

Taxation *in* Australia

Unit trusts: some practical insights

*Peter Slegers, CTA, Carlie Frantzis, ATI, and
Amy Lancaster, ATI*

“Cleaning up” old pensions and reserves in SMSFs

Kym Bailey, CTA



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Invitation to write

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Tax News – at a glance

by TaxCounsel Pty Ltd

December – what happened in tax?

The following points highlight important federal tax developments that occurred during December 2024. A selection of the developments is considered in more detail in the “Tax News – the details” column on page 294 (at the item number indicated).

2024–25 MYEFO

The Mid-Year Economic and Fiscal Outlook for 2024–25, which was released by the Treasurer on 18 December 2024, contains several new tax measures, the more important of which are noted. **See item 1.**

Multinationals: minimum tax rate

In a joint media release on 23 December 2024, the Treasurer and an assistant minister announced that the government had published subordinate legislation in the form of ministerial rules (the *Taxation (Multinational – Global and Domestic Minimum Tax) Rules 2024*) as part of Australia’s implementation of a 15% global minimum tax and domestic minimum tax for large multinationals. **See item 2.**

Legal professional privilege: Commonwealth investigations

In a joint media release issued with the Attorney-General on 23 December 2024, the Treasurer announced the release of a discussion paper on the use of legal professional privilege claims in Commonwealth investigations as part of the government’s comprehensive response to the PwC tax leaks matter. **See item 3.**

Tax regulator secrecy exceptions

In a media release on 20 December 2024, the Assistant Treasurer announced the release of a consultation paper that explores whether there are any additional instances where it may be appropriate for the ATO or the Tax Practitioners Board to disclose protected tax information in the public interest. **See item 4.**

Division 7A: guarantees

The Commissioner has released a draft determination and a taxpayer alert in relation to the Div 7A anti-avoidance provision that can be attracted where a private company

guarantees a loan made by another entity (TD 2024/D3 and TA 2024/2). **See item 5.**

Suspected fraud: unconnected third parties

The Commissioner has released a law administration practice statement which sets out the ATO’s policy on the steps that ATO officers are to take where there is suspected fraud affecting a taxpayer by an entity (or entities) other than the taxpayer and not connected with the taxpayer (PS LA 2024/1). **See item 6.**

Ordinary income: onus discharged

The Federal Court (Logan J) has held that the taxpayer had discharged the onus of proving that 99 deposits from bank accounts in Vanuatu to his or his wife’s Australian bank accounts totalling almost \$33m and that were made over the 11 income years 2005 to 2015 were not ordinary income and, so, were not included in his assessable income (*Cheung v FCT* [2024] FCA 1370). **See item 7.**

AAT: failure to give reasons

In two somewhat related appeals from the AAT involving the operation of the general anti-avoidance provisions of Pt IVA of the *Income Tax Assessment Act 1936* (Cth), the Full Federal Court (O’Callaghan, McEvoy and Needham JJ) unanimously held in each case that the appeal from the AAT be allowed and that each proceeding be remitted to the AAT for the hearing and determination of an identified question or questions (*Grant v FCT* [2024] FCAFC 173; *Collie v FCT* [2024] FCAFC 172). **See item 8.**

Scheme promoter penalties

The Federal Court (Kennett J) has determined the amount of the civil penalties payable by two individuals and two associated corporate entities under the scheme promoter penalty provisions of the *Taxation Administration Act 1953* (Cth) (*FCT v Bakarich (No. 2)* [2024] FCA 1448). **See item 9.**



President's Report

by Tim Sandow, CTA

Welcome to advocacy in 2025

President Tim Sandow welcomes members and outlines his priorities for the Institute's advocacy efforts in 2025.

I'd like to welcome our members to 2025 at The Tax Institute. We are glad to have you with us as we kick off the year.

To begin, my thanks and congratulations to Todd for the wonderful work he did as President last year. I'd also like to welcome our new National Council members, Rae Ni Corraidh (as of July 2024) and Modiesha Stephens, who bring fresh new perspectives and ideas to our Council.

I am excited to carry on the work of The Tax Institute in 2025. This year, alongside delivering all of your regular member benefits, events and educational opportunities, I am focused on three core areas of our advocacy work, all aimed at increasing certainty in the tax system.

Tax reform

The first core area of concern for me is one that perhaps encompasses the two that follow. It has been the elephant in the room for some time now: that our tax system is so complex and unwieldy, with so many band aid solutions applied, it is increasingly difficult for tax practitioners to stay up to date. The fear of "missing something" is very real.

In 2023 and 2024, the spotlight on the tax profession, and particularly the Code of Professional Conduct, increased stress around making any type of error. Hopefully, in 2025, the focus of government and the ATO can be to work with the profession to reform the system so that practitioners can provide advice with more certainty and therefore reduce the concern around making honest errors.

The *Case for Change* paper remains as relevant in 2025 as when it was written in 2021. Holistic reform is an ambitious but important goal. On a practical level, it may be difficult to achieve in the short term.

However, there are a number of areas where we can aim to reduce complexity in the tax system and provide certainty to tax practitioners, for example, reducing the number of thresholds applicable to small business concessions, and

rewriting Div 7A or Div 6 (trust provisions). While these changes do not constitute the sweeping, whole system reform that is sorely needed and that we continue to advocate for, they are a start.

Dealing with announced but unenacted measures

I think we can all agree that it is very difficult to provide tax advice to clients with certainty when the government has announced an intention to change the law from a particular date, but the legislation is not passed for months or even years.

Transparency around changing legislation is a good thing, as is open consultation on these changes. However, when the changes remain unresolved for extended periods, it makes things hard not only for tax practitioners, but also for the clients who are hoping to make business and life plans in accordance with tax legislation.

Administration of the tax system

While we acknowledge that the ATO is a large and complex organisation, streamlining two key areas would really assist practitioners in being able to provide advice to clients with certainty:

- **consistency:** we've seen the ATO make different decisions on what appears to be the same or very similar circumstances. It is very difficult not only to explain this to clients, but also to feel certain and confident in our own work. Consistency in decisions and in the criteria that lead to those decisions is key; and
- **access to the right people:** taxpayers often seek a private binding ruling because they want certainty in a particular tax outcome. Significant delays to these rulings can cause complications in the client's life or business dealings, but could often be quickly resolved with access to the right technical people in the ATO. Unfortunately, this is not always possible. This access and collaboration between the regulator and practitioners is integral to smooth administration of the tax system in Australia.

I described the issues above as the elephant in the room. It can be disheartening to think of how long this particular elephant has stood, ignored, in a corner of our room (our tax system). However, I believe progress can and will be made. This year, The Tax Institute is putting its mind to advocating on these issues and calling for further certainty in the tax system. This will likely not be a quick or easy process, but we are dedicated to seeing it through.

After all, as they say, how does one eat an elephant?

One bite at a time.

I'm looking forward to engaging with you this year and hearing your ideas on how we can all work together to increase certainty in the tax system.



CEO's Report

by Scott Treatt, CTA

Supporting our community in 2025

CEO Scott Treatt shares his key areas of focus for 2025, from advocacy to member engagement.

Welcome to 2025 with The Tax Institute.

I'd like to welcome Tim Sandow into his role as President for 2025. I'd also like to echo Tim in thanking Todd Want, CTA, for his work as President last year, and welcoming Modiesha Stephens to our National Council and extend that welcome to Rae Ni Corraidh, who has sat on National Council since July 2024.

We are growing and adapting to better serve the needs of our members. This year, advocacy work is at top of mind, and I'm pleased to announce to our members that our own Julie Abdalla, who you may already know from our events and advocacy activity, has been promoted to Head of Tax & Legal at the Institute. Julie has demonstrated exceptional expertise and dedication to the needs of our members, and will continue to support the advocacy work of The Tax Institute.

Both the Federal Budget and the federal election will have a big impact on our advocacy efforts this year. However, as Tim has outlined in his President's Report, our focus is on practical solutions to create increased certainty for tax practitioners. I won't repeat the excellent focus areas that Tim has discussed, but instead add some of my own.

Supporting vulnerable members of our community

The cost of living is a major concern and has impacted us all in recent times. Those who are most vulnerable in our community feel that pressure even more and sometimes lack a strong voice to advocate for themselves, especially on complex matters such as taxation. The tax system is complex for those of us who work within it – for your typical taxpayer also under pressure from cost of living or other circumstances, it can seem near impenetrable.

This year, our advocacy efforts include looking at supporting those most vulnerable in our community through meaningful change to the tax system. We are exploring what changes could be made, not just to the law, but also

to administrative processes to assist these vulnerable members of our community.

One avenue is to make it easier for both tax practitioners and the ATO to identify those who may need increased support and to have the administrative and legislative space to offer them that support and compassion. For example, in the case of financial abuse, including through the tax system by way of actions like coerced or fraudulent filing of tax returns, our tax law should allow for relief and compassion.

The government is expanding the National Tax Clinic program, which supports vulnerable individuals and small businesses to access tax advice and assistance. As part of our own advocacy efforts, The Tax Institute will also be exploring what support we can offer to this very worthwhile program.

Funding for regulators and policymakers

A key consideration that has been on our radar for some time is guaranteed and adequate funding to support those who develop, communicate and administer tax policy.

Treasury and the ATO are primarily responsible for these tasks. It is essential that Treasury is equipped to design new tax policy with the appropriate analysis, consultation and technical expertise. It is also, as Tim has outlined, vital that Treasury has the capacity to address the extensive list of announced but unenacted measures. It is also vitally important that the ATO is able to implement and provide more timely guidance on new measures.

Importantly, funding for these vital tasks must be a certainty. Taskforce-based funding to extend and boost the ATO's review and audit programs is no longer adequate (if it ever was). Instead, permanent funding allows for long-term thinking, and better design, implementation and administration of tax policy on an ongoing basis.

The Tax Institute continues to advocate for this funding, as we recognise the vital role it plays in both the maintenance of the tax system, and in allowing our members and tax practitioners more broadly to work effectively and efficiently.

I am looking forward to a productive and positive year in 2025, and I hope you are too as a member of our community. As always, I encourage you to get involved and take advantage of the resources and opportunities afforded to you as a member, and I look forward to connecting with you at some point throughout the year.



Head of Tax & Legal's Report

by Julie Abdalla, FTI

Instant asset write-off

We explore the history of the instant asset write-off measure, evaluating its development and the impact of annual changes on small businesses.

The instant asset write-off (IAWO) is a significant feature of the simplified depreciation regime for small business entities (SBEs), contained in Subdiv 328-D of the *Income Tax Assessment Act 1997* (Cth) (ITAA97). The IAWO measure enables SBEs to claim an immediate deduction for eligible assets that cost less than the relevant threshold, and which are used for a taxable purpose. This measure was designed to simplify claiming depreciation for lower-value assets and has since proven beneficial in supporting small businesses across various economic conditions due to its positive impact on cash flow. The threshold was increased substantially during the COVID-19 pandemic.

The [New Business Tax System \(Simplified Tax System\) Act 2001](#) established the initial IAWO threshold at \$1,000. The threshold was revised in 2012 by the [Tax Laws Amendment \(Stronger, Fairer, Simpler and Other Measures\) Act 2011](#), which raised it to \$5,000, then to \$6,500 for the 2012–13 and subsequent income years. In 2014, the [Minerals Resource Rent Tax Repeal and Other Measures Act 2014](#) maintained the IAWO threshold at \$6,500 for the 2014–15 income year.

Changes in the IAWO threshold from 2015 to 2023

Since 2015, the standard legislated threshold of \$1,000 in s 328-180 ITAA97 has remained in operation. However, regular amendments to s 328-180(4) of the *Income Tax (Transitional Provisions) Act 1997* (Cth) have considerably increased the IAWO threshold on a so-called “temporary basis”.

These changes are as follows:

- the [Tax Laws Amendment \(Small Business Measures No. 2\) Act 2015](#) amended the IAWO to temporarily allow SBEs (having an aggregated turnover of less than \$10m) to immediately deduct certain depreciating assets and general small business pools valued at less than \$20,000 where they were first acquired between 12 May 2015 and 30 June 2017;

- the [Treasury Laws Amendment \(Accelerated Depreciation For Small Business Entities\) Act 2017](#) extended the \$20,000 IAWO measure by 12 months to 30 June 2018;
- the [Treasury Laws Amendment \(Accelerated Depreciation For Small Business Entities\) Act 2018](#) extended the \$20,000 IAWO measure by a further 12 months to 30 June 2019;
- in 2019, the [Treasury Laws Amendment \(Increasing and Extending the Instant Asset Write-Off\) Act 2019](#) increased the threshold from \$20,000 to \$25,000 and extended the measure once again to 30 June 2020;
- on 2 April 2019, just weeks after the government had announced the increase in the IAWO threshold from \$20,000 to \$25,000, the [Federal Budget 2019–20](#) further increased the threshold temporarily to \$30,000 and also increased the aggregated annual turnover threshold for eligible businesses to \$50m;
- the IAWO threshold further increased to \$150,000, again temporarily, as part of the government's [Coronavirus Stimulus Package](#), which extended the measure to larger businesses with an aggregated annual turnover of less than \$500m until 30 June 2021;
- the IAWO threshold was then removed entirely by the Federal Budget 2020–21 measure titled [JobMaker Plan – temporary full expensing to support investment and jobs](#) for 12 months until 30 June 2022. This [temporary full expensing](#) measure allowed an immediate deduction for:
 - the cost of new eligible depreciating assets for businesses with an aggregated annual turnover of less than \$5b;
 - the cost of second-hand assets for businesses with an aggregated annual turnover of less than \$50m; and
 - the remaining balance of a general small business pool at the end of each income year for businesses with an aggregated annual turnover of less than \$10m; and
- the [Federal Budget 2021–22](#) extended this measure for a further 12 months, from 6 October 2020 until 30 June 2023.

Recent changes

As part of the [Federal Budget 2023–24](#), the government announced that it would temporarily increase the IAWO threshold to \$20,000 for the 2023–24 income year, applicable to eligible assets first used or installed ready for use between 1 July 2023 and 30 June 2024. This measure prevented the threshold from reverting to the standard legislated amount of \$1,000 (in s 328-180 ITAA97), allowing SBEs to deduct the cost of multiple assets that individually each cost less than \$20,000.

This measure was contained in the [Treasury Laws Amendment \(Support for Small Business and Charities and Other Measures\) Act 2023](#), which finally passed both houses on 25 June 2024, just days before the end of the 2023–24 income year. The legislative process encountered significant delays: following the announcement of the measure on 9 May 2023, the enabling Bill was only introduced into parliament on 13 September 2023. On 27 March 2024, the Senate proposed amendments to increase the asset

threshold to \$30,000 and the aggregated turnover threshold to \$50m, thereby extending benefits to medium-sized businesses for that income year. However, the House of Representatives disagreed with the Senate's amendments on 15 May 2024, emphasising the urgency of delivering timely tax benefits to SBEs.

The Bill underwent multiple rounds of reconsideration between the Senate and the House, with the Senate maintaining its position on its proposed amendments. Ultimately, the Bill was passed by both houses on 25 June 2024 without amendments to this measure. The protracted discussions created uncertainty for SBEs and their advisers, particularly as the end of the 2023–24 income year approached. This uncertainty was exacerbated by the government's announcement as part of the Federal Budget 2024–25 to extend the \$20,000 IAWO for SBEs by an additional 12 months until 30 June 2025.

