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No restrictions to negative gearing? Think again!

David Krunic, CTA

Elections: outlays by candidates, and gifts and donations for candidates

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The onus of proof following the Cassaniti decision

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THE TAX INSTITUTE

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Invitation to write

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

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

Tax News – at a glance

by TaxCounsel Pty Ltd

July – what happened in tax?

The following points highlight important federal tax developments that occurred during July 2019. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 57 (at the item number indicated).

Taxable payments reporting system

The Commissioner has made a legislative instrument that exempts entities that meet specific criteria from having to prepare and lodge reports with the Commissioner relating to payments to third-party contractors for courier, cleaning, information technology, security, investigation, surveillance or road freight services (TPRS 2019/1). **See item 1.**

Commissioner's general administration powers

The Commissioner has issued a revised practice statement that outlines (for the purposes of ATO staff) issues that arise in relation to his powers of general administration (GPA), including the circumstances in which the Commissioner's GPA may be properly exercised (PS LA 2009/4). **See item 2.**

Employees guide for work expenses

The Commissioner has released a guide called "Employees guide for work expenses" which is designed to help employees when deciding whether their expenses are deductible, and what records are needed to be kept to substantiate them. **See item 3.**

Division 7A: UPE sub-trust arrangements

The Commissioner has extended the operation of PCG 2017/13 to deal with the situation where, in accordance with PS LA 2010/4, investment option 1 has been validly adopted on, or before, 30 June 2013 to place funds representing an unpaid present entitlement under a sub-trust arrangement on a seven-year interest-only loan with the main trust and the principal of the loan is not paid when the loan matures in the 2020 income year. **See item 4.**

Dwellings acquired from deceased estate: CGT exemption

A final practical compliance guideline has been released which considers the exercise by the Commissioner of his discretion to extend the two-year period after death to settle the disposal of a dwelling and retain the CGT main residence exemption (PCG 2019/5). **See item 5.**

Convictions for tax offences quashed

The New South Wales Court of Criminal Appeal has quashed the convictions of two individuals for conspiracy to defraud the Commonwealth and conspiracy to deal with the proceeds of crime (*Castagna v R; Agius v R* [2019] NSWCCA 114). **See item 6.**

Margin scheme

The AAT has held that a taxpayer had discharged the onus of proving that certain land was acquired by it in 2005 on the basis that the margin scheme was applied, despite no direct written evidence (*The trustee for the Seabreeze Estate Unit Trust and FCT* [2019] AATA 1395). **See item 7.**

CGT main residence exemption

The Federal Court (Davies J) has held that a taxpayer had failed to establish that a capital gain made by a discretionary trust (and distributed to the taxpayer) from the disposal of a dwelling was exempt from CGT under the main residence exemption (*Mingos v FCT* [2019] FCA 834). **See item 8.**

President's Report

by Tim Neilson, CTA

What constitutes a "tax professional"?

President Tim Neilson on what it means to be a "tax professional".

A couple of years ago, John Preston, President of the UK's Chartered Institute of Taxation, predicted at our National Convention that critical scrutiny might well be shifted from large corporate and high net wealth taxpayers to those who provide tax services to them.

That prediction may be coming true.

The independent review of the Tax Practitioners Board and the *Tax Agent Services Act 2009* (Cth) (TPB review) is now in progress. One issue raised by the TPB review's terms of reference is the ethical conduct of those providing tax agent services:

> "The review will consider whether the legislative framework for the Tax Practitioners Board delivers on its policy objectives to ensure that tax agent services are provided to the public in accordance with appropriate standards of professional and ethical conduct."

Although the TPB review will no doubt be focused primarily on the role of the Tax Practitioners Board (TPB) in relation to registered tax agents, BAS agents and tax (financial) advisers, its terms of reference refer to interaction with the regulation of relevant related professional activities, which may involve considering the tax activities of others.

You will probably recall that in April, the Inspector-General of Taxation's report *The future of the tax profession* (IG report) was released. It also dealt, to some extent, with the question of standards of conduct of the "tax profession".

