it is clearly explained that some taxes may cause some loss of economic efficiency.[49]

Although "mere gifts" are not ordinary income indisputably, it is not straightforward to distinguish how the nexus is adequate.[50] The undefined gift taxation rules may induce people to report the assessable income as non-assessable. While the ATO successfully collects most of the expected tax revenue through voluntary compliance,[51] there is concern that the progressive tax system may diminish the incentive for compliant taxpayers to strive for higher earnings. This ends in economic and social welfare losses, impairing the revenue raised.[52]

Furthermore, the ATO paid $102.0b in administrative costs in 2020–21,[53] with labour expenses amounting to 50.8%.[54] Every obscure component might escalate increasingly substantial operational costs, especially when numerous borderline cases hinge on gift taxation. Thus, the current gift taxation exacerbates economic efficiency and administrative costs.

Forward-looking: reform proposal

No tax system can be universally perfect or "one-size-fits-all", and this is particularly evident in the realm of gift taxation under ordinary income.[55] The concept of a "simple ratio decidendi" – a single, clear legal principle to be derived from a decision – is challenging to apply in tax law, especially when dealing with the diverse and nuanced nature of gifts.[56] Each gift, by its very nature, is unique and carries its own set of circumstances, making the application of a uniform tax rule problematic. Despite these complexities, there remains a compelling argument for reforming the taxation of gifts under the umbrella of

ordinary income.[57] By adhering to the principles of equity, simplicity and efficiency, a more balanced and fair approach can be developed.

Promoting equity

The *Re:think* white paper agreed that a fair tax system should give certainty.[58] Legislation could offer clear and robust criteria to determine which gifts qualify as assessable income for tax purposes. Moreover, the Australian tax system should treat individuals with similar economic capacities equally, considering the complexity and compliance costs.[59]

> "The three principles of a good tax system — fairness, simplicity and efficiency — can serve as guiding posts for reforming gift taxation."

In 2020–21, the ATO issued 1,045 social media posts and 4,021 rulings to help taxpayers understand how to treat new taxes introduced during the COVID-19 pandemic.[60] In the author's view, the ATO should provide as much guidance for gift taxation as it did during the pandemic. This would simultaneously protect individuals from unfairness. The current ambiguity surrounding the rules for taxing gifts – an issue referred to as the uncertain nexus test with service – may give those with more resources and influence disproportionate tax planning advantages. Also, when interacting with taxpayers on taxable or non-taxable gifts, the ATO should minimise tax jargon, which often needs relevant expertise to interpret the law.[61] Transparency and official guidelines enhance fairness.[62]

Improving simplicity

Australia maintains positive societal norms and expectations, as seen by its high-quality tax self-reporting.[63] On-time tax reporting finished the 2019–20 year at 83.3%.[64] Such a high rate is not grounded on intimidation but on taxpayers' trust.[65] Therefore, the Bill drafter should not presuppose that most taxpayers are unwilling to obey tax laws.

Gift reporting should be more accessible for people so that they understand their obligations and entitlements. When some "gifts" blend gratitude and service appreciation, the gap between assessable and non-assessable gifts should be narrowed to avoid loopholes. Specifically, the government can leverage technology to simplify the reporting process and lower compliance costs[66] because over two million individuals joined MyGov between 2020 and 2021.[67] It is suggested that the online filing tool could include "yes or no" questionaries to categorise the gift type. When there is a mismatched circumstance, the ATO may further clarify online.

Enhancing efficiency

When reforming or modifying a tax, we should focus on reviewing the entire system.[68] Two steps may minimise economic and administrative costs. First, the tax system's complexity is why Australians rely on tax agents or professionals to file taxes more than other OECD countries,[69] so more specific legislation is the easiest way.[70] Second, correct reporting should be promoted. Correct reporting is one of the ATO's indicators for compliance, according to the OECD.[71] As 97% of total net tax collections arose through voluntary compliance,[72] correct reporting is essential to raise revenue and reduce tax auditing costs for the government.

Conclusion

The courts have made concerted efforts to elucidate an approach for addressing the complexities inherent in gift taxation cases. A notable example is Deane J's judgment in *FCT v Dixon* as it provides valuable insights into the judicial handling of such matters.[73] In instances involving gifts, the courts have emphasised the need for meticulous examination to ascertain whether there is a substantial connection linking the gift to the concept of income as a reward for services.[74] This determination is crucial because it is the nature of this link that bestows an income characteristic on a payment, categorising it as assessable under ordinary income tax provisions.[75] However, these issues remain contentious and are far from being conclusively resolved.