The proposed IAWO measure for the 2024–25 income year was originally included in Sch 7 to the [Treasury Laws Amendment \(Responsible Buy Now Pay Later and Other Measures\) Bill 2024](#). However, this Bill received royal assent on 10 December 2024, with a last-minute amendment in the Senate that removed Sch 7 from the Bill. This exclusion has caused further uncertainty regarding the proposed extension of the IAWO measure for the 2024–25 income year. We understand that the government plans to reintroduce this measure in a different Bill this year, although it remains uncertain whether this will occur before the 2025 federal election which must be held no later than

17 May 2025. Notably, the [2024–25 Mid-year Economic and Fiscal Outlook](#) (MYEFO), released on 18 December 2024, did not address the uncertainty surrounding the IAWO. This omission from the MYEFO indicates a lack of immediate plans or commitments from the government regarding the IAWO extension, leaving SBEs and tax practitioners awaiting further developments on this crucial issue. As the government navigates its legislative agenda, the fate of the IAWO for the 2024–25 income year remains a topic of interest and concern for many. If the measure does not pass, the threshold will revert to the standard amount of \$1,000 from 1 July 2024.

Conclusion

In light of these developments, The Tax Institute continues to advocate for a permanent increase in the IAWO asset and aggregated turnover thresholds. This recommendation highlights the need for a more efficient policy design, prioritising long-term certainty over annual extensions. These changes are needed to allow small businesses to plan effectively for their future growth and sustainability. We are of the view that a stable tax environment is essential for small businesses to make informed decisions regarding their investments and operations. By providing a stable framework for asset write-offs and avoiding annual legislative changes to tweak the policy settings, the government can foster a more conducive environment for small business development, ultimately contributing to the prosperity of the broader economic landscape.



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Tax News – the details

by TaxCounsel Pty Ltd

December – what happened in tax?

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

Government initiatives

1. 2024–25 MYEFO

The Mid-Year Economic and Fiscal Outlook for 2024–25, which was released by the Treasurer on 18 December 2024, contains several new tax measures, the more important of which are noted below.

Tax penalty regime

The tax law is to be amended to strengthen the tax penalty regime by:

- ensuring that tax scheme penalties apply where taxpayers are in a loss position (from 1 July 2026);
- penalising large taxpayers that mischaracterise or undervalue interest or dividend payments to which withholding tax would otherwise apply (from 1 July 2026); and
- extending the application of the shortfall interest charge to repayments of overclaimed refundable offsets to disincentivise overclaiming (starting from the first 1 January, 1 April, 1 July or 1 October after royal assent of the Future Made in Australia (Production Tax Credit and Other Measures) Bill 2024).

Interest payments on foreign bail-in bonds

The government will clarify the law to ensure continuity of established ATO administrative treatment of foreign bail-in bonds. This will allow bail-in bonds for Australian branches of foreign banks to continue to be treated as debt for tax purposes, enabling deductibility of interest payments. This will align with the treatment currently applying to bail-in bonds issued domestically by Australian banks. This measure is to apply retrospectively.

Bail-in bonds are financial instruments that are subject to conditions imposed by a prudential regulator that allow the regulator to convert the instrument into equity in a period of financial distress.

Modernising tax administration systems

The government will provide \$76m over four years from 2024–25 to the ATO to modernise income tax reporting systems from 1 July 2026.

Improvements to ATO systems will reduce compliance costs on an ongoing basis for trustees, beneficiaries and tax agents, making lodgment easier and enabling the vast majority of trust tax returns to be lodged electronically. The improvements will also enable trust income for beneficiaries to be pre-filled, in the same way that salary and wages, bank interest and other types of income are currently pre-filled.

Pre-fill capability will be enhanced by amending the law to require trustees to report the tax file numbers of beneficiaries on the trust income tax return's statement of distribution when they have an entitlement. This amendment is to commence on the first day of the next quarter after royal assent of the amending legislation.

Philanthropy

The government will implement further reforms as part of its commitment to double philanthropic giving by 2030 by:

- removing the condition that a gift to a deductible gift recipient be valued at \$2 or more before the donor may claim a tax deduction. This change is to apply to gifts made from 1 July 2024; and
- aligning and increasing the minimum annual distribution rate for public and private ancillary funds and allowing ancillary funds to spread distributions over three years. This is to apply from the first financial year after the registration of amending ministerial guidelines. The distribution rate will be subject to consultation, and a five-year grace period will apply to any increase in the minimum distribution rate.

2. Multinationals: minimum tax rate

In a joint media release on 23 December 2024, the Treasurer and an assistant minister announced that the government had published subordinate legislation in the form of ministerial rules (the *Taxation (Multinational – Global and Domestic Minimum Tax) Rules 2024*) as part of Australia's implementation of a 15% global minimum tax and domestic minimum tax for large multinationals.

The publication of the rules follows the recent passage through parliament and royal assent of the primary legislation to implement the global and domestic minimum taxes (the *Taxation (Multinational – Global and Domestic Minimum Tax) Act 2024*).

Minimum taxes are a key part of a coordinated global approach by the OECD to put a floor on tax competition and establish a fairer domestic and international tax system.

From 1 January 2024, there will be a 15% global minimum tax and domestic minimum tax for multinational enterprise groups with an annual global revenue of at least €750m (approximately A\$1.2b). The global minimum tax will enable Australia to apply top-up tax on a resident multinational parent or subsidiary company where the group's income is taxed below 15% overseas. The domestic minimum tax will enable Australia to apply top-up tax for any low-taxed Australian income.

The Rules provide details on how multinationals should calculate any top-up tax. They will also ensure that future

administrative guidance released by the OECD can be incorporated in a timely and efficient manner.

3. Legal professional privilege: Commonwealth investigations

In a joint media release issued with the Attorney-General on 23 December 2024, the Treasurer announced the release of a discussion paper on the use of legal professional privilege claims in Commonwealth investigations as part of the government's comprehensive response to the PwC tax leaks matter.

The media release acknowledges that legal professional privilege is a fundamental tenet of the legal system but abuse of it can undermine investigations and erode trust. The discussion paper tests key issues identified through initial consultation in the government's review of the use of legal professional privilege in Commonwealth investigations.

Around 100 stakeholders from across government, the legal profession, academia and industry contributed to the initial stage of consultation, jointly led by the Attorney-General's Department and the Treasury.

Feedback in relation to the discussion paper will inform the development of a final options paper in 2025.

4. Tax regulator secrecy exceptions

In a media release on 20 December 2024, the Assistant Treasurer announced the release of a consultation paper that explores whether there are any additional instances where it may be appropriate for the ATO or the Tax Practitioners Board (TPB) to disclose protected tax information in the public interest.

The purpose of the consultation paper is to seek views and feedback on whether there are circumstances, beyond those currently permitted, in which it would be in the public interest for information obtained by the ATO or the TPB to be shared with a specified body or agency for a specified non-tax purpose.

The consultation paper also considers the ability of the ATO and the TPB to disclose suspected serious misconduct of an official or other trusted professional to agencies responsible for investigating serious misconduct to support the right action being taken at the right time to protect public trust in public institutions and trusted professions. It also considers the ATO's and the TPB's ability to disclose information to other entities for certain purposes where it is in the public interest, including to other Commonwealth agencies, to support effective and efficient administration of government programs and services.

The consultation paper seeks feedback on several proposed new exceptions where it may be appropriate for the ATO or the TPB to share information, including:

- to support the investigation of serious offences;
- to support professional integrity;
- to prevent, identify and respond to fraud; and
- to ensure that the ATO can more easily share information with other government agencies for legislated purposes.

The Commissioner's perspective

5. Division 7A: guarantees

The Commissioner has released a draft determination and a taxpayer alert in relation to the Div 7A anti-avoidance provision that can be attracted where a private company guarantees a loan made by another entity (TD 2024/D3 and TA 2024/2).

In broad terms (and subject to the operation of the distributable surplus rule), this provision (s 109U of the *Income Tax Assessment Act 1936* (Cth) (ITAA36)) can operate to treat a private company as having made a payment to an entity (the target entity) for the purposes of Div 7A where:

- the private company guarantees a loan made by another entity (the first interposed entity);
- a reasonable person would conclude (having regard to all of the circumstances) that the private company gave the guarantee solely or mainly as part of an arrangement involving a payment or loan to the target entity; and
- the first interposed entity that is a private company makes a loan to the target entity, or another interposed entity that is a private company makes a payment or loan to the target entity.

TD 2024/D3 states that the requirement (in the first bullet point above) that a private company guarantees a loan made by the "first interposed entity" does not contain any restrictions on the type of entity the first interposed entity must be. The first interposed entity need not be a private company and may be any entity (including, for example, a public company bank).

However, while any entity (including a public company) can be the recipient of a guarantee, the entity that makes the ultimate payment or loan to the "target entity" (see the third bullet point above) must be a private company pursuant to s 109U(1)(c) ITAA36.

Compliance approach

TD 2024/D3 states that the ATO recognises that it is common for banks and other financial institutions to seek guarantees from related entities when providing loans to private companies.

The ATO will focus the application of compliance resources concerning the application of s 109U to high-risk arrangements that display clearly artificial or contrived elements. For example, this would be the case where, on an objective assessment, one or more of the private companies involved in the arrangement entered into or carried out the arrangement with a view to circumventing Div 7A ITAA36, including through the exploitation of one or more private companies with no distributable surplus.

To avoid doubt, the ATO's decision to apply compliance resources in this manner:

1. only applies in respect of s 109U, with the result that, if the private company which gave the guarantee were to pay an amount to the third-party lender (or to the private company borrower) which resulted in a deemed

dividend arising under another provision in Div 7A, the ATO may have cause to devote compliance resources to applying that other provision; and

2. applies regardless of whether the third-party lender is or is not a private company.

TA 2024/2 applies to arrangements which, when viewed objectively, involve a series of steps that are intended to circumvent the operation of Div 7A.

6. Suspected fraud: unconnected third parties

The Commissioner has released a law administration practice statement which sets out the ATO's policy on the steps that ATO officers are to take where there is suspected fraud affecting a taxpayer by an entity (or entities) other than the taxpayer and not connected with the taxpayer (PS LA 2024/1).

More particularly, these are the steps to be taken by officers where the ATO has reasonable grounds to suspect that:

- the entity which committed the fraud acted without any authority to represent the taxpayer; and
- the taxpayer has not contributed to or enabled or benefited from the entity's actions.

Possible indicators that a third party may have acted without the taxpayer's authority include:

- the taxpayer's personal details have been accessed or stolen and have been reported as stolen;
- lodgment, registration or updates to financial account details appear to have been made by someone other than the taxpayer or someone to whom the taxpayer gave system access;
- a financial institution confirms that the account receiving payment is in the name of a third party and transactions show the funds being used by that party; and
- the account the refund is paid into also receives multiple refunds in respect of different taxpayers.

Recent case decisions

7. Ordinary income: onus discharged

The Federal Court (Logan J) has held that the taxpayer had discharged the onus of proving that 99 deposits from bank accounts in Vanuatu to his or his wife's Australian bank accounts totalling almost \$33m and that were made over the 11 income years 2005 to 2015 (the relevant period) were not ordinary income and, so, were not included in his assessable income (*Cheung v FCT*¹).

In 1974, Mrs Gazelle Leong (née Cheung) and her then husband, Mr George Leong, established in what is now known as Vanuatu a modest supermarket business, which they named Au Bon Marche (ABM). ABM was a profitable business. By independence in 1980, ABM had grown into the largest supermarket chain in Vanuatu. Half a century after its establishment, ABM comprised six retail supermarket outlets, a food wholesale facility and four fuel stations.

The wholesale arm of ABM serviced numerous small retail businesses in Vanuatu. ABM was a profitable business. Mrs Leong had been actively engaged in the conduct of the ABM business since its establishment. The taxpayer was a brother of Mrs Leong and was a resident of Australia during the income years to which the assessments or amended assessments related.

The Commissioner made assessments (or amended assessments) of income tax on what he assessed to be the taxpayer's taxable incomes for the relevant period. The principal foundation for these assessments or amended assessments lay in a view formed by the Commissioner about the character of the 99 deposits. The Commissioner considered that these deposits constituted income according to ordinary concepts.

Other foundations for the assessments were to be found in interest income in the total amount of \$1,953,631 received by the taxpayer over the relevant period and in deposits by ABM to entities associated with the taxpayer over the relevant period in the total amount of \$2,524,095. The taxpayer accepted that the interest income formed part of his assessable income.

Logan J said that, during the relevant period, as it always had been, the ABM business was carried on in Vanuatu, never in Australia. Related to that, the income of that business was derived in Vanuatu, never in Australia. The source of that income was in Vanuatu, not in Australia. Moreover, his Honour held that that income was derived, during the relevant period, by Mrs Leong, as the then sole owner of the ABM business.

Also during the relevant period, the taxpayer was a resident of Australia. As an Australian resident, his assessable income included the ordinary income he derived "directly or indirectly from all sources, whether in or out of Australia, during the income year" (s 6-5 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97)).

Logan J said that, from s 6-5(2) ITAA97 and his residency in Australia, it followed that the fact that the source of payments to the taxpayer was in Vanuatu did not mean that those payments could not form part of his assessable income. However, given his conclusion that it was Mrs Leong alone who owned the ABM business during the relevant period, Logan said that it followed that the taxpayer did not derive income from an ownership interest in that business.

Logan J further concluded that none of the payments were a reward to the taxpayer, either formally or informally, for services rendered to that business. In themselves, these conclusions did not mean that any of the payments did not constitute income under ordinary concepts. However, his Honour's further conclusion was that none of the payments were otherwise income under ordinary concepts. Thus, the assessments concerned had, to that extent, been proved to be excessive. As, by agreement, the issues in the taxation appeal had been confined, it followed that the taxpayer's appeal had to be allowed.

As a general comment, Logan J said that it was apt to observe that the confining of issues in taxation appeals (and

taxation reviews, for that matter) was a desirable practice. It is always for the Commissioner, in the responsible administration of tax legislation, to make a considered value judgment as to whether it is apt to agree to confine issues. Absent such agreement, the Commissioner is entitled to rely on any deficiency of proof by a taxpayer in proving, by reference to the grounds of objection, that an assessment is excessive.

8. AAT: failure to give reasons

In two somewhat related appeals from the AAT involving the operation of the general anti-avoidance provisions of Pt IVA ITAA36, the Full Federal Court (O’Callaghan, McEvoy and Needham JJ) unanimously held in each case that the appeal from the AAT be allowed and that each proceeding be remitted to the AAT for the hearing and determination of an identified question or questions (*Grant v FCT*²; *Collie v FCT*³).

More particularly, in each case, the Full Federal Court held that the AAT:

- failed to comply with s 43(2B) of the *Administrative Appeals Tribunal Act 1975* (Cth) by not making reference to relevant evidence and other material in respect of its findings in relation to material questions of fact and thereby did not provide proper reasons;
- made material findings of fact not based on any rational evidence; and
- failed to have regard to relevant material and submissions that were put to it by the taxpayer.

In joint judgments, their Honours said that, in their view, there was in each case a “wholesale failure” of the tribunal to have regard to material evidence, to weigh in the balance competing submissions, and to provide adequate reasons for any of its conclusions.

The court said that, in the present cases, it was incumbent on the tribunal to ask and answer the question posed by s 177C ITAA36 by reference to the competing evidence and submissions which were before it. As was readily apparent from the tribunal’s reasoning, it did neither.

There was also in each case a ground of appeal relating to the “preposterous” delay in the tribunal delivering its decision some two and a half years after the hearing took place. Their Honours said, however, that they were not persuaded that any of the errors in the reasons of the tribunal might be inferred to be a product of the delay. As Gleeson CJ said in *NAIS v Minister for Immigration and Multicultural and Indigenous Affairs*:⁴

“5. Undue delay in decision-making, whether by courts or administrative bodies, is always to be deplored. However, that comfortable generalisation does little to advance the task of legal analysis when it becomes necessary to examine the consequences of delay. The circumstances in which delay, of itself, will vitiate proceedings, or a decision, are rare.”