The very title of the IG report invites the question "what is the 'tax profession'?". The report itself makes it clear that that is not a straightforward question:

> "Throughout this report the IGT has adopted the term 'tax professional' in the general sense of referring to professionals working in tax. Given the nature of tax and its relationship to nearly every facet of modern life, the numbers of professionals whose work relates in some way to tax is myriad.
>
> …, it is important to consider what constitutes a 'tax professional'. Some stakeholders have advocated for a broader definition which seeks to ensure that professionals such as data analysts, [digital service providers] and tax educators are captured as well as traditional tax professionals such as bookkeepers, accountants and lawyers, including ATO personnel. Some have gone even further, suggesting that sections of the judiciary and other external decision makers, who deal with tax matters, should be included."

One risk of adopting such a broad definition is that it may obscure the extraordinary variety that exists in tax. At the Institute, we regard the diversity of our membership as one of our greatest assets. We're conscious of the necessity to cater for the many different needs of various groups within the Institute, and that's reflected in the array of different specialised events, different streams at conventions, different methods of making our content accessible, and so on.

We addressed some issues concerning that diversity in our submission to the TPB review. For example, we noted that the *Tax Agent Services Act 2009* regulates a myriad of tax-related activities, but the procedural requirements for registration as a tax agent focus very heavily on return lodgment, and there may be scope for people to be admitted to the regulated ranks on a different basis if they'll be doing quite different things. (The IG review recognised this in relation to the increased role of digital service providers in tax, and the TPB review seems likely to address that too.)

And it is important that, once those people are registered, the regulation of their conduct is appropriate to their condition.

This may well involve considering what regulation they are already subject to (as alluded to in the quote above from the TPB review terms of reference). The Institute's membership includes members of various accounting bodies with their ethical rules, lawyers with their mix of statutory and non-statutory regulation and others, including of course ATO officers subject to the discipline of the public service regime. Duplication and inconsistency would obviously be undesirable.

(As an aside, those of us in non-government roles often criticise the ATO, but it is one of Australia's most precious assets. Even at a very basic level, we take for granted that how we're dealt with by the ATO won't depend on handing over an envelope of cash, or on our political connections. In many other parts of the world, the ATO's zero tolerance approach to anything remotely resembling corruption or cronyism would be greatly envied. Public service rigour can frustrate us, but it exists for a reason.)

The Institute stands for the highest standards of integrity. Both with the TPB review and otherwise, we'll be working, as we always have, to promote the best possible system because that's in the best interests of our members. And we will, as always, strive to take into account the interests of all our members, from every segment of the tax …"profession".

Because our membership is so diverse, I avoid using the phrase "tax profession". I usually refer to the "tax community". The very diversity that exists in tax raises a question of whether there is a single tax "profession" in addition to the other professions and vocational groups of which the tax community is composed, such as law or accounting. A "profession" as usually understood consists of an identifiable group of people with a shared commitment to a vocation with high intellectual and ethical standards, and a shared collegiate sense of responsibility for that vocation generally and for their fellow members of that group.

Actually, that sounds a lot like The Tax Institute. Perhaps there is such a thing as "the tax profession" after all.

CEO's Report

by Giles Hurst

With a view to the future

CEO Giles Hurst discusses some key wins and what's on the horizon.

By now, you will all have heard that our head office in Sydney has migrated north of the bridge. While this is a temporary move, it has been an exciting change for our staff members and the main event still awaits us.

I am thrilled to announce that, in due course, we will be moving into our new purpose-built office at Northpoint Tower, 100 Miller Street, North Sydney, NSW.

One of North Sydney's most prestigious commercial properties, Northpoint offers everything we could want for our new home. The move will be in line with plans to continue investing downstream for members.

Adorned with stunning harbour views on the 37th floor and state-of-the-art media facilities, the design of our floorplan caters very much to events and to welcoming members to use our facilities and engage much more closely with all of us.