The inherent challenge lies in the fact that gift taxation cases are highly dependent on their specific facts and circumstances.[76] In this dynamic landscape, the three principles of a good tax system – fairness, simplicity and efficiency – can serve as guiding posts for reforming gift taxation.

The ATO has set objectives for 2024 that align with these principles, aiming to create a more streamlined, equitable and effective tax system.[77] In light of this, applying these principles to the taxation of gifts can contribute significantly to achieving a more balanced and fair tax regime.

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A Matter of Trusts

by James Gao, Sladen Legal

Distribution resolutions and trust income

Validly executed distribution resolutions or minutes are critical to ensuring that the correct beneficiaries are entitled to trust distributions.

Introduction

Every year, typically before 30 June, trustees execute distribution resolutions or prepare meeting minutes to ensure that the correct beneficiaries are presently entitled to the trust's income and/or capital. A distribution resolution or meeting minute (hereinafter referred to as "distribution resolution") serves as evidence that the trustee has paid, applied or set aside income and/or capital to one or more beneficiaries.

Distribution resolutions must comply with the terms of the trust deed, the general law of trusts, and legislation.

Taxation of trust income regime

Division 6 of Pt III of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) sets out the primary rules for taxing trust income. In most cases, the main operative provision is s 97.

Section 97(1)(a) states:

> "(1) Subject to Division 6D, where 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*:
>
> (a) the assessable income of the beneficiary shall include:
>
> (i) so much of that *share of the net income of the trust estate* as is attributable to a period when the beneficiary was a resident; and
>
> (ii) so much of that share of the net income of the trust estate as is attributable to a period when the beneficiary was not a resident and is also attributable to sources in Australia; and" (emphasis added)

This article will focus on s 97(1)(a). It should be noted that paras (b) and (c) of s 97(1) deal with exempt income and non-assessable non-exempt income of beneficiaries who are not under any legal disability. There are also separate rules for resident natural persons who are deemed under s 95A(2) ITAA36 to have a present entitlement, non-resident beneficiaries, children under 18 years old, and beneficiaries under a legal disability who have income from other sources, among others.[1]

Importantly, the hypothesis to trigger s 97(1) uses "share of the income of the trust estate", while the conclusion uses "share of the net income of the trust estate". In other words, if a beneficiary is presently entitled to receive a share of the "income of the trust estate", then the beneficiary's assessable income will include the same share of the "net income of the trust estate".

"Income of the trust estate" is commonly referred to as "trust income", "distributable income" or "accounting income", while "net income of the trust estate" is commonly referred to as "tax income" (see below).

Section 97 was enacted at the same time as the rest of the ITAA36. The explanatory memorandum accompanying the ITAA36 does not discuss the difference between "income of the trust estate" and "net income of the trust estate". This suggests that the drafters did not anticipate significant differences between the two. One explanation could be that the two main sources of discrepancies between the two definitions (capital gains and franking credits) were both introduced after the enactment of s 97.

To understand s 97(1), it is helpful to discuss each of its key terms.

Trust estate

According to TR 2012/D1, "income" and "trust estate" are distinct concepts. Income is a product of the trust estate.[2]

The term "trust estate" appears throughout Div 6 and is attached to the term "trustee", but is not defined for the purposes of Div 6. The High Court in *FCT v Everett*[3] said that the trust estate means the same as trust property.

Income of the trust estate

The High Court in *FCT v Bamford*[4] affirmed the following principle (stated by Sundberg J in *Zeta Force Pty Ltd v FCT*[5]):

> "45. ... 'income of the trust estate' in the opening part of s 97(1) refer to distributable income, that is to say income ascertained by the trustee according to appropriate accounting principles and the trust instrument."

In doing so, the High Court rejected the ATO's submission that "income of the trust estate" means income according to ordinary concepts.

The key takeaway is that the "income of the trust estate" will depend on the provisions in the trust deed.

Share

The High Court in *FCT v Bamford* also confirmed that "share" for the purposes of "share of the income of the trust estate" means the beneficiary's share of the distributable income. The words "that share" for the purposes of "share of the net income of the trust estate" mean the same proportion or percentage share applied against the trust's net income. "Share" does not mean a quantum or fixed amount.[6]

Net income

Section 95 ITAA36 is the interpretation provision for Div 6 and defines "net income" as follows:

> "'**net income**', in relation to a trust estate, *means the total assessable income of the trust estate calculated under this Act as if the trustee were a taxpayer in respect of that income and were a resident, less all allowable deductions*, except deductions under Division 393 of the *Income Tax Assessment Act 1997* (Farm management deposits) and except also, in respect of any beneficiary who has no beneficial interest in the corpus of the trust estate, or in respect of any life tenant, the deductions allowable under Division 36 of the *Income Tax Assessment Act 1997* in respect of such of the tax losses of previous years as are required to be met out of corpus." (emphasis added)

In other words, "net income" is the hypothetical taxable income (assessable income minus deductions) of a resident taxpayer, being the trust.