The new tribunal

As a result of the enactment of the *Administrative Review Tribunal Act 2024* (Cth), the role of the AAT has, from

14 October 2024, been taken over by the Administrative Review Tribunal (ART). The ART has the same obligations that the AAT had under s 43(2B) of the *Administrative Appeals Tribunal Act 1975* (see s 111 of the *Administrative Review Tribunal Act 2024*).

9. Scheme promoter penalties

The Federal Court (Kennett J) has determined the amount of the civil penalties payable by two individuals (a Mr Bakarich and a Ms Nguyen) and two associated corporate entities under the scheme promoter penalty provisions of the *Taxation Administration Act 1953* (Cth) (TAA53) (*FCT v Bakarich* (No. 2)⁵).

More particularly, the Commissioner alleged contraventions of s 290-50(1), Sch 1 TAA53 on the part of each respondent by their conduct in promoting tax exploitation schemes that had the dominant purpose of obtaining R&D tax offsets for taxpayers where it was not reasonably arguable that those claims were available at law. These contraventions were admitted and the Commissioner sought civil penalty orders pursuant to the TAA53 and declarations of contraventions.

Mr Bakarich was the sole director, secretary and shareholder of the second respondent (The Dream Consortium Pty Ltd (TDC)) from the time of its incorporation on 16 March 2014 to 20 August 2019 when he was declared a bankrupt. Mr Bakarich had final responsibility for, and control over, the work of TDC during the relevant period in which the tax exploitation schemes occurred. In around December 2014, Mr Bakarich and Ms Nguyen resolved that they would carry on business together. That business was to be an accounting practice run by Ms Nguyen in association with TDC, providing accounting and finance functions to small businesses, and would via a corporate entity trade as The Dream Accountants (TDA).

It was common ground that Mr Bakarich, TDC and TDA had contravened the scheme promoter penalty provisions of the TAA53 in relation to the promotion of 12 tax exploitation schemes involving 11 taxpayers across the 2015 and 2016 financial years, and that Ms Nguyen did so in relation to three taxpayers across the 2015 financial year. Approximately \$591,000 was charged to clients for the schemes in which Mr Bakarich was involved and approximately \$16,000 for the schemes in which Ms Nguyen was involved. Had the schemes involving Mr Bakarich gone undetected, scheme participants would have been able to claim around \$7m in refundable tax offsets to which they were not entitled. Mr Bakarich also admitted that his conduct in respect of each of the schemes involved tax evasion.

Initially, Mr Bakarich actively resisted the allegations against him but eventually the Commissioner and Mr Bakarich jointly asked the court to make declarations by consent and impose an agreed penalty of \$4,500,000 on him in relation to the promotion of the 12 tax exploitation schemes.

Ms Nguyen admitted that she had contravened s 290-50(1) by engaging in conduct that resulted in her being a promoter of three tax exploitation schemes. The

Commissioner did not allege that the schemes as they related to Ms Nguyen involved tax evasion or that she knew of false representations.

The Commissioner alleged that TDC and TDA contravened s 290-50(1) by promoting the 12 tax exploitation schemes referred to above. TDC and TDA were defunct corporate entities. Kennett J said that he was satisfied that TDC and TDA had engaged in conduct which resulted in promoting the 12 tax exploitation schemes, therefore contravening s 290-50(1).

Section 290-50(5) requires the court, when deciding what penalty is appropriate, to have regard to “all matters it considers relevant” and provides a non-exhaustive list of factors that the court may have regard to. Kennett J said that, of these factors, (b) (the deterrent effect that any penalty may have) was to be given the greatest weight. It was well-established that the purpose of a civil penalty is “primarily, if not solely, the promotion of the public interest in compliance with the provisions of the Act by the deterrence of further contraventions of the Act” (*Australian Building and Construction Commissioner v Pattinson*⁶).

Other points made by Kennett J from the decided cases were that:

- the penalty should put a price on contravention that is sufficiently high to deter repetition by the contravener and by others who might be tempted to contravene;
- the penalty must not be seen as an “acceptable cost of doing business”;
- the penalty should be no greater than necessary to achieve deterrence and should not be so high as to be oppressive; and
- general deterrence is important in the context of tax exploitation schemes and particularly for those that exploit R&D tax incentives.

Further, where contraventions arise from a “course of conduct”, the penalty imposed should reflect that fact, otherwise there was a risk that the respondent would be doubly punished in respect of the relevant acts or omissions that made up the multiple contraventions.

In cases where multiple separate penalties are sought to be imposed on the contravener, the “totality” principle requires the court to be satisfied that the total penalty is not out of proportion to the overall misconduct by assessing the penalties as a whole to ensure that they are proportionate to the gravity of the contraventions.

Kennett J said that, although the proposed penalties were agreed as between the Commissioner and Mr Bakarich and Ms Nguyen respectively, the appropriate penalty amount was ultimately a matter for the court, having regard to all of relevant matters. The court should not act as a mere “rubber stamp”. Some of the established considerations that the court should take into account when determining whether the agreed penalty is appropriate are as follows:

- the appropriate penalty is not a “precise figure”, but rather a figure that falls within a “permissible range in all the circumstances”;

- the court should not ask whether it would have arrived at the same penalty in the absence of agreement and it should not reject an agreed figure simply because it would have been disposed to select some other figure; and
- the court should generally recognise that the agreed penalty is most likely the result of compromise and pragmatism on the part of the regulator, and so would reflect, among other things, the regulator’s considered estimation of the penalty necessary to achieve deterrence and the risks and expense of the litigation had it not been settled.

Where the court is “persuaded of the accuracy of the parties’ agreement as to facts and consequences, and that the agreed penalty jointly proposed is an appropriate remedy in all the circumstances”, it is “highly desirable” for the court to impose the proposed penalty. Further, accepting proposed agreed penalties promotes the predictability of outcomes for regulators and wrongdoers which may encourage entities to acknowledge contraventions and assist in avoiding lengthy litigation.

Kennett J was satisfied that the penalties proposed by the parties in relation to Mr Bakarich (total penalty \$4,500,000) and Ms Nguyen (total penalty \$100,000) were appropriate and should be imposed. In relation to TDC and TDA, his Honour said that he was satisfied that the entities had contravened s 290-50(1) and the Commissioner had demonstrated the appropriateness of the civil penalties sought (\$4,500,000 in each case).

TaxCounsel Pty Ltd
ACN 117 651 420

References

- 1 [2024] FCA 1370.
- 2 [2024] FCAFC 173.
- 3 [2024] FCAFC 172.
- 4 [2005] HCA 77.
- 5 [2024] FCA 1448.
- 6 [2022] HCA 13.



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Tax Tips

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New assessment amendment period

Recent legislative amendments have extended the period within which the Commissioner may amend an income tax assessment of a small or medium business entity.

Background

The *Treasury Laws Amendment (2024 Tax and Other Measures No. 1) Act 2024* (the 2024 amending Act), which became law on 10 December 2024,¹ has amended the income tax law to increase the period within which the Commissioner may amend an assessment of a small or medium business entity that is an individual, a company or the trustee of a trust where the amendment period would otherwise be two years.

More particularly, prior to the amendments, the standard period within which the Commissioner could amend an assessment of a small or medium business entity (either on an amendment application by the entity or on the Commissioner's own initiative) was two years after the day on which the Commissioner gave notice of the assessment to the entity. After the expiry of this limitation period, the Commissioner was generally not able to amend such an assessment unless an exception applied, for example, the exceptions that apply in relation to giving effect to an objection decision, where there is fraud or evasion, or where a tax avoidance scheme is involved.

It was explained in the explanatory memorandum² that the relatively short statutory limitation period of two years was intended to provide swift certainty for small and medium business entities about their income tax liabilities. However, this timeframe had led to an increased number of these taxpayers seeking an extension of time to lodge an objection to an assessment and pursuing appeals of objection decisions by the Commissioner, resulting in increased administrative burdens for such taxpayers and the Commissioner.

The amendments made by the 2024 amending Act are intended to alleviate some of these administrative and financial burdens for both taxpayers and the Commissioner by increasing the amendment period from two to four years where the initial two-year amendment period has expired and the taxpayer has applied for an amendment. The taxpayer has no right of objection in relation to any

amended assessment that the Commissioner may make during this further two-year amendment period.

This article considers aspects of the operation of the new two-year amendment period. The statutory provisions that govern the amendment of assessments are somewhat complex and this article seeks to draw attention to the more significant aspects of the recent amendments.

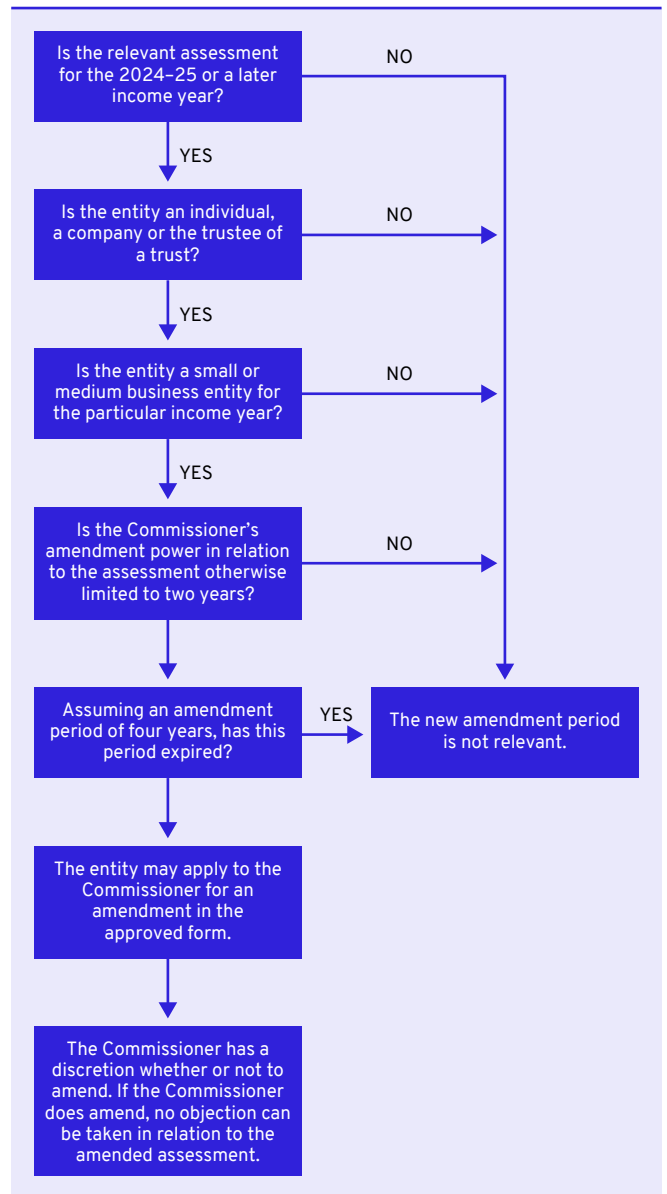
Diagram 1 summarises the effect of the 2024 amending Act.

The Commissioner's amendment powers

The Commissioner's general powers in relation to the amendment of an income tax assessment are provided for in s 170 of the *Income Tax Assessment Act 1936* (Cth) (ITAA36).

Putting to one side circumstances where the Commissioner's power to amend an assessment is not

Diagram 1. The new amendment rules



accompanied by a time constraint (for example, where the Commissioner is of the opinion that there has been fraud or evasion), the broad position is that the Commissioner may only amend an income tax assessment within a prescribed period (two or four years), calculated from the day on which the Commissioner gave notice of the assessment to the taxpayer.

As indicated, one circumstance where the two-year amendment period is relevant is where the taxpayer (whether an individual, a company or the trustee of a trust) is a small or medium business entity at any time during the income year to which the amendment would relate.³

The recent amendments

In broad terms, the effect of the amendments made by the 2024 amending Act is to provide for a four-year amendment period in relation to assessments of small or medium business entities, but to prohibit an objection being taken where the first two years of the four-year amendment period has elapsed. The example below illustrates this.

The principal amendment made by the 2024 amending Act was the insertion of a new item (item 3A) into the table in s 170(1) ITAA36. That new item reads as follows:

“170 Amendment of assessments

- (1) The Commissioner may amend an assessment as follows:

Amendment of assessments

Time of amendment	Qualification
...	
3A The Commissioner may amend an assessment of an individual, a company or a person (in the capacity of a trustee of a trust estate) for a year of income within 4 years after the day on which the Commissioner gives notice of the assessment to the taxpayer if:	This item is subject to items 5 and 6.”
(a) the individual, company or trust is a small business entity or a medium business entity for the year; and	
(b) the individual company or trustee, applies for an amendment in the approved form before the end of that 4 year period; and	
(c) the Commissioner could amend the assessment within 2 years under item 1, 2 or 3; and	
(d) the period within which the Commissioner could amend the assessment under item 1, 2 or 3 has ended.	

The Commissioner may amend the assessment to give effect to the decision on the application.

Item 5 of the table, which is referred to in the “Qualification” column for item 3A, relates to the situation where there is fraud or evasion, and item 6 applies in relation to an amendment that is needed to give effect to a decision on a review or an appeal or as a result of an objection made by the taxpayer or pending a review or an appeal.

The 2024 amending Act also inserted subs (2A) into s 170 ITAA36, which reads as follows:

“(2A) The Commissioner cannot amend an amended assessment under item 3A of the table in subsection (1) if the period of 4 years after the day on which the Commissioner gives notice of the original assessment concerned has ended.”

This subsection effectively limits the Commissioner’s amendment power in relation to item 3A of the table to the period of four years.

Further, the 2024 amending Act amended the *Taxation Administration Act 1953* (Cth) (TAA53) to prevent an objection from being lodged by a small or medium business entity against an assessment once the initial two-year amendment period has expired.⁴

It will be noted that the extended amendment period provided for by item 3A commences when the two-year amendment period under item 1, 2 or 3 of the table in s 170(1) has expired (see para (d) in item 3A of the table). This ensures that only one amendment period applies for a taxpayer at any one time. This is intended to provide certainty about how the amendments interact with other parts of the ITAA36.

The explanatory memorandum⁵ states that, while the Commissioner may amend an assessment within the extended amendment period, the Commissioner is not required to make a requested amendment. The explanatory memorandum points out that this is consistent with the discretionary nature of the Commissioner’s existing amendment powers. This approach means that the Commissioner may decline to make an amendment if the Commissioner becomes aware that the application would result in the assessment not correctly reflecting the taxpayer’s taxable income if the requested amendment were made.

Any amendment made by the Commissioner to give effect to the decision on the taxpayer’s amendment application must be made within four years after the day on which the Commissioner gave notice of the assessment to the taxpayer. Section 173 ITAA36 provides that an amended assessment is an assessment. Therefore, the amendment periods set out in the table in s 170(1) apply equally in respect of amended assessments. To prevent the amendment period from being refreshed in perpetuity, the Commissioner is prevented from amending an amended

assessment if the four-year period in respect of the original assessment has ended.

However, as a result of an amendment made by the 2024 amending Act, the Commissioner may amend an amended assessment about a particular in the way provided for in the table in s 170(3) within two years after notice of that amended assessment is given to the taxpayer if the four-year amendment period under item 3A of the table in s 170(1) applies in respect of the original assessment.