While our new headquarters are currently being built, we welcome responses from those who would like to attend a celebratory event hosted by the Institute, before the end of the year.

There will be no ghosts in the corridors, and we can look forward to once again placing this great Institute back at the very heart of tax, here in Australia.

Gearing up for the future

As we continue down the path of getting The Tax Institute ready for the next phase of its development, I want to touch on a few notable mentions.

This year, we introduced a higher late payment fee, and this has had the positive effect of encouraging members to renew on time. Your membership renewal means that we're able to regenerate growth to service members and make decisions to facilitate that growth.

Our Tax Policy and Advocacy team has been working hard to represent members in a recent submission regarding the Review of the Tax Practitioners Board and Tax Agent Services regime. The submission highlights numerous issues that the Institute believes should be thoroughly explored in the second stage of the review, which we expect to have begun by the time you read this. The outcome of this review, which is expected to be completed by the end of October this year, could well change the landscape of the tax profession as we know it. The Institute's Tax Policy and Advocacy team will be ensuring that members' interests, particularly those members who are registered tax agents, are appropriately represented.

We're looking at ways to revitalise all aspects of The Tax Institute's work, including how we deliver submissions and populate our committees and councils, as well as how we leverage voluntary talent with a view to ensuring regular rotation and reinvigoration of all our systemic apparatus.

We are aware of how this helps to keep our output fresh, dynamic, relevant and, where required, thought-provoking.

Strengthening our international ties

The Chartered Institute of Taxation (CIOT) in the United Kingdom has announced the appointment of Helen Whiteman as chief executive officer. Helen joins from CILEx Regulation where she is currently CEO, having previously been chief operating officer at the Chartered Institute of Legal Executives.

Helen takes up her new role at CIOT on 2 September, replacing Peter Fanning, who is retiring.

I look forward to working with Helen and strengthening ties, with a continued focus on Chartered Tax Adviser as a mark of excellence.

National Convention 2020

Undoubtedly the profession's flagship event, the 2020 National Convention promises to be bigger and better than ever before. Sydney is set to host next year, and we expect the International Convention Centre to be bustling with tax professionals – both domestic and international. The event will combine the National Convention and the popular NSW Tax Forum as a single, three-day must-attend summit.

Save the dates 11 to 13 March 2020, and watch this space for exciting new developments.

Tax Counsel's Report

by Stephanie Caredes, CTA

Is the turbulence over?

Tax Counsel Stephanie Caredes, CTA, discusses whether the turbulent times of the first half of 2019 have passed and whether there will be smooth sailing for the rest of 2019.

The first half of 2019 brought with it significant political events back-to-back, which, for tax professionals, also meant turbulence was in the air.

Budget and federal election

A federal Budget is undoubtedly one of the biggest tax events on the calendar each year. It brings with it questions about what will be introduced into the tax system and what will be changed. This year's Budget in April was somewhat lacklustre. The only significant change was contained in the government's personal tax cuts plan, which passed through parliament in early July. It provoked much political jousting, with what seems in retrospect to be an empty threat from certain corners to not agree to the third stage of the plan (the flattening of the personal marginal tax brackets in 2024-25). However, it passed through parliament unscathed. Eligible individual taxpayers can now obtain the benefits of the higher low and middle income tax offset.

Overlaying this was the looming federal election which we all knew was coming, though for a very long time we didn't know when it would be. The election brought with it the big question of who would win and therefore whose tax policies would permeate the Australian tax landscape. There was a lot to contend with from the Opposition, the ALP. Much time has been spent by The Tax Institute writing about the impact of the ALP's tax policies, so I won't spend time rehashing the discussion in this column. Suffice to say, the proposals would have brought some unfavourable changes, particularly for tax professionals.

On the other hand, there was not much to contend with from the government. The core of the government's tax policies was contained in the federal Budget and, as noted above, this has already become law.

The election itself gave a highly unexpected outcome — a Coalition victory. Most bets were on an ALP victory, so many in the tax profession had prepared themselves, maybe even steeled themselves, for contending with the ALP tax policies, only to breathe a collective sigh of relief after the election.