Present entitlement

Under the general law of trusts, there is present entitlement if the beneficiary has a vested and indefeasible interest in possession and the legal right to call for and receive payment of the income.[7]

For discretionary trusts, s 101 ITAA36 provides that a beneficiary, in whose favour the trustee of a discretionary trust exercises its discretion to pay or apply income, is deemed to be presently entitled to that income. Section 95A(1) confirms that once the beneficiary is presently entitled to an amount of income, that present entitlement continues even after that amount is paid to, or applied for the benefit of, the beneficiary.

It should be noted that, if there is part of the income of the trust estate to which no beneficiary is presently entitled, s 99 or 99A ITAA36 applies. Section 99A taxes the trustee on that amount of unallocated income at the top marginal tax rate. If the trust is a testamentary trust and the Commissioner's discretion is exercised, s 99 taxes the trustee at marginal rates.

Taxation of trusts on capital gains and franked distributions

The rules governing the "streaming" of capital gains and franked distributions to beneficiaries are contained in Subdiv 115-C and Subdiv 207-B of the *Income Tax Assessment Act 1997* (Cth) (ITAA97), respectively. "Streaming" for tax purposes is by the concept of "specific entitlement".

Specific entitlement is established when: (1) the beneficiary has received or can be reasonably expected to receive an amount that is referable to the capital gain or franked distribution; and (2) the streaming of the capital gain or franked distribution is clearly recorded within a certain time.[8]

Broadly, Subdiv 115-C deems a beneficiary who is specifically entitled to the capital gain to have made the capital gain. If relevant, the beneficiary will be able to use its capital losses and any CGT discount or concessions. Similarly, Subdiv 207-B allows beneficiaries who are specifically entitled to franked distributions to include the amount that they are entitled to in their assessable income.

There are also provisions to prevent double taxation in Div 6E of Pt III ITAA36. The effect of these provisions is that, if the trustee makes a beneficiary specifically entitled to a capital gain or franked distribution, those specific amounts are streamed to the beneficiary outside of Div 6 of Pt III (taxation of trust income). The taxation in Div 6 of Pt III (that is, s 97) will not include the streamed capital gains and franked distributions.

The upshot of the above is that tax laws allow the streaming of capital gains and franked distributions by way of specific entitlement. However, they require the trust deed to also allow the trustee to make beneficiaries specifically entitled to capital gains or franked distributions.

Definitions of "income" in trust deeds

As affirmed by *FCT v Bamford*, accounting principles, the trust deed and the trustee determine the "income of the trust estate". Like all trust matters, the starting point for preparing a distribution resolution should be understanding the trust deed.

No definition of income

This is more common for older deeds, but if a trust deed does not define "income", the trust's income is determined by "appropriate accounting principles".

In these circumstances, it is likely that "income of the trust estate" will equal net ordinary income.[9] This will exclude all statutory income. While franked dividends, but not the franking credit, are ordinary income, the trustee will not be able stream capital gains under the trust deed's income distribution power, only the capital distribution power. The problem is exacerbated by the fact that older deeds typically restrict the capital distribution power to only be exercisable on the vesting day of the trust. Without the power to distribute either income or capital, the trustee will have difficulties distributing the capital gains, leaving the presently entitled beneficiaries with the tax liability on the capital gains.

Income equalisation clause

A common definition for "income" in trust deeds is to equate the trust's income to "net income" as defined in s 95(1). The ATO calls this definition an "income equalisation clause".[10]

An example of an income equalisation clause is as follows:

> "**income**" means the net income of the Trust Fund for an Accounting Period calculated in accordance with section 95(1) of the *Income Tax Assessment Act 1936* as amended or substituted from time to time.

By equating the "income of the trust estate" with the s 95(1) net income definition, the trustee will be able

to stream assessable capital gains under the trust deed's income distribution power. However, if there is a non-assessable capital gain (for example, the discounted portion of the capital gain), that falls outside the scope of s 95(1) net income. The trustee will only be able to get the non-assessable portion into the hands of the beneficiaries through the capital distribution power. If there is no capital distribution power, the trustee will have difficulties distributing out the non-assessable capital gains or disregarded capital gains.