Extension of time to object

Where the period for the lodgment of an objection against an assessment has expired, the TAA53 provides that the taxpayer may nevertheless lodge the objection with the Commissioner, together with a written request asking the Commissioner to deal with the objection as if it had been lodged within the relevant period.⁶ The request must state fully and in detail the circumstances concerning, and the reasons for, the person's failure to lodge the objection with the Commissioner within the required period.

While these provisions remain relevant where a taxpayer wishes to object against an assessment to which item 1, 2 or 3 of the table in s 170(1) applies, they are not relevant in relation to item 3A.

Commencement of the amendments

The amendments made by the 2024 amending Act apply in relation to assessments issued after 1 January 2025 (the commencement date of Sch 3 to the 2024 amending Act) for income years starting on or after 1 July 2024.⁷

Small or medium business entities

The amendments made by the 2024 amending Act only apply where the taxpayer is a small or medium business entity.

In broad terms, for an entity to be a "small business entity", the entity must carry on a business and satisfy a \$10m aggregated turnover test.⁸

A "medium business entity" is an entity that is not a small business entity but would be a small business entity if the aggregated turnover test applied by reference to an aggregated turnover of \$50m (rather than \$10m).⁹

Example

The following example illustrates some aspects of the operation of the amendments made by the 2024 amending Act.

Example

Going Good Pty Ltd, which at all relevant times is a medium business entity, lodged its income tax return for the 2024–25 income year on 10 December 2025. It is assumed that this is the day on which the Commissioner gives notice of the assessment to the

Example (cont)

taxpayer for the purposes of item 3A of the table in s 170(1). The company's income tax return disclosed a capital gain from the disposal of a CGT asset. Subsequently, it is discovered that it is reasonably arguable that an amount of \$80,000, which was overlooked when preparing the company's return for the 2024–25 income year, is in fact a cost base element of the asset that was disposed of.

Scenario 1

The cost base mistake is discovered and an application for the amendment of the 2024–25 assessment is made to the Commissioner on 15 February 2026. Under item 2 of the table in s 170(1), the Commissioner may amend the 2024–25 assessment within two years of 10 December 2025. If the Commissioner declines to amend the assessment, Going Good Pty Ltd could lodge an objection against the assessment. The objection would need to be lodged by 10 December 2027 (unless the Commissioner were to grant a further period within which to object).

Scenario 2

The cost base mistake is not discovered until 28 July 2028 and an application for the amendment of the 2024–25 assessment is made to the Commissioner on 10 August 2028. Under item 3A of the table in s 170(1), the Commissioner may amend the assessment up until 10 December 2029. If the Commissioner declines to amend the assessment, Going Good Pty Ltd could not lodge an objection against the assessment.

If the Commissioner does not amend

As indicated above, where a small or medium business entity applies to the Commissioner to amend an assessment under the power of amendment conferred by item 3A of the table in s 170(1) but the Commissioner declines to make the amendment, the taxpayer does not have any remedy.

Where the requirements of item 3A are otherwise met, the item provides that the Commissioner "may" amend an assessment. It would seem to be clear that this confers a discretion on the Commissioner,¹⁰ the exercise of which could not be challenged.

Further, a decision of the Commissioner to decline to amend an assessment in reliance on item 3A would not be a decision to which the *Administrative Decisions (Judicial Review) Act 1977* (Cth) could apply.¹¹

Observations

While the amendments made by the 2024 amending Act will authorise the Commissioner to make an amendment to an assessment of a small or medium business entity within a further two years, there is, as has been noted, no mechanism available for the taxpayer entity to challenge

any decision of the Commissioner to refuse to amend the assessment.

This may mean that small and medium business entities will still need to examine their returns and assessments before the expiration of the initial two-year amendment period to identify any possible need to take protective measures by lodging an objection before the expiration of the initial two-year amendment period provided for by item 1, 2 or 3 of the table in s 170(1) ITAA36. And if that initial two-year amendment period has expired, the possibility of lodging an objection with a written request asking the Commissioner to deal with the objection as if it had been lodged within that period may need to be considered.

Although there is now an extra two years within which the Commissioner may amend an assessment of a small or medium business entity, there will be circumstances in which the lateness of an application for an amendment may, in practical terms, mean that the Commissioner cannot amend the assessment (for example, if the amendment application is lodged just before the end of the four-year amendment period).

An application for an amendment to be made within the extra two-year period must be made in the approved form. The terms of the approved form will be of some interest.

A further point to note is that the power of amendment conferred on the Commissioner by item 3A is limited to an amendment that gives effect to the Commissioner's decision on the amendment application. This would presumably include any needed consequential amendments to the assessment. However, if the Commissioner was aware that an unrelated increasing amendment, while also needed for the assessment to be correct, cannot be made because the amendment application did not request it, this may be a factor that the Commissioner takes into account when making a decision in relation to the amendment application.

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References

- 1 The amendments, which are contained in Sch 3 to the 2024 amending Act, partially implement the "Driving collaboration with small business to reduce the time spent complying with tax obligations" measure in the 2023–24 Budget.
- 2 To the amending Bill that became the *Treasury Laws Amendment (2024 Tax and Other Measures No. 1) Act 2024* (see paras 3.3 and 3.15). References to the explanatory memorandum in this article are references to this explanatory memorandum.
- 3 Items 1, 2 and 3 of the table in s 170(1) ITAA36.
- 4 S 14ZW(1)(aa)(i) and (1A)(b)(i) TAA53.
- 5 See para 3.15.
- 6 S 14ZW(2) and (3) TAA53.
- 7 See item 6 of Sch 3 to the 2024 amending Act.
- 8 S 328-110 of the *Income Tax Assessment Act 1997* (Cth).
- 9 S 170(14) ITAA36.
- 10 See s 33(2A) of the *Acts Interpretation Act 1901* (Cth); *Commissioner of State Revenue v ACN 005 057 349 Pty Ltd* [2017] HCA 6; and *Finance Facilities Pty Ltd v FCT* [1971] HCA 12.
- 11 See para (e) of Sch 1 to the *Administrative Decisions (Judicial Review) Act 1977* (Cth).



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Darren Adams

Director

Darren Adams & Co, Drouin, Victoria

Darren proves to us that you really can have it all! A father of two and owner of accounting firm Darren Adams & Co, Darren walks us through his experience studying CTA1 Foundations with The Tax Institute.

Early career and education

Darren has spent over 15 years building a successful career in public practice. Located in Drouin, in Gippsland, Victoria, Darren's firm serves a variety of clients, but it's the relationships he builds with those clients that make his work in tax so rewarding.

"We public practitioners become more than just tax advisers. We become a sounding board for matters that aren't always tax-related", he reflects.

Growing up in Gippsland, Darren had limited accounting career options that also allowed him to stay close to home. Public practice was the most viable path, and from there, his journey in tax began. After completing a bachelor's degree at Monash University, he completed the CPA Program and is working towards a Graduate Certificate in Applied Tax Advisory through The Tax Institute. He also plans to earn his Chartered Tax Adviser (CTA) designation.

CTA journey

When asked about his experience studying CTA1 Foundations, the first subject in both the Graduate Certificate in Applied Tax Advisory and the CTA program, Darren says the course took him back to the basics.

"A lot of our job is now automated with technology, but this subject brought me back to the fundamentals that are crucial to understanding the tax system."

Balancing the demands of owning a practice with family life has been a challenge for Darren, especially as he and his wife raise two children, one of whom is on the autism spectrum. His routine of early mornings and flexible work



hours has allowed him to find time for study. "The flexibility of being self-employed and having the support of my wife and kids allowed me to succeed", he explains.

Thoughts on continuous learning

Darren's advice for other tax professionals considering further study is to continue improving their knowledge, no matter how far they've come in their careers. His plans for the future include completing the Graduate Certificate in Applied Tax Advisory, achieving the CTA designation, and eventually pursuing a Graduate Diploma of Applied Tax Law. For Darren, learning never stops, and his dedication to mastering tax ensures that he will continue to grow personally and professionally.

Unit trusts: some practical insights

by Peter Slegers, CTA, Director,
Carlie Frantzis, ATI, Lawyer, and
Amy Lancaster, ATI, Lawyer, Tax &
Revenue Group, Cowell Clarke

Unit trusts have a wide application in commerce, particularly in the property sector, offering the flexibility of a trust structure but with the certainty more often found in corporate structures. This article will revisit the fundamental legal nature of a unit trust and the concept of units. It will then review the merits of the modern unit trust structure, comparing it with other typical business and asset holding structures such as private companies and partnerships of discretionary trusts. It will also take a closer look at some of the common but nonetheless challenging tax issues that arise when advisers are dealing with unit trust structures. The authors' review is limited to private unit trusts and does not address public or listed unit trusts. It is hoped that this article will provide advisers with greater insight into this commonly used but sometimes misunderstood business and investment vehicle.

For many decades, unit trusts have been a mainstay of commercial and tax structuring activity in Australia, particularly, but not exclusively, in the property sector.

Unit trusts are unique, providing for the derivation of pre-tax income and substantial flexibility,¹ while also providing the certainty more typically found with corporate structures.

This article will revisit the fundamentals of unit trusts before delving into some of the critical but often overlooked tax issues. In so doing, it will highlight many of the advantages and disadvantages of unit trust structures, planning opportunities and potential pitfalls.

While unit trusts have a wide commercial application and commonly feature as public or even listed entities, the focus of this article will be on private unit trusts.

What precisely is a unit trust?

Background

References to “unit trusts” and “units in a unit trust” are to be found throughout the income tax legislation.² Yet, for

the most part, a helpful definition of a “unit trust” remains elusive.

Under the general law, a “unit trust” in common with a “discretionary trust” does not have any constant, fixed normative meaning.³ It therefore largely remains a term of commercial convenience.

In many ways, the state and territory tax laws possibly come the closest to describing, rather than defining, what your everyday tax adviser would regard as a fair, albeit crude, description of a unit trust when they typically make reference to trust schemes in which persons hold units.⁴ In other words, a unit trust may simply be regarded as a trust in which the equity interests are expressed as units.

The first unit trust was reputedly launched in the United Kingdom in 1931, inspired by the comparative durability of United States mutual funds through the Wall Street crash of 1929.⁵ Australian law followed suit in 1935, with the unit trust becoming an important segment of the Australian public investment market.⁶

The popularity of a unit trust as a private investment vehicle, however, did not gain traction until the 1960s, at which point such structures became increasingly used due to their significant tax advantages over corporate structures at the time.⁷

Nature of units

The starting point for gaining a better understanding of the nature of a unit trust is the High Court decision in *Charles v FCT*⁸ (*Charles*). In that decision, the Commissioner of Taxation sought to tax distributions to unitholders that partly comprised of capital receipts in the hands of the trustee. The High Court found for the taxpayer and viewed the capital receipts as maintaining the same character in the hands of the unitholders as they had in the hands of the trustee.

The case is significant in that the High Court made some seminal observations in relation to the nature of a unit in a unit trust. The following passage from the judgment is particularly instructive:

“11. At first sight it may seem that a person who invests in units under a trust deed such as that which is here in question does so with a view to obtaining the half-yearly distributions for which the deed provides, just as he might have bought shares in an investment company with a view to deriving half-yearly dividends from them; and that the periodical distributions received should be regarded as income in the one case just as they would be in the other ... But [this] view is untenable, for a unit held under this trust deed is fundamentally different from a share in a company. A share confers upon the holder no legal or equitable interest in the assets of the company; it is a separate piece of property; and if a portion of the company's assets is distributed amongst the shareholders the question whether it comes to them as income or as capital depends on whether the corpus of their property (their shares) remains intact despite the distribution ... But a unit under the trust deed before

us confers a proprietary interest in all of the property which for the time being is subject to the trust of the deed ...; so that question whether monies distributed to unitholders under the trust form part of the income or their capital must be answered by considering the character of those monies in the hands of the trustee before the distribution is made.”

Thus, a unit in a unit trust, or at least a unit trust of the kind that was considered in *Charles* case, is to be treated as a proprietary interest in the underlying trust property itself.

The far more recent High Court decision in *CPT Custodian* maintained this view but emphasised that any analysis of units in a unit trust will significantly depend on the provisions of the trust deed. In that case, the High Court rejected the Commissioner of State Revenue’s argument that a unitholder in a land-owning unit trust owned an interest in the land itself.

At first glance, it may be difficult to reconcile these two High Court decisions. However, it is clear that much reliance was placed on the specific provisions of the trust deed of the unit trust in both cases, a point that the High Court emphasised in *CPT Custodian*:

“36. The deed considered in *Charles* divided the beneficial interest in the trust fund into units ... and the trustees were bound to make half-yearly distributions to unit holders, in proportion to their respective numbers of units, of the ‘cash produce’ which had been received by the trustees ... [The taxpayers in this case] rightly stress that the deeds with which this litigation is concerned were differently cast and in terms which do not support any direct or simple conclusion respecting proprietary interests of unit holders such as that reached in *Charles*.”

Thus, a thorough examination of the nature of the interests under the trust deed is critical to determining the legal nature of the unitholder’s interests.

This may often impact on the outcomes of various statutory provisions, particularly under state and territory duty and land tax laws. The fundamental nature of a unit in a unit trust may, however, be less significant when it comes to federal income tax legislation, where the overall design of the CGT regime in particular often treats units, for all intents and purposes, as discrete property (rather than a proprietary interest in the underlying trust property). Thus, in many ways under the CGT regime, units in a unit trust are treated in the same or a similar manner to shares in a company.⁹

Tax features of modern unit trusts

The utility of the modern private unit trust as a structuring vehicle for investments and business is best demonstrated by considering some of the salient tax attributes of unit trust structures. There are endless comparisons that can be made between the tax features of unit trusts and other vehicles such as companies and discretionary trusts (including partnerships of discretionary trusts). The authors’ comments are limited to the following five major points.

First and foremost, unit trusts are not taxed as entities. That is to say, either the trustee or, more typically, the unitholders (as presently entitled beneficiaries under Div 6 ITAA36) are subject to tax on the unit trust’s net income.

On the basis that a present entitlement generally arises each income year under the trust deed as a matter of practice (see further below), unit trusts are often viewed as “flow-through” vehicles in which the unitholders derive pre-tax receipts that are only subject to assessment at the unitholder level. In this respect, they share a common attribute with partnerships.

This “flow-through” nature of a unit trust has two distinct advantages, namely:

1. it allows the identity of the unitholder to determine the tax treatment of the assessable income which may allow for greater flexibility where the unitholders are discretionary trusts or significant tax concessions where the unitholders are self-managed superannuation funds (SMSFs); and
2. the pre-tax nature of the income derived by a unit trust may mean that unitholders with tax losses from other activities are able to offset those tax losses against the income they derive from the unit trust as a presently entitled beneficiary.¹⁰

A second useful feature of a unit trust for tax purposes is that (in common with companies) it is possible to raise equity without a CGT event. That is to say, the issue of units in a unit trust (as with the issue of shares in a company) is an acquisition and not a disposal/CGT event.¹¹ The units of course need to be issued at their market value to prevent the general value shifting measures from arising, but otherwise no adverse tax issues should ordinarily arise from the issue of units.¹²

A third, possibly less common, advantage of a unit trust is in circumstances where the unit trust itself derives tax losses. In the authors’ experience, it is often possible to effectively inject income from discretionary trusts to a loss unit trust in order to absorb those losses. Critically, the discretionary trusts must have fixed entitlements in the unit trust’s income or capital for the purposes of the trust loss measures.¹³ By comparison, injecting income into a loss company raises a number of challenges, including compliance with the sometimes ponderous company loss provisions.¹⁴

A fourth advantage of a unit trust (in this case, over a company) is that it is not subject to Div 7A ITAA36. That is not to say that Div 7A does not apply to unit trusts that are part of a group, but normally a private company needs to exist elsewhere in the group for Div 7A to have any application. If you are only dealing with a unit trust and other trust structures (with the only companies in the group being trustee companies), then no Div 7A issues should arise.