On the horizon — more turbulence?

30 June has obviously passed. Many members are in the midst of another busy tax time. They are unlikely to have much time to give any thought to what's on the horizon that might be another source of turbulence. However, the Institute has.

Currently, the Tax Practitioners Board and the tax agent services regime are under review. By the time you read this column, we expect that the second stage of the review will have begun. The second stage involves a discussion paper that is expected to capture the main themes raised in the suite of submissions lodged in April this year. The Institute raised a number of issues, including:

- ensuring that there is consistency in the registration and regulation of tax agents and the services they provide;
- concerns with the safe harbours;
- whether the Tax Practitioners Board has sufficient resources to administer the Code of Professional Conduct; and
- whether the Tax Practitioners Board has sufficient resources to carry out its disciplinary function.

Held at the centre of the regime and the work of the Tax Practitioners Board should be the protection of consumers.

The outcome of this review will have a direct impact on the tax profession, particularly for registered agents. It is too early to tell the likely direction of the review and to what changes it may lead. Members who would like to read the Institute's submission in detail will find it on our website.[1]

Further out on the horizon is the issue of the "digitalisation of tax". This issue is currently on the OECD's agenda.[2] It is a growing issue with the increasing globalisation of the economy. Globalisation is only going to increase and this may well mean that the tax jurisdictional boundaries will continue to disintegrate.

Treasury did start to look at this issue in late 2018,[3] but for now the government has retreated from leading on this issue, resulting in Australia falling into line with its OECD counterparts. This is an outcome that the Institute advocated for and supports.

What does this mean for the second half of 2019? Will the rest of this year be smooth sailing for the tax profession? Are we through the turbulent times? With possible changes to the regulation of the tax profession and new pressures coming to the Australian tax system as a result of the impending digitalisation of tax, I don't think so.

References

1 The Tax Institute, *Review of the Tax Practitioners Board*, April 2019. Available at www.taxinstitute.com.au/tisubmission/review-of-the-tax-practitioners-board.

2 OECD, *Tax and digitalisation*, October 2018. Available at www.oecd.org/tax/beps/tax-and-digitalisation-policy-note.pdf.

3 Australian Government, The Treasury, *The digital economy and Australia's corporate tax system*, October 2018. Available at www.treasury.gov.au/consultation/c2018-t306182.

Tax News – the details

by TaxCounsel Pty Ltd

July – what happened in tax?

The following points highlight important federal tax developments that occurred during July 2019.

The Commissioner's perspective

1. Taxable payments reporting system

The Commissioner has made a legislative instrument that exempts entities that meet specific criteria from having to prepare and lodge reports with the Commissioner relating to payments to third-party contractors for courier, cleaning, information technology, security, investigation, surveillance or road freight services (TPRS 2019/1).

The taxable payments reporting system (TPRS) in Subdiv 396-B of Sch 1 to the *Taxation Administration Act 1953* (Cth) (TAA) requires certain entities to lodge an annual report with the ATO giving details about consideration provided to other entities for supplying certain types of services on their behalf.

As a result of amendments made to the TAA in 2018, the TPRS was expanded to apply (from 1 July 2018) to entities that supply courier or cleaning services and engage third parties to supply these services on their behalf and (from 1 July 2019) to entities that supply information technology, security, investigation, surveillance or road freight services and engage third parties to supply these services.

Under the TPRS, the Commissioner is given the power to exempt entities from certain reporting obligations. The purpose of TPRS 2019/1 is to provide limited, but ongoing, exemptions to the TPRS reporting requirements relating to supplies covered by the 2018 amendments. Under these exemptions, a reporting entity is not required to report details of relevant transactions in a particular reporting period if it meets the following criteria:

– the reporting entity satisfies the "turnover threshold test" for the relevant TPRS reporting obligation; and

– the reporting entity is not required to report details of these transactions under a separate TPRS reporting obligation.