For this reason, it should be noted that, on top of an income equalisation clause, it is beneficial to have sufficient capital distribution powers and clauses on streaming capital gains under Subdiv 115-C and franked distributions under Subdiv 207-B in order to clearly appoint those amounts to the desired beneficiaries.

Additionally, there may be tax issues if the trustee streams other types of income. The Federal Court decision *FCT v Greenhatch*[11] suggests that, without a specific statutory power to stream, even if the streaming is permitted under the trust deed (under trust law), it may not be effective under tax law. There is no other specific statutory power to stream other forms of income.

The ATO's position in TR 2012/D1 is that the following items are included when calculating a trust's net income, but are excluded from being "income of the trust estate":[12]

"• the amount of a franking credit included in the calculation of the trust's net income under subsection 207-35(1) of the ITAA 1997;

- so much of a share of the net income of one trust (the first trust) that is included under section 97 in the calculation of the net income of another trust, but which does not represent a distribution of income of the first trust;
- so much of a net capital gain that is attributable to an increase of what would have otherwise been a relevant amount of capital proceeds for a CGT event as a result of the market value substitution rule in section 116-30 of the ITAA 1997;
- so much of a net capital gain that is attributable to a reduction of what would have otherwise been a relevant cost base or reduced cost base of a CGT asset as a result of the market value substitution rule in section 112-20 of the ITAA 1997;
- an amount taken to be a dividend paid to the trustee of the trust pursuant to subsection 109D(1), and
- an amount of attributable income under an attribution/accruals regime such as Part X (about controlled foreign companies) or Division 6AAA of Part III (about non resident transferor trusts)."

TR 2012/D1 explains that the ATO considers that these amounts may form part of the income of the trust estate only to the extent that they are matched by notional expense amounts.[13]

Re-characterisation clause

For maximum flexibility, a trust deed can include a re-characterisation clause. A re-characterisation clause gives the trustee the power to determine what the trust's income is. This can include ordinary income, statutory income or notional amounts that are not assessable income.

An example of a re-characterisation clause is as follows:

x.1 The Trustee may determine the income of the Trust Fund for each Accounting Period.

x.2 In determining the income of the Trust Fund under clause x.1 the Trustee may in its discretion determine whether:

x.2.1 the income of the Trust Fund includes or does not include the whole or part of any receipt, profit, gain or other amount including any notional amount included in assessable income pursuant to the Tax Acts;

x.2.2 any accumulated income, capital or corpus is income of the Trust Fund;

x.2.3 the income of the Trust Fund is reduced or is not reduced by any payment, expense or outgoing including any notional amount excluded from assessable income pursuant to the Tax Acts;

x.2.4 the income of the Trust Fund is reduced or is not reduced by any loss which has occurred in an earlier Accounting Period;

x.2.5 the income of the Trust for the Accounting Period is the "net income" as that term is defined by section 95 of the ITAA36.

x.3 If the Trustee does not make an effective and valid determination under this clause in respect of an Accounting Period then for the purposes of the Trust the income of the Trust Fund for the Accounting Period will be the "net income" as that term is defined by section 95 of the ITAA36.

A re-characterisation clause confers the trustee with the most flexibility from a trust law perspective to distribute in accordance with tax laws.

Similar to the income equalisation clause, on top of re-characterisation clauses, it is beneficial to have sufficient capital distribution powers and clauses on streaming capital gains under Subdiv 115-C and franked distributions under Subdiv 207-B to clearly appoint those amounts to the desired beneficiaries.

Conclusion

If the trust plans to distribute capital gains to beneficiaries, it is worthwhile to review the income and capital distribution powers in the trust deed to ensure that there is a valid

method for distribution. Validly executed distribution resolutions or minutes are critical to ensuring that the correct beneficiaries receive trust distributions.

If the underlying distribution power is not sufficient, the resolution may be rendered ineffective and the following consequences may arise:

- errors in the trust's financial statements and income tax returns;
- beneficiaries paying tax on amounts that they were never entitled to;
- default beneficiaries failing to declare the correct amount of their assessable income; and
- trustees failing to declare the correct amount of their assessable income and being taxed at the highest marginal rate.

Before distributing, and subject to the variation power in the trust deed, the trustee may amend the trust deed to ensure that they have sufficient distribution power to achieve their desired outcomes.