Finally, it might be said that, while accessing tax-sheltered amounts from unit trusts poses its challenges (see the commentary on CGT event E4 below), it is possibly less

challenging than accessing such amounts from companies. Indeed, returning value to shareholders, whether on an interim basis or on a winding-up of a company, is generally a more challenging exercise than returning value to unitholders. Where s 104-70 ITAA97 (CGT event E4) applies, it is generally not as detrimental as where a tax-sheltered amount is treated as a dividend and, on account of the balance not having been subject to tax, as an unfranked dividend.¹⁵

While the advantages set out above need to be weighed against some of the problems that arise in the case of unit trust structures, unit trusts are certainly worth bearing in mind in any structuring exercise.

Use in the property sector

Possibly the greatest industry use of unit trusts is in the property sector. That is to say, in many ways, unit trusts may make for the best vehicle to hold real property between arm's length parties. This is for the reasons that follow.

First, unlike companies, unit trusts (with non-corporate unitholders) will generally qualify for the general CGT discount of 50% for discretionary trust unitholders or 33.33% for SMSF unitholders. This is particularly significant for capital-appreciating assets, particularly where the small business CGT concessions may be inaccessible due to the property being leased or the net asset values or turnover of the business using the property exceeding the small business thresholds. Even where the CGT discount is not available on the basis that property development is being undertaken (which will generate revenue rather than capital gains), the pre-tax nature of the profits allows for the often-generated tax losses (not only from unsuccessful developments, but also from start-up losses) to be used tax effectively.

Second, the syndicated nature of investments in the property sector often means that the ability to raise capital is much preferred through a unit trust structure. If one compares a number of arm's length discretionary trusts investing in a property (which will generally amount to a general law partnership) as opposed to the same discretionary trusts investing in a unit trust, the obvious advantage is the ability to introduce new investors without a CGT event, as well as the ease of administration dealing with units rather than the disposal and acquisition of fractional interests.¹⁶

Last, the ability to borrow at the level of the trustee of a unit trust also makes it far preferable to any direct investment of entities, for instance, where a syndicate of SMSFs together invest in the acquisition of a commercial building.

Significant provisions of the trust deed

Distinct issues for unit trusts

Many of the issues to consider when reviewing the trust deed of a discretionary trust will have equal relevance when reviewing the trust deed of a unit trust.¹⁷

Some distinct issues when reviewing a unit trust deed include the following:

- reviewing the unitholder's entitlement to the trust property. This will be important when establishing whether the trust is a "fixed trust" for the various provisions of the income tax legislation dealing with this concept (see below);
- considering the manner in which units are issued, transferred and redeemed. This is critical to managing the entry, exit and variation of entitlements of equity holders in the unit trust. The provisions governing the issue and redemption of units, and whether this is carried out at market value, will also have relevance when determining the application of the trust loss measures;¹⁸ and
- governance issues relating to management of the unit trust between the trustee and unitholders, including the removal and appointment of the trustee (normally, there is no concept of an appointor and the change of trustee is effected by an ordinary or special resolution of unitholders).

One particularly critical issue for unit trust deeds is to ensure that the trust deed provides an express provision to exempt the trust from the *Broomhead* principle. In *JW Broomhead (Vic) Pty Ltd (in liq) v JW Broomhead Pty Ltd*,¹⁹ the Victorian Supreme Court determined that the beneficiaries of a fixed trust were impliedly required to indemnify the trustee against all losses incurred in carrying on the activities of the trust. This exposes the personal assets of each unitholder to a claim by the trustee of the unit trust should the unit trust have insufficient assets to indemnify the trustee against its losses. However, the court's decision made it clear that the implied indemnity is subject to the terms of the trust deed and can be ousted by an express provision.²⁰ Most unit trust deeds will contain such an express provision to exclude this right of indemnity. However, in the authors' view, it is always worthwhile reviewing the trust deed for this provision, especially given the consequences of the *Broomhead* principle applying.

Present entitlement and part-year distributions

A hallmark of the conventional unit trust is that the unitholders are given a fixed right to income and capital based on the unitholder's proportion of the total issued units (of the same class) in the trust at the end of each income year.

A significant issue arises, therefore, where units in a unit trust are sold and purchased part-way through an income year. This is on the basis that:

- the former unitholder will not, as a matter of course, obtain the benefit of having owned the units for part of the income year;
- the new unitholder will obtain the benefit of having owned the units for a full income year even though the new unitholder only owned the units for part of the income year; and

- the new unitholder may be assessed to tax for the whole of the income year even though they only owned the units for part of that income year.

One way that this issue can be addressed is by drafting the sale and purchase of units agreement such that the purchase price is adjusted to account for part of the year-end distribution. The adjustment might ensure that the former unitholder receives an increase in the purchase price for their units up to that part of the income year in which they were still a unitholder less an estimate of the tax liability that will arise to the new unitholder for the tax arising on that part of the income year in which they were not a unitholder. Of course, a similar proportionate adjustment would be made if the vendor and purchaser are not selling and buying all of their units but only selling and buying a proportion of units.

An alternative approach to making adjustments under the sale and purchase of units agreement would be for the trustee to rely on a power under the trust deed to make an interim distribution of income to unitholders in proportion with their unitholding at the time of sale and then to make a further part-distribution on 30 June. One downside with this approach is that all of the unitholders (of the same class) would need to receive the interim distribution and not just the unitholders selling or purchasing units. Another downside with this approach is that any income tax liability factored into an interim distribution made by a trustee of a unit trust is necessarily based on an estimate of the income which the trust will have derived at year-end, which may not correspond with the actual income tax liability of the unitholder at year-end.

“Care needs to be taken in the manner in which the tax-sheltered amount arising from the general CGT discount is accessed.”

The approach of adjusting the purchase price for the units under the sale and purchase of units agreement will have slightly different tax and duty outcomes for the vendor and purchaser. To this end, increasing the purchase price to account for part of the year-end distribution that the unitholder is entitled to receive will benefit vendors that are individuals or discretionary trusts as they will be able to apply the 50% discount to the whole of the capital gain and not pay income tax on part of the year-end distribution.

However, increasing the purchase price will disadvantage the purchaser as the purchaser will need to source further funds to acquire the units and may also have a greater duty impost, particularly where the increased purchase price exceeds the market value of the units. Of course, one benefit to the purchaser in paying a higher purchase price is that the units will have a higher cost base.

The income tax benefits to the vendor on an increase of the purchase price under the sale and purchase of units agreement may be managed by reducing the increase to the purchase price by the amount of income tax which the vendor would have paid on the year-end distribution on the relevant units.

The above complexities can be overcome if the sale and purchase transaction settles on 1 July of the relevant income year as there would be no need for the trustee of the unit trust to make an interim distribution, and any adjustments to the purchase price would be minimal.

Fixed versus non-fixed trusts

General observations

The tax implications of a transaction involving a unit trust vary considerably depending on whether the unit trust is treated as a “fixed trust” or a “non-fixed trust”. Similarly, different tax outcomes will arise depending on whether or not unitholders have fixed entitlements in the trust.

It may be desirable to structure a unit trust as a fixed trust (or a trust with fixed entitlements) for a number of reasons. These include:

- satisfying the relevant tests for unit trusts that qualify as fixed trusts when applying tax losses under the trust loss measures of Sch 2F ITAA36;
- for the purposes of the holding period rules for franking credits on franked dividends derived by a unit trust;²¹ and
- so that the income derived by an SMSF that holds units in a unit trust is not deemed to be non-arm’s length income (NALI) and therefore subject to a penal tax rate of 45%.²²

For completeness, a summary of the provisions of the income tax legislation that directly or indirectly rely on a trust being a fixed trust or a unitholder having a fixed entitlement is set out in the Appendix to this article.

Trust loss measures

A trust will be a “fixed trust” for the purposes of Sch 2F ITAA36 if persons have fixed entitlements to all of the income and capital of the trust.²³

Section 272-5(1), Sch 2F ITAA36 in turn provides as follows in relation to “fixed entitlements”:

“If, under a trust instrument, a beneficiary has a vested and indefeasible interest in a share of income of the trust that the trust derives from time to time, or of the capital of the trust, the beneficiary has a **fixed entitlement** to that share of the income or capital.”

The terms “vested and indefeasible” are not defined in the tax legislation and, accordingly, bear their ordinary meaning.²⁴ This is subject to the “savings rule” in s 272-5(2) (see further below).

The Federal Court in *Walsh Bay Developments Pty Ltd v FCT*²⁵ (*Walsh Bay*) commented that a vested interest is one where the holder has an “immediate fixed right to present or future enjoyment”. That is, the holder is in an unfettered position to demand payment of the share of the income.

This can be contrasted to what is properly described as a contingent interest, where the holder's right to demand payment depends on the occurrence of an event which may or may not take place. It is important to note that a condition of possession will not constitute a contingency.²⁶ For example, where the right to a portion of the trust income is unconditional but the holder's right to gain actual possession of that income is conditional on that amount first being properly determined, the holder's interest will still be a vested interest.

As to whether a vested interest is defeasible, the Federal Court in *Walsh Bay* went on to comment that a defeasible interest is an interest where the holder's right to demand payment is subject to be defeated by the operation of a subsequent condition or supervening event.²⁷ The Federal Court in *Walsh Bay* noted that the distinction between a contingent interest and a defeasible interest is not always easy to apply.²⁸ The distinction can be drawn as follows: a contingent interest is an interest which only arises on the occurrence of an event, whereas a defeasible interest is an interest which has already arisen but is subject to be withdrawn on the occurrence of an event. An indefeasible interest, as opposed to a defeasible interest, is one that is not subject to any such condition or event.

By way of further guidance, the Federal Court in *Colonial First State* held that an interest will be indefeasible in the context of Sch 2F if it cannot be terminated, invalidated or annulled. This requires an analysis of whether there is any circumstance in which the trustee (or any other person) could terminate, invalidate or annul a beneficiary's entitlement to their share of the income or capital of the trust.

In *Colonial First State*, the Federal Court held that a power to modify, replace or repeal the constitution (effectively the trust deed in that case) of a wholesale fund meant that the interests of the unitholders in the fund were defeasible for the purposes of Sch 2F. In PCG 2016/16, the Commissioner cites *Colonial First State* as authority for the assertion that "broad" powers of amendment will cause unitholders' interests under a trust deed to be defeasible (and therefore render the trust a non-fixed trust).

In PCG 2016/16, the Commissioner also provides a number of examples of common powers in modern trust instruments that the Commissioner considers will cause a beneficiary's interest to be defeasible, namely:

- a power to issue new units after the trust is settled or to redeem existing units (subject to the "savings rule" (see below));
- a power to reclassify existing units so that they do not all have equal rights to receive the income and capital of the trust;
- a power to reclassify receipts as being on income or capital account where the units that have been issued do not all have the same rights to receive the income and capital of the trust;
- a power to appoint a beneficiary's interest in the income or capital of the trust to another beneficiary;

- a power to settle or appoint any part of the corpus of the trust fund to a new trust with different beneficiaries; and
- a power to enforce the forfeiture or cancellation of partly paid units due to the non-payment of a call, except where such partly paid units would be void ab initio.²⁹

The "savings rule" in s 272-5(2), Sch 2F ITAA36 provides relevantly that, if units in an unlisted unit trust are redeemable (or further units are able to be issued) for a price that is determined on the basis of the net asset value according to Australian accounting principles, the mere fact that the units are redeemable (or that further units may be issued) does not result in the interests of the unitholders being defeasible. The implication generally to be drawn from this provision is that, if units are able to be issued or redeemed (other than at their net asset value according to Australian accounting principles), the interests of the unitholders *will* be defeasible and therefore will not amount to fixed interests in the capital of the trust.

In light of the above, it can be seen that it is often difficult for many conventional unit trusts to satisfy the definition of a "fixed trust" within the meaning of the trust loss provisions.

NALI provisions

SMSFs are often used as unitholders in unit trusts. Therefore, it is necessary to consider the trust deed and other surrounding circumstances to ensure that the income of the SMSF is not treated as NALI and taxed at the top marginal rate.

Section 295-550(4) ITAA97 broadly provides that income derived by a complying superannuation fund as a beneficiary of a trust, other than because of holding a fixed entitlement to income, is NALI.

The Commissioner adopts the view that, in the context of the NALI provisions, the concept of "fixed entitlement" is designed to test whether the amount of trust income was included in the income of the superannuation fund because the fund has an interest in the income that was vested immediately before the income was derived by the trustee.³⁰

As described above, the legal concept of a "vested interest" relies on the holder having an immediate fixed right of present or future enjoyment, which in turn requires that:

- the identity of the beneficiary is established; and
- that beneficiary's right to the interest (as distinguished from their right to possession) must not depend on the occurrence of some event.³¹

That is to say, a vested interest is one that is bound to take effect in possession at some time and which is not contingent on any event occurring. This is to be contrasted with a contingent interest, which gives no right at all unless or until some future event happens (such as the exercise of a discretion by the trustee).³²

Therefore, in circumstances where the unitholder of a unit trust has a right to income of the trust that is susceptible to measurement and which is not contingent on any event

occurring (such as the exercise of a discretion by the trustee), there should be a basis for characterising that interest as a fixed entitlement to income.

This is consistent with the Commissioner's comments in TR 2006/7 regarding the policy for the introduction of the NALI provisions (insofar as they apply to trust distributions). In particular, the Commissioner states that these provisions are intended to distinguish between investment returns on fixed entitlements in unit trusts and distributions made to persons as beneficiaries of discretionary trusts resulting from the exercise of discretions.

Commissioner's discretion and safe harbour

Under the trust loss provisions, the Commissioner is provided with a discretion to treat a beneficiary's interest in a trust that would not otherwise be fixed as constituting a fixed entitlement.³³

The Commissioner's PCG 2016/16 also outlines a "safe harbour" compliance approach. The safe harbour allows trustees of certain trusts to manage the trust's tax affairs as if the Commissioner has exercised the discretion, without the trustee having to apply to the Commissioner for the exercise of that discretion.³⁴ If absolute certainty is required, however, an application can be made to the Commissioner for the exercise of the discretion in any given case (rather than self-assessing on the safe harbour).

For completeness, it should be noted that the safe harbour compliance approach under PCG 2016/16 only applies in the context of the trust loss provisions in Sch 2F ITAA36. It does not apply to other measures that might rely on a unitholder having fixed entitlements in the trust.

Practical observations: how to structure a fixed trust

Care is clearly required when seeking to establish a fixed trust or when amending a trust deed to ensure that it meets the requirements of a fixed trust.

In the authors' experience, the preferred approach is to draft the trust deed (or deed amendment) on the basis that the trust is structured as a fixed trust as far as is possible under the law, but at the same time recognising the potential uncertainties in this area. For example, the following factors should be considered when drafting or amending a trust deed for fixed trust purposes:

- ensuring that the trustee does not have a discretion to make differential distributions of trust income or capital between the unitholders, and instead requiring the net income and capital to be distributed in proportion to the units held by the respective unitholders;
- ensuring that there is no power to issue or redeem units in the trust other than for a price based on the net asset value according to Australian accounting principles;
- ensuring that the deed provides that all new units are of the same classes, carry identical rights, and are issued in the same proportions as the existing units already on issue from time to time;

- ensuring that there is no power to reclassify existing units in the trust or to designate new units into classes;
- ensuring that there is no power to reclassify receipts as being on income or capital account (ie that there is no "income recharacterisation" power);
- ensuring that there is no power to appoint a beneficiary's interest in the income or capital of the trust to another beneficiary;
- ensuring that there is no power to settle or appoint any part of the corpus of the trust to a new trust with different beneficiaries (for example, it may be appropriate to restrict a clause allowing for a new settlement to having the same beneficiaries in the same proportions as the existing trust); and
- ensuring that the power to amend the trust deed is drafted narrowly to ensure that an amendment that would otherwise purport to remove a beneficiary's fixed entitlement in the income or capital of the trust is impermissible and ineffectual.