In very broad terms, a reporting entity will satisfy the turnover threshold test for a TPRS reporting obligation in a reporting period if, during that reporting period, the total consideration it receives for the supply of relevant services is less than 10% of its relevant GST turnover.

2. Commissioner's general administration powers

The Commissioner has issued a revised practice statement that outlines (for the purposes of ATO staff) issues that arise in relation to his powers of general administration (GPA), including the circumstances in which the Commissioner's GPA may be properly exercised (PS LA 2009/4).

The practice statement points out that provisions located within various taxation laws place the power to conduct the day-to-day administration of those laws in the hands of the Commissioner. These powers exist in order to assist the Commissioner to administer the taxation laws in accordance with parliament's legislative intent.

In the course of administering tax laws on behalf of the Commissioner, the ATO's primary focus should be on interpreting the law in a manner which supports that law's purpose. This means that, where the law is open to more than one interpretation, the alternative interpretations of the law should be explored before considering reliance on the GPA.

In the rare circumstance where the operation of the law is unclear or leads to unforseen or unexpected consequences, it may be appropriate to consider whether the issue can be resolved using the Commissioner's GPA.

The courts have recognised that the general administration provisions reinforce the principle that the Commissioner is authorised to do whatever may be fairly regarded as incidental to, or consequential on, the things that the Commissioner is authorised to do by the taxation laws.

The GPA are narrow in scope and governed by the operation of administrative law principles. A proper exercise of the powers is confined to dealing with management and administrative decisions, such as the allocation of compliance resources more broadly recognised as practical compliance approaches.

The Commissioner's GPA cannot be used to remedy defects or omissions in the law. It is the Commissioner's remedial power which provides discretion to modify the operation of a tax law to ensure it can be administered to achieve its intended purpose or object.

An implied authority for a tax officer to exercise the GPA on the Commissioner's behalf exists if it is within the scope of the officer's usual duties to make a judgment call or decision that affects the allocation of resources, including the officer's own time. Generally speaking, such everyday decisions are made by officers at all levels in the course of their usual duties.

Consistent with the ATO's intent to concentrate its efforts on matters that pose the highest risk to efficient and effective administration of the tax and superannuation systems, the ATO also understands that most people want to do the right thing. Given this, the ATO may choose to not allocate compliance resources or take other compliance action to examine certain interactions with the tax and superannuation systems, so that its limited resources for an optimal outcome can be better utilised.

3. Employees guide for work expenses

The Commissioner has released a guide called "Employees guide for work expenses" which is designed to help

employees when deciding whether their expenses are deductible, and what records are needed to be kept to substantiate them.

The guide considers the following:

- claiming a deduction: the basic conditions;
- apportioning work-related expenses;
- commonly claimed expenses;
- substantiation requirements;
- exceptions and relief from substantiation; and
- decline in value under the capital allowance provisions.

The guide is located in the legal database.

4. Division 7A: UPE sub-trust arrangements

The Commissioner has extended the operation of PCG 2017/13 to deal with the situation where, in accordance with PS LA 2010/4, investment option 1 has been validly adopted on, or before, 30 June 2013 to place funds representing an unpaid present entitlement (UPE) under a sub-trust arrangement on a seven-year interest-only loan with the main trust and the principal of the loan is not paid when the loan matures in the 2020 income year.

If all, or part, of the principal of the loan is not repaid on or before the date of maturity, the Commissioner will accept that a seven-year loan on complying terms in accordance with s 109N of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) may be put in place between the sub-trust and the private company beneficiary before the private company's lodgment day. This will provide a further period for the amount to be repaid with periodic payments of both principal and interest.

However, if such a seven-year loan on complying terms in accordance with s 109N is not put in place between the sub-trust and the private company beneficiary before the private company's lodgment day, a deemed dividend will arise at the end of the income year in which the loan matures.

5. Dwellings acquired from deceased estate: CGT exemption

A final practical compliance guideline has been released which considers the exercise by the Commissioner of his discretion to extend the two-year period after death to settle the disposal of a dwelling and retain the CGT main residence exemption (PCG 2019/5).