Things become trickier if issues are found after distribution.[14]

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References

1 Ss 97(2) and (3), and ss 98 to 102 ITAA36.

2 Para 10 of TR 2012/D1.

3 [1980] HCA 6 at [22].

4 [2010] HCA 10.

5 (1998) 84 FCR 70.

6 *Bamford* [2010] HCA 10 at [45], affirming *Zeta Force Pty Ltd v FCT* 84 FCR 70.

7 *FCT v Harmer* (1991) 173 CLR 264 at 271.

8 Ss 115-228 and 207-58 ITAA97.

9 See, for example, para 30 in example 3 of TR 2012/D1.

10 Paras 14–17 of TR 2012/D1.

11 [2012] FCAFC 84.

12 Para 15 of TR 2012/D1.

13 Para 16 of TR 2012/D1.

14 For a discussion on rectifying invalid distributions, see E Hennebry, "Managing invalid distributions", (2023) 57(10) *Taxation in Australia* 614.

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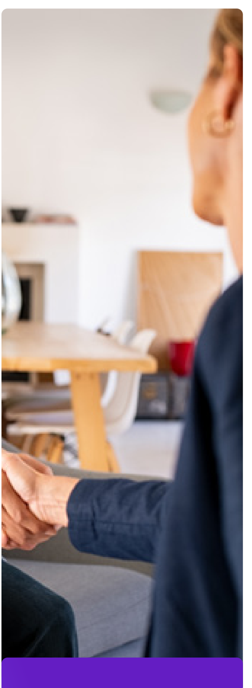

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Superannuation

by Daniel Butler, CTA, and
Fraser Stead, DBA Lawyers

Employee or contractor — new ATO guidance: part 5

The ATO recently released TR 2023/4 and PCG 2023/2 to provide additional guidance in respect of the distinction between an employee and an independent contractor.

Overview

The relatively brief, legally binding portion of TR 2023/4 (paras 6–14) confirms the ATO's interpretation of the definitions of "employee" and "independent contractor". Importantly, the ruling explains when an individual is an "employee" of an entity for pay as you go (PAYG) purposes with respect to s 12-35 of Sch 1 to the *Taxation Administration Act 1953* (Cth) (TAA53). The provision imposes an obligation on a paying entity to withhold amounts from the salary, wages, commission, bonuses or allowances that it pays to an employee. However, while the ATO notes that TR 2023/4 may assist in understanding the ordinary meaning of an employee in regard to s 12(1) of the *Superannuation Guarantee (Administration) Act 1992* (Cth) (SGAA92), the ruling is not binding on the Commissioner in this respect.

TR 2023/4

Some notable points of TR 2023/4 include:

> "7 Whether a [worker] is an employee of an entity … is a question of fact to be determined by reference to an objective assessment of the totality of the relationship between the parties …
>
> 9 Where the worker and the engaging entity have comprehensively committed the terms of their relationship to a written contract … it is the legal rights and obligations in the contract alone that are relevant in determining whether the worker is an employee of an engaging entity.
>
> [9] Evidence of how the contract was performed, including subsequent conduct and work practices, cannot be considered for the purpose of determining the nature of the legal relationship between the parties.
>
> 10 However, evidence of how a contract was actually performed may be considered to establish the contractual terms or to challenge the validity of a written contract consistent with general contract law principles …
>
> 11 … the terms of the contract between the parties must be considered holistically …
>
> 13 The 'label' which parties choose to describe their relationship, whether within a written contract or otherwise, is not determinative of, or even relevant to, that characterisation …"

TR 2023/4 broadly reflects the High Court's decisions in *Construction, Forestry, Maritime, Mining and Energy Union v Personnel Contracting Pty Ltd*[1] (*Personnel Contracting*) and *ZG Operations Australia Pty Ltd v Jamsek*[2] (*Jamsek*). In part 2 of our series of articles, we provided a more in-depth analysis of these High Court decisions.[3]

Consistent with these High Court decisions, a clear emphasis is placed on the legal rights and obligations of each party as determined with reference to the terms of the comprehensive written agreement.

The *Fair Work Act 2009* (Cth) was recently amended by the insertion of new s 15AA(1) of the *Fair Work Legislation Amendment (Closing Loopholes No. 2) Act 2024* (Cth). This section focuses on the real substance, practical reality and true nature of the relationship between the individual and the person. This determination should have regard to the totality of the relationship including not only the terms of the contract, but also how the contract is performed in practice.