Naturally, the drafting of a trust deed or deed amendment will depend on the specific taxing regime regarding fixed trusts or fixed entitlements.

Background to CGT event E4

The law

From time to time, a unit trust will derive various forms of income and other receipts that are not assessable. These amounts may be referred to as tax-sheltered amounts. One of the major disadvantages of unit trusts is that the payment of such tax-sheltered amounts will often trigger CGT event E4.³⁵

CGT event E4 happens where:³⁶

- the trustee of a trust makes a payment to a unitholder in respect of their unitholding or interest in the trust; and
- some or all of the payment is non-assessable.

Where CGT event E4 happens, the cost base of the units owned by the unitholder is reduced by the non-assessable amount.³⁷ Moreover, a capital gain arises to the unitholder where the non-assessable amount exceeds the cost base of their units for the amount of the excess.³⁸ Invariably, where unit trusts have not been capitalised but instead funded by borrowings or credit loans, the unitholders will only have a nominal cost base and therefore the whole of the non-assessable amount may amount to a CGT event E4 capital gain.

Tax shelters

The effect of CGT event E4 is to trigger CGT consequences on the payment of a variety of tax-sheltered amounts to unitholders (by reducing the cost base of units and potentially triggering a capital gain). In this regard, it may be said that certain tax-sheltered amounts derived by a unit trust are "trapped" in that structure.

There are numerous tax-sheltered amounts that may be subject to CGT event E4. Some of the typical amounts regularly encountered in practice include:

- amounts arising from the unit trust holding depreciating assets (especially where accelerated depreciation is allowed under the capital allowance provisions);³⁹
- amounts arising from a unit trust that owns buildings or structures that qualify for deductions under the capital works provisions;⁴⁰
- pre-CGT capital gains;⁴¹
- capital gains disregarded by the small business 50% reduction;⁴² and
- income distributions received by a unit trust that are sheltered by the unit trust having available current year or carry-forward tax losses to apply against that income.

The tax legislation expressly excludes tax-sheltered amounts arising from the general 50% discount from CGT event E4.⁴³ However, for this concession to be available, care needs to be taken in the manner in which the tax-sheltered amount is accessed (see further below).

Payments versus loans

In the authors' view, CGT event E4 should not apply where the trustee of a unit trust makes a loan to a unitholder (even where such amount may be wholly or partly funded by a tax-sheltered amount). Arguably, CGT event E4 is only intended to target the payment of tax-sheltered amounts from a unit trust structure where such a payment represents a reduction in the capital value of the unit trust and not the advancing of funds to a unitholder as a genuine loan (that must be repaid). Of course, once the loan is repaid and such amounts are then distributed to the unitholder, CGT event E4 would apply. The loan only represents a deferral in this regard.

In the authors' opinion, it is highly likely that CGT event E4 would apply where the trustee makes a loan to a unitholder (funded by non-assessable amounts) and subsequently forgives the loan. In this case, the loan and forgiveness may be viewed as a device to distribute tax-sheltered amounts to the unitholder by "dressing up" the transaction as something that, as a matter of substance, amounts to a payment in the context of the use of that term in s 104-70 ITAA97.

Payments to associates

As stated above, the conventional unit trust gives its unitholder a defined right to income and capital each income year based on their proportionate unitholding in the unit trust.

Some unit trusts, however, have a hybrid function and can provide the trustee with a discretion to distribute income not only to unitholders, but also to associates (typically, relatives and related entities) of the existing unitholders. While this may have commercial utility for the unitholders, it may also provide greater flexibility in tax planning.

To this end, and as stated above, CGT event E4 will only apply where the person or entity receiving a payment of a

non-assessable part has a unit or an interest in the trust that extends beyond the interest that a beneficiary may have in a discretionary trust. In the authors' view, a payment to an associate of a unitholder would not fall within the ambit of CGT event E4 on the basis that an associate's interest in the unit trust is akin to that of a beneficiary in a discretionary trust and is wholly dependent on the trustee exercising its discretion.⁴⁴

Provided the trustee has had the discretion to distribute to associates of a unitholder from the unit trust's establishment, the authors consider that the subsequent exercise of such a discretion should not attract the anti-avoidance provisions under Pt IVA ITAA36. An issue may arise, however, where the unit trust deed is later amended to facilitate the trustee making payments of non-assessable amounts out of the unit trust on a tax-free basis.

Unit redemptions and advances of capital

Background

Unitholders in a unit trust may wish to extract value from the unit trust following the derivation of a substantial capital gain or where the trust has been used as a vehicle to accumulate value over time.

Capital in a unit trust can be extracted from the trust and accessed by the unitholders through the following means:

- the advancement of capital to the unitholders by the trustee; or
- the redemption of units in the unit trust.

Which approach is taken may depend on a range of commercial issues for the trustee and unitholders, particularly whether the parties wish for the unit trust to continue in existence or be wound up. The different approaches will, however, give rise to significantly different tax outcomes for the unitholders.

Advances of capital and redemption of units

An advancement of capital involves the trustee resolving to appoint and pay capital amounts in the unit trust to the unitholders without disturbing the ownership of the units. An advancement of capital will trigger CGT event E4 on the basis that the trustee will have paid tax-sheltered amounts to the unitholders (see above).

A redemption of units involves the trustee cancelling some or all of the unitholder's units in exchange for the trustee paying capital proceeds to the unitholder. A redemption of units will trigger CGT event C2 on the basis that there will have been an extinguishment of an intangible CGT asset (ie units).⁴⁵

There are some important differences in the tax outcomes arising from the occurrence of CGT events E4 and C2, namely:

- only the capital gain arising from CGT event C2 will take account of and include any amount that has been sheltered from tax by application of the 50% discount;⁴⁶ and
- a capital loss can only arise under CGT event C2 and not CGT event E4.⁴⁷

The above differences and their application in practice are illustrated in the case study below.

Comparison of capital extraction methods

Case study

The Avengers Trust is a unit trust of which there are several arm's length unitholders.

The unitholders are controlled by superheroes who have pooled funds together to acquire warehouses owned by the Avengers Trust that are used to store and manufacture body armour and other protective suits worn by each of the superheroes.

All of the unitholders are the trustees of discretionary trusts.

In the 2025 income year, one of the larger warehouses is sold for \$6m, giving rise to a gross capital gain in the Avengers Trust of \$4m. The Avengers Trust and the unitholders qualify for the 50% discount but no other concessions.

After the payment of bank debt and transaction costs, there is \$5m available for distribution to the unitholders.

The unitholders have varying percentages of units in the Avengers Trust and different cost bases.

Two unitholders of note are as follows:

1. the Captain America Trust, one of the original unitholders of the unit trust, owns 20% of all units in the Avengers Trust. The total cost base of these units is \$50,000; and
2. the Black Widow Trust, which bought into the unit trust at a later date, owns 10% of all units in the Avengers Trust. The total cost base of these units is \$400,000.

The unitholders are desirous of accessing the net proceeds from the sale of the warehouse on a tax-effective basis.

On the basis that the gross capital gain made by the trustee of the Avengers Trust will be reduced by the 50% discount, \$2m will be included in the taxable net income of the Avengers Trust. The unitholders will be assessed on this amount based on the amount attributed to each of them under Subdiv 115-C ITAA97 and their specific entitlement to the net financial benefit referable to the capital gain.

On the basis that the \$2m net capital gain has been assessed as assessable income to the unitholders,⁴⁸ this will leave \$3m⁴⁹ to be distributed as capital of the Avengers Trust. As the trustee of the Avengers Trust has applied the 50% discount, \$2m of this amount will be tax-sheltered. This tax-sheltered amount is expressly excluded from the operation of s 104-70 by item 1 of the table in s 104-71(4) ITAA97.

Assuming that the unitholders wish for the Avengers Trust to continue in existence, the trustee would need to resolve to distribute the proceeds remaining in the Avengers Trust by way of an advancement of capital (which would trigger CGT event E4 in relation to the tax-sheltered amount). This would have a number of tax consequences for the Captain America Trust and Black Widow Trust (see Table 1).

On the basis that the Captain America Trust qualifies for the 50% discount, its net capital gain on CGT event E4 would be \$75,000.

Assuming instead that the unitholders wish for the Avengers Trust to be wound up and to go their separate ways, the trustee would need to effect a redemption of all of the units held in the trust (which would trigger CGT event C2 in relation to capital proceeds received by the unitholders for the redemption of their units). This would have a number of tax consequences for the Captain America Trust and Black Widow Trust (see Table 2).

On the basis that the Captain America Trust qualifies for the 50% discount, its net capital gain on CGT event C2 would be \$275,000.

Table 1. Advancement of capital: tax consequences

Unitholder	Capital distribution	Less tax-sheltered amount ⁵⁰	Non-assessable part	Cost base of units	Adjusted cost base	CGT event E4 gain
Captain America Trust (20% of units)	\$600,000	\$400,000	\$200,000 ⁵¹	\$50,000	Nil ⁵²	\$150,000
Black Widow Trust (10% of units)	\$300,000	\$200,000	\$100,000 ⁵³	\$400,000	\$300,000 ⁵⁴	Nil

Table 2. Unit redemption: tax consequences

Unitholder	Capital proceeds	Less cost base of units	CGT event C2 gain/(loss)
Captain America Trust (20% of units)	\$600,000	\$50,000	\$550,000
Black Widow Trust (10% of units)	\$300,000	\$400,000	(\$100,000)

The following observations can be made from the above comparisons:

- the amount comprising the capital proceeds on a CGT event C2 will include the amount that has been sheltered by the 50% discount. Therefore, a higher capital gain will arise to those unitholders which do not have a substantial cost base (for example, the Captain America Trust) when compared to CGT event E4; and
- capital losses are only available on the occurrence of CGT event C2 but not on CGT event E4 (only a cost base reduction will arise on the latter event). For the Black Widow Trust, if this capital loss is triggered in the same income year as the CGT event from the sale of the warehouse by the Avengers Trust, the Black Widow Trust can apply the capital loss against its share of the capital gain attributed to it. However, a capital loss is only available against the grossed-up capital gain and not the capital gain arising after applying the 50% discount. Therefore, the \$100,000 loss would be applied against the Black Widow Trust's grossed-up capital gain of \$400,000, reducing it to \$300,000 before applying the 50% discount to further reduce the gain to \$150,000.

It can be seen from Table 3 that CGT event E4 would favour the Captain America Trust, whereas CGT event C2 would favour the Black Widow Trust.

Ultimately, when deciding whether capital should be extracted from a unit trust by way of an advance of capital or a unit redemption, consideration should be had not only to what is commercially viable, but also to the tax attributes of each unitholder's unitholding in the trust.

Small business CGT concessions: accessing tax-sheltered amounts

15-year exemption and retirement exemption

Where a capital gain is disregarded by a trust under the 15-year exemption (Subdiv 152-B ITAA97), the trust accessing the exemption may make a payment of an exempt amount within two years of the CGT event to an individual who is a CGT concession stakeholder of the trust just before the event.⁵⁵

The retirement exemption (Subdiv 152-D ITAA97) also requires a payment of an exempt amount to an individual

who is a CGT concession stakeholder where a capital gain is disregarded by a trust, unless the CGT concession stakeholder is under 55 before the choice is made to apply the retirement exemption.⁵⁷ This payment must be made within seven days after the trust makes the choice to apply the retirement exemption (which must be lodged with the trust's tax return for the year in which the CGT event has happened).

On the basis that the payment is made to an individual (directly or indirectly) who qualifies as a CGT concession stakeholder within the above time periods for the 15-year exemption and retirement exemption, the amount will be non-assessable non-exempt income.⁵⁸ This will overcome CGT event E4 which, as noted above, occurs where a trustee makes a payment to a unitholder and some or all of the payment is non-assessable.

Character of payment

The income tax legislation does not describe the nature or character of the payment made by the trustee of the unit trust to the unitholder/beneficiary qualifying as a CGT concession stakeholder under the 15-year exemption or retirement exemption. In the authors' view, as noted above, the correct characterisation of the payment may be a capital distribution. However, such a characterisation would necessitate payments being made equally to all unitholders of the same class, including those unitholders that may not qualify as CGT concession stakeholders, for instance, because their unit holding is less than 20%. It remains to be seen in these circumstances whether the payment of amounts to CGT concession stakeholders may be characterised in some other manner.

As noted above, the legislation does not speak to the character in which the sheltered amount arising from the 15-year exemption and retirement exemption must be paid from a trust to its unitholders/beneficiaries. Although the position is uncertain, the payments to unitholders may arguably be recorded as non-deductible expenses of the trust that arise as a consequence of the trustee choosing to apply the 15-year exemption or retirement exemption. The validity of the approach may be further supported if the trust deed expressly allows for such payments to the unitholders. This may require a deed amendment to be effected to grant the trustee such a specific power.

Table 3. Advancement of capital versus unit redemption

Unitholder	Warehouse disposal – share of net capital gain	Net capital gain/(loss) from CGT event E4	Total assessable amount
Captain America Trust (20% of units)	\$400,000	\$75,000	\$475,000
Black Widow Trust (10% of units)	\$200,000	Nil	\$200,000
Unitholder	Warehouse disposal – share of net capital gain	Net capital gain/(loss) from CGT event C2	Total assessable amount
Captain America Trust (20% of units)	\$400,000	\$275,000	\$675,000
Black Widow Trust (10% of units)	\$200,000	(\$100,000)	\$150,000 ⁵⁶

There are some commercial issues with this approach, in that the amount remaining in the trust will be capital owing to all of the unitholders rather than amounts owing exclusively to the unitholders that do not comprise CGT concession stakeholders. However, such issues may not be overly significant if the unitholders are members of the same family group.

Concluding remarks

Whatever the disadvantages in unit trusts as business and investment vehicles, their overall utility is likely to ensure that they remain a popular structure for years to come.

The flow-through nature of the vehicle, coupled with its obvious commercial uses as a trust with defined equity interests, guarantees the unit trust a place in the repertoire of effective structures called on by tax advisers when appraising their clients of the various options available.