Section 118-195 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) disregards capital gains and capital losses made from certain CGT events that happen in relation to a dwelling that was a deceased person's main residence and was not being used to produce assessable income just before they died, or was acquired by the deceased before 20 September 1985.

If a taxpayer disposes of an ownership interest in a dwelling that passed to the taxpayer as an individual beneficiary or as the trustee of the deceased's estate within two years of the deceased's death, any capital gain or loss that is made on the disposal is disregarded. The Commissioner has the discretion to extend the two-year period.

The guideline states that, generally, the Commissioner will allow a longer period where the dwelling could not be sold and settled within two years of the deceased's death due to reasons beyond the taxpayer's control that existed for a significant portion of the first two years.

The guideline outlines a safe harbour compliance approach that allows the taxpayer to manage their tax affairs as if the Commissioner had exercised the discretion to allow a longer period.

The guideline also outlines the factors that the Commissioner will consider when deciding whether to exercise the discretion to extend the two-year period.

The guideline also notes that a taxpayer may be entitled to a partial exemption for any capital gain or loss made from the disposal of an ownership interest in a dwelling if s 118-195 does not apply (s 118-200 ITAA97). The guideline applies equally in relation to the Commissioner's discretion to extend the two-year period for partial exemptions.

Recent case decisions

6. Convictions for tax offences quashed

The New South Wales Court of Criminal Appeal has quashed the convictions of two individuals for conspiracy to defraud the Commonwealth and conspiracy to deal with the proceeds of crime (*Castagna v R; Agius v R*[1]).

The appellants (Dr Anthony Castagna and Mr Robert Agius) were charged with offences arising out of payments made by Macquarie Bank Ltd and its associated companies in exchange for the supply of Dr Castagna's services as a consultant during the period from 1998 to 2009. It was alleged that Dr Castagna was required to declare these payments as part of his "assessable income" for income tax purposes and that he failed to do so. Thus, the charges were that the appellants were members of a conspiracy to defraud or cause financial loss to the Commonwealth by concealing Dr Castagna's "assessable income", and a conspiracy to deal with money which was the proceeds of crime, being the part of the payments not declared as "assessable income".

The payments were made by Macquarie Bank and its associated companies pursuant to a series of agreements between itself, Dr Castagna, and Billbury Ltd, a company controlled by Mr Agius. The agreements provided that Billbury would supply Dr Castagna's services as a consultant in exchange for the payments from Macquarie Bank. The agreements did not provide for any payment to be made directly to Dr Castagna. The evidence showed that, at the relevant times, Macquarie Bank required all agreements with its consultants to be with companies rather than individuals. Thus, there was no suggestion that the agreements between Macquarie Bank, Dr Castagna and Billbury were "shams".

At trial, the prosecution case was that, even though the payments were made to Billbury and the agreements between Macquarie Bank, Billbury and Dr Castagna were not "shams", the payments were "ordinary income" which had been "derived" by Dr Castagna within the meaning of s 6-5(2) ITAA97, and therefore were "assessable income" which he had not, but was required to, declare on his income tax returns. The prosecution case invited the jury to consider the circumstances of the case as a whole to determine whether the payments to Billbury were "ordinary income" which had been "derived" by Dr Castagna.

At the conclusion of the prosecution case, the appellants each made an application for a directed verdict on the basis that, as a matter of law, the payments to Billbury could not be "ordinary income" which had been "derived" by Dr Castagna by reason of the terms of the agreements between Macquarie Bank, Billbury and Dr Castagna.

The trial judge (Adamson J) rejected the applications. The primary judge gave directions to the jury about how they were to approach the task of determining whether the payments to Billbury were "ordinary income" which had been "derived" by Dr Castagna which reflected the prosecution case by inviting them to consider the circumstances of the case as a whole. The jury found each of the appellants guilty of the offences with which they were charged.

Dr Castagna and Mr Agius appealed to the Court of Criminal Appeal from their convictions.