This provision was inserted by the Labor Government to supposedly close the "loophole" created by the High Court in the *Personnel Contracting* and the *Jamsek* decisions, discussed above. It should be noted, however, that this change is limited to the *Fair Work Act 2009* and does impact the status of the test for tax and superannuation purposes, not for the multitude of other legislative provisions where a distinction between an employee and a contractor arises.

Unfortunately, Australia has a very complex industrial system by world standards which is beyond the reach of many small to medium businesses as a determination is required having regard to the particular legislation being considered or other relevant criteria.

Explanation to TR 2023/4

The lengthy non-binding explanation to TR 2023/4 describes in greater detail the factors that should be considered when deciding if an individual is an employee for PAYG purposes. Below we set out a brief summary of some of the key factors.

Totality of the relationship

The appendix to TR 2023/4 provides further detail on this concept:

> "22 The totality of the relationship between a worker and an engaging entity comprises the legal rights and obligations they have in respect of each other – that is, the contractual relationship between the parties. To determine the nature of the contractual relationship between a worker and an engaging entity, it is the terms of the contract alone, whether express or implied, which are to be taken into account."

A two-step process is then provided for determining whether an employment relationship exists. First, identify the contract between the parties. Second, identify the terms of the contract. It is these terms alone that are relevant to a determination of the nature of the relationship. However, evidence surrounding the formation of the contract may be considered to assist with the identification of the purpose of a contract, to establish evidence of equitable rights (eg estoppel and rectification), or to show that the contract was a sham.

Core distinction and employment test

At para 39 of TR 2023/4, the core distinction between an employee and an independent contractor is summarised as follows:

"• an employee serves in the business of an employer, performing their work as a part of that business

- an independent contractor provides services to a principal's business, but the contractor does so in furthering their own business enterprise; they carry out the work as principal of their own business, not part of another."

The relevant test is stated as: "is the worker an employee of the engaging entity?" Again, this is with regard to the terms of the contract and the contractual relationship between the parties.

Indicia of employment

Paragraphs 45–75 then set out the factors or indicia of employment as identified in the relevant case law to assist in ascertaining whether a worker is an employee or an independent contractor. Importantly, these factors must be weighed in relation to the totality of the relationship between the parties. Below we set out a summary of some of these factors.

Presenting as an emanation of the business

A distinction is noted between workers who voluntarily wear uniforms or other logos that bear their employer's insignia and those who are contractually obliged to do so, the latter of which will tend towards a finding of employment.

Control and right to control

The focus of this factor is not in the actual exercise of control but the contractual right of the employer to exercise control. Such a contractual right will tend towards a finding of employment.

The ability to delegate, subcontract or assign work

An unfettered right to delegate, subcontract or assign their work to others will be a very strong indicator against the worker being an employee (ie being an independent contractor).

Results contracts

A contract to achieve a specified result is a strong indication that the contract is one for services and consistent with an independent contractor relationship. Nevertheless, there are non-hourly remuneration models that are still consistent with employment.

Provisions of tools and equipment

Workers who provide their own equipment, assets and tools, and who incur expenses and other overheads, may be indicators of an independent contractor relationship, but regard must be had to the nature, scale and cost of the tools and equipment.

Risk

A clause requiring a worker to take out public liability/indemnity insurance will likely be a neutral factor unless the totality of the relationship suggests that a worker is an independent contractor, in which case such a clause will support that finding.

Generation of goodwill

While not all businesses generate goodwill, it would be common for an independent contractor to generate goodwill for their own business.

Despite the distinct ambiguity of many of the above indicia of employment, it is relatively clear that such indicia are only suggestive of the type of relationship involved. TR 2023/4 stresses on multiple occasions that regard must always be had to the totality of the relationship relevantly determined by the terms of the contract. Similarly, certain labels and clauses in a contract may be consistent with a contractor or an employee relationship (eg a clause requiring a worker to provide invoices suggests a contractor relationship), while again not being determinative by themselves.

PCG 2023/2

Released in conjunction with TR 2023/4, PCG 2023/2 specifically highlights when the ATO will investigate a worker's classification (eg employee or independent contractor) in an arrangement between an engaging entity and a worker. PCG 2023/2 details how the ATO will allocate its compliance resources based on seven risk factors using the now relatively standard ATO system of no, low, medium and high risk.