Peter Slegers, CTA

Director, Tax & Revenue Group
Cowell Clarke

Carlie Frantzis, ATI

Lawyer, Tax & Revenue Group
Cowell Clarke

Amy Lancaster, ATI

Lawyer, Tax & Revenue Group
Cowell Clarke

Acknowledgment

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References

- 1 Particularly where the units are held by discretionary trusts.
- 2 For instance, "unit trust" is defined in s 202A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) but only for the purposes of dealing with tax file numbers. "Public traded unit trust" has the meaning given by s 149-50 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) but "unit trust" remains undefined. A "widely held unit trust" is defined in s 272-105, Sch 2F ITAA36 but, again, "unit trust" remains undefined. "Units" and "unit trusts" are also frequently referred to in the CGT provisions, for example, see s 108-5 ITAA97, item 3 of the table in s 109-10 ITAA97, and the exceptions to CGT event D1 in s 104-35(5) ITAA97.
- 3 *CPT Custodian Pty Ltd v Commissioner of State Revenue* [2005] HCA 53 at [15] per Gleeson CJ and McHugh, Gummow, Callinan and Heydon JJ (*CPT Custodian*).
- 4 See the definition of "unit" in s 2 of the *Land Tax Act 1936* (SA) and s 2 of the *Stamp Duties Act 1923* (SA); see the definition of "unit trust" in s 3 of the *Land Tax Management Act 1956* (NSW); see the definition of "unit" and "unit trust scheme" in the Dictionary to the *Duties Act 1997* (NSW); and see the definition of "unit" and "unit trust scheme" in s 3(1) of the *Land Tax Act 2005* (Vic) and s 3(1) of the *Duties Act 2000* (Vic).
- 5 NE Morecroft, *The origins of asset management from 1700 to 1960*, Palgrave Macmillan, 2017, pp 221-257.
- 6 B Mees, M Wehner and P Hanrahan, *Fifty years of managed funds in Australia*, preliminary research report, Investment and Financial Services Association Ltd, 2011, pp 9-10; GC Spavold, "The unit trust – a comparison with the corporation", (1991) 3(2) *Bond Law Review* 249.
- 7 In particular, the prevention of double taxation that applied to companies prior to the introduction of the dividend imputation system, as well as receipts of the trustee maintaining their (tax-free) character in the hands of the unitholder.
- 8 [1954] HCA 16.
- 9 Note 1 in s 108-5 ITAA97 expressly confirms the status of units as a CGT asset.
- 10 Subject, of course, to the tax loss rules that apply to the particular type of unitholder.
- 11 S 109-10 ITAA97. Also see the exception to CGT event D1 in s 104-35(5)(d) ITAA97.
- 12 S 104-35(5) ITAA97.
- 13 S 270-25, Sch 2F ITAA36.
- 14 Div 165 ITAA97.
- 15 Whether a taxable dividend under s 47(1) ITAA36 or the general definition.
- 16 See the CGT treatment of disposals and acquisitions of partnership interests in IT 2540.
- 17 For a discussion of these issues, see P Slegers, "Effective trust deeds and trust resolutions", (2012) 46(10) *Taxation in Australia* 443.
- 18 S 272-5(2)(d), Sch 2F ITAA36.
- 19 [1985] VicRp 88.
- 20 [1985] VicRp 88 at [395].
- 21 Former s 160APHL(14) ITAA36.
- 22 S 295-550(4) ITAA97 and s 26 of the *Income Tax Rates Act 1986* (Cth).
- 23 S 272-65, Sch 2F ITAA36.
- 24 Note that the meaning of "vested" has not been judicially considered in the context of Sch 2F ITAA36, save for some cursory discussion in *Colonial First State Investments Ltd v FCT* [2011] FCA 16 (*Colonial First State*).
- 25 *Walsh Bay Developments Pty Ltd v FCT* (1995) 130 ALR 415 at 427 (*Walsh Bay*).
- 26 (1995) 130 ALR 415 at 427-428.
- 27 (1995) 130 ALR 415 at 428.
- 28 *Ibid*.
- 29 Para 16 of PCG 2016/16.
- 30 Para 208 of TR 2006/7.
- 31 *Walsh Bay* at 427 and 428.
- 32 The Commissioner adopts this view in para 209 of TR 2006/7.
- 33 S 272-5(2), Sch 2F ITAA36.
- 34 See the criteria contained in category 6 in attachment B to PCG 2016/16.
- 35 This is distinct from beneficiaries of discretionary trusts, which the ATO has taken the view that CGT event E4 cannot apply to (see TD 2003/28).
- 36 S 104-70(1) ITAA97. Note that tax-sheltered amounts are more precisely defined in the legislation as non-assessable parts.
- 37 S 104-70(6) ITAA97.
- 38 S 104-70(4) ITAA97.
- 39 See Div 40 ITAA97 in relation to standard depreciation, and Subdiv 40-BB and s 328-180 of the *Income Tax (Transitional Provisions) Act 1997* (Cth) in relation to accelerated depreciation.
- 40 Div 43 ITAA97.
- 41 See the specific disregarding provisions for each CGT event under Div 104 ITAA97. This may not result in an adverse tax outcome if the relevant units in the unit trust were also acquired prior to 20 September 1985 (see s 104-70(7) ITAA97).
- 42 Subdiv 152-C ITAA97.
- 43 S 104-71(4) ITAA97. There is no equivalent exclusion in s 104-71(4). Also see TD 2006/71 on the small business 50% reduction.
- 44 This applies the reasoning adopted by the Commissioner in TD 2003/28.
- 45 S 104-25 ITAA97.
- 46 As stated above, tax-sheltered amounts arising from the application of the 50% discount are not captured by CGT event E4.
- 47 See s 104-25(3) and the note to s 104-70(4).
- 48 Including the Captain America Trust and the Black Widow Trust.
- 49 \$5m refers to the net proceeds, less \$2m.

50 Arising from the 50% discount (see item 1 of the table in s 104-71(4) ITAA97).

51 The total non-assessable part of \$1m multiplied by 20%.

52 A CGT event E4 capital gain arises because the non-assessable part exceeds the cost base of the units. The cost base of the units is reduced to nil per s 104-70(5) ITAA97. No capital loss is available under CGT event E4.

53 The total non-assessable part of \$1m multiplied by 10%.

54 The non-assessable part does not exceed the cost base. Therefore, no CGT event E4 capital gain arises.

55 S 152-125 ITAA97.

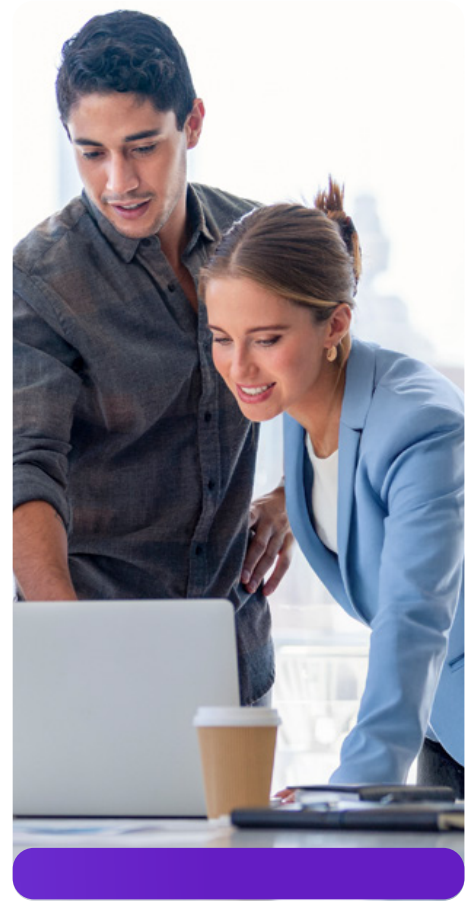
56 The gross capital gain arising from the sale of the warehouse attributed to the Black Widow Trust of \$400,000 less the capital loss arising from the partial redemption of units of \$100,000 and less the 50% discount.

57 S 152-325 ITAA97.

58 S 152-125(1)(a)(ii) ITAA97.

Appendix. Fixed trust provisions

<i>Income Tax Assessment Act 1936</i>	
Schedule 2F	Trust loss provisions
Section 102UC	Trustee beneficiary reporting
Sections 160APA and 160APHD	Franking of dividends
Section 160APHL(14)	Holding period for franking credits
<i>Income Tax Assessment Act 1997</i>	
Section 104-72	CGT event E4 and trusts
Section 115-50	Discount capital gains
Section 115-110	Foreign or temporary residents – individuals with trust gains
Section 116-35	Capital proceeds – market value substitution rule
Section 118-510	CGT and venture capital
Section 124-781	Capital gains and scrip-for-scrip roll-over
Subdivision 165-F	Company tax losses – ownership of a company by non-fixed trusts
Section 170-265	Company as a member of a linked group
Section 295-550	Non-arm's length income for complying superannuation funds
Section 328-440	Small business restructure roll-over – ultimate economic ownership of a non-fixed trust
Section 415-20	Designated infrastructure entity
Section 703-40	Consolidation: treating entities held through non-fixed trusts as wholly-owned subsidiaries
Section 707-325	Consolidation: modified market value of an entity becoming a member of a consolidated group
Section 713-50	Consolidation: determining destination of distribution by non-fixed trust
Section 719-35	Consolidation: treating entities held through non-fixed trusts as wholly owned subsidiaries
Section 725-65	Direct value shifting: cause of the value shift
Section 727-110	Indirect value shifting: common ownership nexus test
Sections 727-360, 727-365, 727-400 and 727-410	Indirect value shifting: control, common ownership and ultimate stake tests
Section 855-40	Capital gains or losses of foreign residents



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“Cleaning up” old pensions and reserves in SMSFs

by Kym Bailey, CTA, Technical Services Manager, JBWere

Treasury has provided an opportunity for SMSFs to clean up legacy pensions, as well as a general (sector-wide) opportunity for superannuation funds to more efficiently allocate existing reserve balances to members. Both opportunities are welcome news for the sector, particularly SMSFs that have defined benefit pensions that were commenced at least 18 years ago and don't intersect well with the legislative changes in 2017 that introduced a raft of pension changes. The legacy pension commutation opportunity will provide SMSFs a five-year window to reorganise their balance sheets and potentially position themselves for a broader range of decision-making opportunities which could include winding-up the fund in a straightforward process. The relaxation of the rules for reserve allocation is also an opportunity to restructure balance sheets and has the potential to make the payment of death benefits more streamlined and tax effective. This opportunity does not have an end date so will provide for orderly and systematic management of reserves.

Background

The *Treasury Laws Amendment (Legacy Retirement Product Commutations and Reserves) Regulations 2024* (the Regulations) is a legislative instrument that came into force on 6 December 2024.

The instrument changes the law to allow a five-year window for SMSFs to commute “legacy pensions”, ie those commenced prior to 20 September 2007 or those pensions that commenced as a result of a conversion of an earlier legacy pension.

In addition, the Regulations provide for a permanent change to the method by which reserves can be allocated to members.

The legacy pension Regulations are specific to self-managed superannuation funds (SMSFs), whereas the change to reserve allocation is sector wide.

Legacy pension overview

The term “legacy pension” applies specifically to the following superannuation income streams (identified by the legislative reference found in the *Superannuation Industry (Supervision) Regulations 1994* (Cth) (SISR), as well as the common usage title):

- lifetime pensions (reg 1.06(2) SISR);
- life expectancy pensions (reg 1.06(7) SISR); and
- market-linked income streams (reg 1.06(8) SISR).¹

The above pensions are classified as defined benefit pensions as they provide a defined income stream for a defined period of time. This compares with a defined contribution pension product where the main stipulation is that a minimum annual pension drawing is required. The balance of the pension is subject to market fluctuations and there is no guarantee of the annual payments or the longevity of the pension. An account-based income stream can generally be commuted at the member's request.²

On the other hand, a defined benefit pension is non-commutable under the current rules, unless the commuted capital is used to immediately commence a new market-linked income stream. While the member is alive, the capital must remain in the superannuation system as this is the trade-off for the income and length of pension guarantees.

Legacy pension commutation

This legacy pension commutation opportunity was first announced in the Liberal National Party's Budget of May 2021 and was confirmed by the Australian Labor Party as a policy direction that it would also take.

The timing of the actual realisation of a change to the law is likely to be connected with the Div 296 draft Bill that is before parliament.³ Under that proposed new law, a member's total superannuation balance (TSB) is key to whether the new tax is imposed on a member. Where an SMSF holds a defined benefit pension, the calculation of the TSB is fraught as the trustee would be required to obtain an actuarial valuation on an annual basis.

Even if this isn't the motive for the publication of the Regulations, having member balances in defined contribution-style products will make fund administration, and potentially cashflow management, more streamlined.

It has been 18 years since SMSFs were permitted to commence new defined benefit pensions. Existing pensions were able to continue to be paid from the SMSF. However, members have aged, resulting in the minimum age of defined benefit pension account holders being in their late 70s, with many members much older. The inability to commute the pension means members have become “stuck” with not only pension inflexibility, but also an inability to close down their SMSF interest.

The introduction of the transfer balance cap (TBC) in 2017, which was designed to limit the level of capital that could be housed in the tax-free pension phase of superannuation,

did not result in any significant changes to defined benefit pensions being paid via an SMSF. However, in order to make the new law work across all superannuation entities, significant layers of complexity were introduced to navigate the new rules as they apply to defined benefit pensions⁴ (this is similar in the design of the new Div 296 law where “sector neutrality” was a stated aim). This significant change should have been the point where the ability to commute defined benefit pensions was introduced but, instead, the sector has had to manage what are now termed “legacy pensions” for a further seven years.

At the time, in order to close off any “loopholes” or potential avenues to manipulate the new capping arrangements, the ATO issued an SMSF Regulator’s Bulletin⁵ to ensure that the ability of SMSFs to utilise reserves was severely curbed to avoid TBC/TSB manipulation.

One concession that was introduced at the time provided for market-linked income streams to commute from the defined benefit calculation that applies to the TBC calculation to a new market-linked income stream that is assessed under the accumulation rules. In other words, a new market-linked income stream is assessed for TBC based on the market value of the member’s interest in the pension. The market-linked income stream remains a defined benefit pension and is subject to the rules detailed in reg 1.06(8) SISR.⁶

The new Regulations provide a real opportunity for members to take action and move the capital into either the accumulation phase or an account-based pension if they have TBC space, or to withdraw the capital from the SMSF.

Legacy pension commutation in action

Members will have a period of five years from the date the regulations were made (6 December 2024) to complete a pension commutation, and they must commute the entire amount.

The only impediment to taking the commutation action will be for individuals who have “asset-test exempt income streams”.⁷ That is, they are in receipt of a transfer payment from Centrelink and the superannuation pensions they receive are not included in the means test, or only 50% is. These individuals will lose that asset-test exempt income stream status if they choose the commutation option. The decision will be based on whether the government benefits are more valuable during their lifetime rather than the potential death benefit tax issues for their beneficiaries.

For a lifetime or life expectancy pension (reg 1.06(2) and (7) SISR), a commutation will result in an amount of capital that defaults to a *reserve*. This arises as the original capital that seeded the pension was calculated to include a “buffer” to ensure liquidity and solvency of the pension (this takes out the “market risk” from the guaranteed pensions streams). Over time, these reserves grew with the allocation of fund earnings year on year.

Thankfully, the Regulations include a new opportunity to allocate reserves.

Reserves: background

Reserves are held in a superannuation fund for a specific purpose.⁸ They do not form a part of member balances, and income earned is taxed at the fund tax rate. The trustee is required to provide a strategy for the reserve management that is in accordance with the fund’s overall investment strategy.⁹

Defined benefit pensions often have associated reserve balances as the actuarial assessment of the capital adequacy and solvency requirements for the pension warrants a reservation of capital. The “pension reserve” is an account that is available to the trustee in order to satisfy the fund’s liability to make the pension payments.

Reserve allocation: under previous law

When a defined benefit pension is commuted (usually on death) or comes to the end of its term, any associated reserves are re-badged as “general reserves” and don’t form a part of a member benefit payment.

Reserves that have no defined purpose are also classified as “general reserves” and are subject to two allocation options.

Where a reserve is allocated to a member, it is treated as a concessional contribution unless:¹⁰

“the amount is allocated in a fair and reasonable manner to every member and the allocation is less than 5% of the member’s interest in the fund.”

As a result, the choice for a trustee is either imposing contributions tax and the potential for excess contributions tax or a slow “drip-feeding” at a rate of less than 5% of member balances.