Importance of obtaining specific legal and tax advice

In addition to the ordinary meaning of "employee" under common law, an independent contractor may still meet the extended definition of an employee under s 12 SGAA92. Notably, criterion 6 and criterion 7 in Table 4 of PCG 2023/2 deal with obtaining specific advice confirming the classification of employee under s 12-35, Sch 1 TAA53 and the expanded definition of an employee under s 12 SGAA92, respectively. This advice must be from an appropriately qualified professional (eg a solicitor, a tax professional or specific advice from the ATO):

> "6 The party relying on this Guidelines obtained specific advice confirming the classification was correct."
>
> "7 An engaging business relying on this Guideline also obtained specific advice confirming the application of the extended meaning of employee under the SGAA, and communicated this outcome to the worker."

The definition for the high-risk zone for each criterion also states:

"Any arrangements that do not fall within the 3 other risk zones."

The implication is clear. A failure to obtain specific advice in relation to worker classification will automatically place an entity in the high-risk category. Notably, an engaging entity minimises risk by obtaining legal and tax advice.

PCG 2023/2 notes that the Commissioner will be satisfied with regard to criterion 6 and criterion 7 if the advice was at least reasonably arguable. A reasonably arguable position must be cogent, well-grounded and considerable in its persuasiveness.

Conclusion

TR 2023/4 and PCG 2023/2 reflect the ATO's revised position in view of the High Court's decisions in *Personnel Contracting* and *Jamsek*. These ATO materials summarise the various factors in determining a worker's classification as employee or contractor. In accordance with the High Court decisions, the primary focus is on the totality of the relationship as evidenced by the terms of a comprehensive written contract.

PCG 2023/2 highlights the need for, in addition to a comprehensive written agreement, a reasonably arguable position by an engaging business to minimise risk. PCG 2023/2 notes that professional advice is required from a lawyer or a tax professional.

Related articles

For further guidance, refer to the earlier articles in this series.[4]

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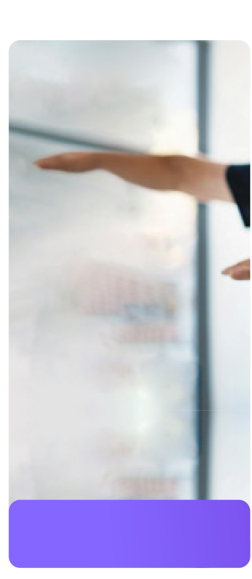

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Alternative Assets Insights

by Rachael Cullen and Ari Esmerian, PwC

Victorian tax reform: an update

The Victorian Government has released details of the proposed commercial and industrial property tax reform announced in the most recent Victorian Budget.

Overview

On 11 December 2023, the Victorian Government announced details of the final design of the commercial and industrial property tax reform which will see the abolition of transfer duties on certain property from 1 July 2024, to be ultimately replaced with an annual property tax. This follows an announcement in the 2023–24 Victorian Budget and subsequent consultation with business and industry representatives. The proposed legislation and further guidance are still to come in 2024 but the most recent announcement provides a much clearer picture of how the proposed reform is intended to operate.

In detail

Under the proposed reforms, commercial and industrial property will be transitioned over time from being subject to stamp duty on changes of ownership, to being subject to an annual property tax of 1% per annum (referred to as the commercial and industrial property tax (CIPT)). This CIPT will apply in addition to any land tax ordinarily payable.

From 1 July 2024, commercial and industrial property should only be subject to one final round of stamp duty. Once that duty is paid, property will become part of the new tax system and no further duty should apply (provided it remains commercial/industrial). Instead, the CIPT will become payable annually from the 31 December after the tenth anniversary of the final stamp duty payment.

What types of property will the reform apply to?

The types of property that the CIPT reform will apply to include:

- Victorian land that has a qualifying commercial or industrial use – being land that has been coded by the Valuer-General as commercial, industrial, extractive industries or infrastructure and utilities;
- it will not apply to land that has been coded by the Valuer-General as residential, primary production, community services, sport or heritage and culture;
- for mixed use properties, a "sole or primary use" test will be applied. The "primary" use will be determined by the Victorian Commissioner, looking at factors such as land or floor area of each use, relative intensity, economic and financial significance of each use, and the length of time of each use. If the property is determined to be solely or primarily for commercial or industrial use, the entire property will enter the new system (including the non-qualifying portions);
- student accommodation will generally be considered to be commercial property providing it is not provided in connection with a university (such as university colleges);
- once a parcel of land has entered the new system, the subdivision of that land will not change that qualification – the subdivided parcels will be able to be transacted without duty and will retain the same property tax commencement date as the original parcel; and
- lots that are consolidated into a larger parcel will be part of the new system if 50% or more of the total land area of the new parent property is made up of land that had already entered the new system.

When will properties come within the new system?