Concessional contributions are taxed at 15% up to a cap of \$30,000 per annum (FY 2025). Any amount over the concessional contribution cap is taxed at the member’s marginal tax rate less 15%.¹¹

The current options are limited and, as a result, reserves in a fund that no longer have a defined purpose tend to “rest” indefinitely in the fund.

Reserve allocation: new law

The Regulations provide a new system that should enable trustees to manage reserves in a timelier manner.

There are two components to the Regulations in respect of reserve allocation.

The first is in connection with pension reserves, ie reserves that arose due to a pension commutation. These reserves can be allocated to the pension member without assessment against a contribution cap and no associated taxation.¹² Where the pension is reversionary, the pension reserve can be allocated to the reversionary beneficiary as well as to a death benefit beneficiary where there is no reversionary nominated providing it is in conjunction with the payment of the death benefit.

The Regulations define a “pension reserve” and state that a pension reserve could already exist – usually as a result of the term of a pension having expired (life expectancy pensions). These existing reserves are also not subject to the member’s contribution cap when allocated.

Apart from these allocations from pension reserves, all other allocations will be assessed against the member’s non-concessional contribution cap (NCC). This is a marked difference to the current rules whereby the assessment is against the member’s concessional contribution cap.

“A pension reserve can be allocated to the pension member, or their reversionary beneficiary, without limit.”

The fundamental principles of reserve allocation will remain as follows:

- where an allocation of less than 5% of the member balance is made to all fund members, the reserve allocation does not count towards a contribution cap and no tax is applied; and
- all other allocations are assessed against the individual member’s NCC.¹³

Case study

An SMSF has a general reserve of \$350,000 that they wish to transfer to the current two fund members.

Under the current allocation options, the trustee would have the choice of spreading the contribution allocation over four years or causing the members to incur excess concessional contribution tax (see Table 1).

Under the new rules, as detailed in the Regulations, the trustee could allocate the reserve balance to the members in one year based on the non-concessional contribution cap (see Table 2).

Summary

This legacy pension commutation is a welcome development for SMSFs that hold a legacy pension. The commutation window provides members with five years in which to stop the pension and make a decision about the subsequent capital. The change to reserve allocation is also welcome as all associated capital will be able to be dealt with by the pension member. They will be able to make sound decisions concerning their superannuation benefits without taxation issues impeding flexibility.

Reserves that an SMSF was able to hold for a specified purpose such as: the “anti-detriment payment”, income smoothing reserves, insurance reserves, and even administration reserves were classified as a “general reserve” from the time the ATO issued SMSFRB 2018/1). Under this new opportunity, general reserves will be able to be allocated to superfund members based on their NCC.

This will speed up the allocation of reserves within SMSFs, but members who have a TSB greater than the level of the general TBC (currently \$1.9m) will incur an excess NCC determination. The tax impost will be based on the calculation of the “associated earnings” that are applied to the excess. It is anticipated that this tax will likely be lower than that under the current arrangements, particularly on the death of fund members and/or SMSF wind-up.

Kym Bailey, CTA

Technical Services Manager
JBWere

Table 1. Current allocation of reserves across fund members

Account balances		Reserve allocation > 5%	Y2	Y3	Y4
Member 1	\$1,250,000	\$61,250.000	\$64,251.25	\$67,399.56	\$5,981.58
Member 2	\$950,000	\$46,550.000	\$48,830.95	\$51,223.67	\$4,513.42
General reserve	\$350,000	\$107,800.000	\$113,082.20	\$118,623.23	\$10,495.00
	\$2,550,000				

Table 2. New opportunity for reserve allocation

Account balances	Concessional contribution	Excess concessional contribution marginal tax rate - 15% tax
Member 1	\$175,000	\$34,800.00
Member 2	\$175,000	\$34,800.00
		\$69,600.00
Assume concessional cap \$30,000 and MTR 39% (inc ML)		

References

- 1 The Regulations include the *Retirement Savings Accounts Regulations 1997* (Cth), as well as references to annuities. These are not discussed in this article.
- 2 Reg 1.06(9A) SISR.
- 3 Treasury Laws Amendment (Better Targeted Superannuation Concessions and Other Measures) Bill 2023.
- 4 See Subdiv 294-D of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).
- 5 SMSFRB 2018/1.
- 6 See the *Treasury Laws Amendment (Allowing Commutation of Certain Income Streams) Regulations 2022* (Cth).
- 7 These income streams meet all of the rules in ss 9A, 9B, 9BA and 9BB of the *Social Security Act 1991* (Cth).
- 8 S 115 of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA); reg 1.03(1) SISR.
- 9 S 52B(2)(g) SISA.
- 10 Reg 291-25.01(4) of the *Income Tax Assessment (1997 Act) Regulations 2021* (Cth). Repealed 7 December 2024.
- 11 S 291-15 ITAA97.
- 12 Reg 292-90.02 of the *Income Tax Assessment (1997 Act) Regulations 2021*.
- 13 Reg 292-90.01(2A) of the *Income Tax Assessment (1997 Act) Regulations 2021*.



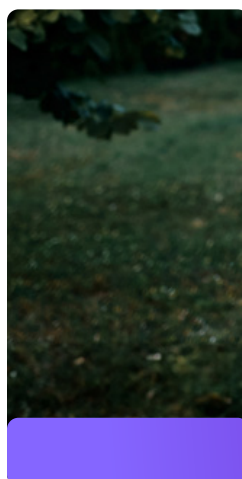
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A Matter of Trusts

by Edward Hennebry, FTI, Sladen Legal

Family trust distribution tax

Before concluding that you have a family trust distribution tax liability, have you considered whether the trustee of the family trust has complied with the trust deed?

Overview

Many discretionary trusts make family trust elections (FTEs) to facilitate carrying forward losses and to pass on franking credits to beneficiaries (that is, they are “family trusts”).

Despite these benefits, increased ATO audit activity has highlighted the unforgiving nature of family trust distribution tax (FTDT).

Unlike Div 7A of the *Income Tax Assessment Act 1936* (Cth), the ATO has no discretion to disregard FTDT caused by honest mistakes and FTDT is not subject to limited statutory amendment timeframes (unlike most provisions of the tax law).

While making a retrospective FTE or interposed entity election may sometimes save the day, the criteria to make those retrospective elections are prescriptive.

But before concluding that you have an FTDT liability, have you considered whether the trustee has complied with the trust deed?

When does FTDT apply?

FTDT can apply when a trustee of a family trust:¹

- “confers a present entitlement” to; or
- “distributes”,

income or capital to a person or an entity outside the “family group” of the “test individual” of that family trust.

In such circumstances, FTDT is imposed on the trustee at a rate of 47% on the amount of the present entitlement or distribution. If the trustee is a company, the directors are also jointly and severally liable for the FTDT.

Conferring a present entitlement

Conferring a present entitlement depends on the terms of the trust deed. A trustee will generally confer a present entitlement by executing a minute or resolution to pay, apply or set aside income or capital of the trust to a beneficiary.²

Unlike “confers a present entitlement” that picks up its general law meaning, the legislation defines “distributes” for FTDT purposes.

For a trust, the primary definition of “distributes” is defined exclusively as:

- paying or crediting the income or capital of the trust in the form of money to a person;
- transferring the income or capital of the trust in the form of property to a person;
- reinvesting or otherwise dealing with the income or capital on behalf of the person or in accordance with the directions of the person; or
- applying the income or capital for the benefit of the person,

in the person’s capacity as a beneficiary of the trust.³

Second, the legislation includes an extended definition of “distributes” which, unlike the primary definition above, is not confined to distributions to persons “in their capacity as a beneficiary of a trust.”⁴ Because of this extended definition, a trustee of a family trust may also be liable to pay FTDT on a distribution of income or capital to a person not in their capacity as a beneficiary of the trust.⁵

The ATO’s views on the extended definition are in TD 2017/20. The ATO view is that the extended definition of “distributes” applies to persons who are *not* beneficiaries (rather than not just in their capacity as beneficiaries). One day, a court may have to decide whether the extended definition applies to persons who are not beneficiaries or just to beneficiaries but not “in their capacity” as beneficiaries.

However, and importantly, the extended definition of “distributes” only applies to the extent that the amount distributed exceeds the amount of any consideration given in return (which, according to TD 2017/20, is to ensure that “genuine commercial dealings” – whatever they are – do not “inappropriately” give rise to a liability to pay FTDT).

Distributions of income or capital not in accordance with trust deed

The ATO’s views, and examples, in TD 2017/20 concern transactions that are (arguably) in accordance with a trust deed. What about a transaction that is not in accordance with the deed?

Take the following example:

- Gonzo Co is the corporate trustee of the Gonzo Trust and has made an FTE specifying Gonzo as the test individual;
- on 30 June, Gonzo (as sole director of Gonzo Co) signs a resolution to pay, apply or set aside \$100,000 of the Gonzo Trust’s net income to Norman (purportedly in accordance with the income distribution power under the trust deed of the Gonzo Trust);
- Norman is Gonzo’s uncle and is therefore not part of Gonzo’s “family group” for the purposes of the FTE rules;

- 10 days later, Gonzo Co transfers \$100,000 from the Gonzo Trust's bank account into Norman's bank account;
- the trust deed of the Gonzo Trust provides that a "foreign natural person" is an excluded beneficiary and ineligible to receive distributions of income or capital; and
- Norman, while a relative of Gonzo and purportedly within the class of general beneficiaries of the Gonzo Trust, is a "foreign natural person" and is therefore an excluded beneficiary under the trust deed of the Gonzo Trust.

Does FTDT apply in these circumstances?

Analysis of the above example

On the one hand, FTDT *may apply* for the following reasons:

- notwithstanding that the distribution of income by Gonzo Co to Norman is not permitted under the trust deed, a payment or crediting of \$100,000 has been made to Norman; and
- the ATO might argue that, consistent with TD 2017/20, the "the unqualified reference to 'distributes ... to a person' in the extended definition includes distributions (as defined) to persons who are not beneficiaries of the trust".

On the other hand, FTDT *may not apply* for the following reasons:

- the trust deed of the Gonzo Trust is the source of Gonzo Co's obligation to administer trust property on behalf of beneficiaries. The duty to comply with the terms of the trust deed has been described as "perhaps the most important duty" of a trustee;⁶
- as Gonzo Co sought to exercise a power that is not in accordance with the trust deed of the Gonzo Trust, it may be that the distribution of income from Gonzo Co to Norman is without legal effect from inception (ie "void ab initio"). That is, Gonzo Co did not confer a present entitlement on Norman;
- the above might be supported by the Federal Court in *Ramsden v FCT*,⁷ which concerned a trustee which had resolved to appoint income to a person who was not a beneficiary of the trust:⁸

"45 The Commissioner has a duty to assess whether a taxpayer is a beneficiary presently entitled to income for the purposes of s 97 of the Assessment Act. *Neither the Commissioner nor the Court are required to give effect to a transaction that is null and void, or otherwise legally ineffective. A trustee who acts ultra vires in making an appointment of income effects nothing.*

...

47 *The ultra vires appointment was thus, in my view, void ab initio and a nullity, and not merely voidable following a challenge by disappointed beneficiaries.*" (emphasis added)

- further, Norman has an immediate obligation to repay the \$100,000 to the Gonzo Trust because the payment was to satisfy a resolution that was not legally effective.⁹

That is, the amount distributed does not exceed the amount of any consideration – the obligation to repay – given in return. However, the extended definition of "distributes" includes a payment "including by way of a loan". Does that mean that the payment to Norman falls under the extended definition because of the obligation to repay (like with a loan)? Or does the extended definition, while including loans, only applies to loans on non-arm's length terms? Example 3 of TD 2017/20 suggests that the extended definition only applies to non-arm's length loans.

Overall, the above is not free from doubt and is yet another example of how the tax laws and the trust laws do not always easily interact. However, it does highlight the importance of checking the trust deed.

So what now?

If we consider that the payment of \$100,000 to Norman does not fall within the extended meaning of "distributes" because it was in breach of trust, this may mean that FTDT does not apply. However, even if there is no liability for FTDT, the \$100,000 to which Norman was purportedly made presently entitled would be included in the assessable income of:

- the default beneficiaries;
- the trustee (Gonzo Co); or
- the balance beneficiaries (ie the beneficiaries appointed the balance of the Gonzo Trust's income or capital for the income year).

If the period of review had expired for the relevant person, while the \$100,000 would be included in assessable income, the earlier assessment could not be amended (absent fraud or evasion).

It may transpire that the quantum of income tax (and interest) payable because of Gonzo Co's failure to adhere to the terms of the trust deed will be less than what would have been the case if FTDT (and interest) applied. For example, the balance beneficiary may be a company.¹⁰

Conclusion

FTDT is punitive. But before you lose sleep on how you are going to manage an FTDT liability, check the trust deed and the trustee distribution minutes. As *Ramsden* and other cases show, it is quite possible for trustees (or their advisers) to misinterpret clauses in a trust deed, resulting in protocols not being followed or the wrong persons receiving income from a trust.¹¹

Edward Hennebry, FTI
Special Counsel
Sladen Legal

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References

- 1 FTDT can also apply to partnerships and companies, but the focus of this article is on trustees of family trusts.
- 2 *Harmer v FCT* [1991] HCA 51; *Pearson v FCT* [2006] FCAFC 111.
- 3 S 272-45 of Sch 2F to the *Income Tax Assessment Act 1936* (Cth) (ITAA36).
- 4 S 272-60 of Sch 2F ITAA36.
- 5 This can also include indirect distributions via an interposed company, partnership or trust.
- 6 *Youyang Pty Ltd v Minter Ellison Morris Fletcher* [2003] HCA 15.
- 7 [2004] FCA 632.
- 8 This point was upheld on appeal in *FCT v Ramsden* [2005] FCAFC 39.
- 9 See, for example, the discussion in the opinion from Dominic O'Sullivan KC and Michael O'Meara (now SC) included in TR 2018/6, and in particular, para 41 which provides that a recipient of a payment from a trustee of a trust that is not authorised under the trust deed would ordinarily be obliged to reimburse the trustee.
- 10 There may be "flow-on" effects for the company and its shareholders that are beyond the scope of this article.
- 11 See also *BRK (Bris) Pty Ltd v FCT* [2001] FCA 164.



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Contacts

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National Office

CEO: Scott Treatt, CTA

Level 21, 60 Margaret Street

Sydney, NSW 2000

T 1300 829 338

E tti@taxinstitute.com.au

State Offices

New South Wales and ACT

Chair: Alison Stevenson, CTA

Vice Chair: Kristie Schubert, CTA

Level 21, 60 Margaret Street

Sydney, NSW 2000

T 02 8223 0000

E nsw@taxinstitute.com.au

Victoria

Chair: Dioni Perera, FTI

Vice Chair: Frank Hinoporos, CTA

Level 3, 530 Collins Street

Melbourne, VIC 3000

T 03 9603 2000

E vic@taxinstitute.com.au

Queensland

Chair: Kim Reynolds, CTA

Vice Chair: John Middleton, CTA

310 Edward Street

Brisbane, QLD 4000

T 07 3225 5200

E qld@taxinstitute.com.au

Western Australia

Chair: Ross Forrester, CTA

Vice Chair: Billy-Jo Famlonga, FTI

152 St Georges Terrace

Perth, WA 6000

T 08 6165 6600

E wa@taxinstitute.com.au

South Australia and Northern Territory

Chair: George Hodson, CTA

Vice Chair: TBA

75-77 Dale Street

Port Adelaide, SA 5015

T 1300 829 338

E sa@taxinstitute.com.au

Tasmania

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Vice Chair: Ron Jorgensen, CTA

E tas@taxinstitute.com.au

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