Entry into the new system will occur when:

- a contract for sale is entered into on or after 1 July 2024 (ie both signing and completion need to occur on or after 1 July 2024);
- there is a 50% or more change in ownership of the property, via either a dealing in the property itself or indirectly via a dealing in shares or units; and
- there is a relevant "positive duty liability", that is, duty needs to be paid under an eligible type of transaction (including where certain concessions apply, such as the 50% regional commercial and industrial concession). This can include either transfer duty or landholder duty.

The property will not enter into the new system if:

- the transaction is exempt from duty, eg under an exemption for deceased estates, charitable institutions, or transfers between spouses; or
- the duty is triggered under an excluded/complex arrangement, eg corporate reconstruction concessions, dutiable leases, economic entitlement provisions, or subsale provisions.

In addition, anti-avoidance provisions will be put in place to support the integrity of the reform. Details of these measures are yet to be released.

What happens once the property is in the new system?

Once a property has become part of the new system, any subsequent dealings (including direct or indirect dealings)

should not be subject to stamp duty as long as the property continues to be classified as commercial or industrial property.

From the 31 December after the tenth anniversary of the last duty payable (eg settlement of the transfer), the CIPT will apply annually. This tax is set at 1% of the property's unimproved land value per annum, with no tax-free threshold.

The CIPT will be separate to land tax which will continue to apply in the same way that it currently does. However, the CIPT will be administered in a similar way to land tax and share many common features, including:

- existing land tax exemptions will also apply to the CIPT;
- the CIPT will not be allowed to be passed through by landowners to specific retail tenants identified under the *Retail Leases Act 2003* (Vic); and
- the CIPT will be able to be paid in a single annual payment or by instalments.

There will be no additional surcharge as part of the CIPT system for foreign persons. However, it will not displace the land tax surcharge that already exists.

Information on whether a property is in the new system will be included in a property clearance certificate issued by the State Revenue Office.

What happens if the classification of the property changes?

If a commercial or industrial property that has become part of the new system subsequently converts to a non-qualifying use (eg residential purposes):

- the property will not be subject to the CIPT while it is used for that non-qualifying purpose (even where it has reached the tenth anniversary after entry into the system and the CIPT has started to apply);
- any dealings in the property will be subject to duty, while it has the non-qualifying use; and
- if there has been a dealing in the property in the 10 years before the change in use, a "change-of-use duty" may apply.

The "change-of-use" duty will be calculated based on the stamp duty that would have been payable when the property was transacted (including any relevant concessions) less 10% for every 31 December that has passed since the transaction occurred (up to a maximum of 100%). Property owners will need to notify the State Revenue Office within 30 days of a change of use occurring.

If the property subsequently returns to a "qualifying"/ commercial and industrial use, there will not be any refund of the "change of use" duty, and whether or not the annual property tax is payable will be determined based on the original 10-year period (that is, it will apply based on the timing of the original entry into the new system, rather than having the clock reset).

New loan scheme for upfront duty payment

In addition to the new system set out above, the Victorian Government has announced a new government-facilitated loan scheme that will be offered to certain purchasers of commercial and industrial land as an alternative to self-financing the upfront duty amount.

This effectively gives eligible purchasers the ability to choose whether to transition to an annual payment arrangement (via loan repayments) from the time of the purchase instead of an upfront sum.

This scheme will be available to eligible applicants, who are:

- Australian citizens/permanent residents or an Australian business;
- the first purchaser of a commercial or industrial property where the contract is entered into, and settlement occurs, on or after 1 July 2024;
- purchasing property with a purchase price of up to $30m; and
- approved for finance from an authorised deposit-taking institution or other approved lender for the subject property.

The loan will be issued by the Treasury Corporation of Victoria with a fixed market-based interest rate equal to the Treasury Corporation of Victoria's bond rate plus a credit risk margin (to be finalised and published in 2024).

The interest will be calculated upfront, and a total amount comprising the stamp duty and total interest will be required to be repaid over 10 annual payments, commencing one year after settlement. Early repayment will be possible, but a break fee will apply.

A first ranking statutory charge will be registered on title and the total loan amount will need to be repaid if the property is subsequently sold or converts to a non-qualifying use. The loan cannot be transferred or novated to a subsequent purchaser.

Foreign owners will not be eligible for the loan scheme.

What's next?

The latest announcements provide a lot more clarity regarding how the proposed reforms and new CIPT system are intended to operate. However, this continues to be an area to monitor, with further details and the legislation required to facilitate this reform expected to be introduced to the Victorian Parliament in 2024.

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