In a joint judgment, the Court of Criminal Appeal (Bathurst CJ and Macfarlan and Gleeson JJA) held that:

- Adamson J had erred on the applications for directed verdicts and in directing the jury that, in order to determine whether the payments to Billbury were "ordinary income" which had been "derived" by Dr Castagna within the meaning of s 6-5(2), it was necessary to consider the circumstances surrounding the agreements. It would only have been relevant to do so to determine if there was some other legal relationship which affected how the agreements would be carried out. However, since no such case was put at trial, it was an error to go beyond the terms of the agreements to determine whether the payments were "ordinary income" which had been "derived" by Dr Castagna;
- it was not open to the jury to find that the payments to Billbury formed part of Dr Castagna's "assessable income" because they were held by Billbury on trust for Dr Castagna. The prosecution had not put any such case to the jury at trial. If it had, it would have been necessary for the jury to be satisfied that the settlor had the relevant intention to create the trust and that the requirements for a trust to be created had been fulfilled, which was not done; and
- in the circumstances, no order that Dr Castagna and Mr Agius be retried should be made.

7. Margin scheme

The AAT has held that a taxpayer had discharged the onus of proving that certain land was acquired by it in 2005 on the basis that the margin scheme was applied, despite no direct written evidence (*The Trustee for the Seabreeze Estate Unit Trust and FCT*[2]).

The taxpayer (a trustee of a unit trust) acquired certain land in January 2005 from a partnership of two companies (the partnership). The issue was whether, on the sale of the developed land, the taxpayer could use the margin scheme to calculate the GST payable. For the taxpayer to be able to use the margin scheme, it was in practical terms necessary for it to have acquired the land under the margin scheme.

From the 2005 transaction, only the first page of the contract for the sale and acquisition of the land was able to be located, and this did not include enough information from which it could be determined that the margin scheme was applied.

The AAT said that the unchallenged evidence was that the partnership sold the land to the taxpayer for less than it had acquired it. In other words, it had a negative margin. The partnership did not report the sale of the land in its relevant business activity statement (BAS). The taxpayer did not become GST-registered until approximately a year after the purchase of the land.

Although the nil BAS lodged by the partnership did not, of itself, support the view that the margin scheme was used, it was entirely consistent with the margin scheme having been used. The BAS lodged by the partnership accorded with the way the Commissioner instructed taxpayers in the BAS instructions booklet to complete their BAS for margin scheme supplies, that is, not report the sale if there was a negative margin.

The AAT further considered that the fact that the taxpayer did not become GST-registered until about a year after it purchased the land, when it started incurring expenses regarding the development, was particularly persuasive and fortified the foundations for the finding that the margin scheme was applied. The strong inference to be drawn from the taxpayer's conduct was that the partnership had chosen to use the margin scheme as an acquisition of a freehold interest in land was not a creditable acquisition if the margin scheme was applied. It was pointless for the taxpayer to register for GST at the time of the contract if the margin scheme applied to the transaction. If it had been a taxable supply where the margin scheme had not been used, it could be inferred that the taxpayer would have almost certainly registered so as to claim an input tax credit for the GST charged.

The AAT said that these findings were supported by the oral evidence that had been given for the taxpayer.

The decision in this case illustrates the need for adequate records to be kept for tax purposes for such period as will mean that no question can arise for which they could be relevant, for example, if the Commissioner were to amend an assessment. There are, of course, record-keeping obligations imposed by the taxation law and, although the fact that such records have not been kept will not, of itself, mean that the taxpayer could not discharge the onus of proving an assessment to be excessive, the keeping of records as required is obviously a practical necessity. The failure to keep adequate records as required is, of course, an offence.

It may be noted that the margin scheme provisions now require that, for the scheme to apply, the vendor and the purchaser must so agree in writing. Had that been the law that was relevant to the supply by the partnership, there would have had to be cogent evidence that such a written agreement had been made.

8. CGT main residence exemption

The Federal Court (Davies J) has held that a taxpayer had failed to establish that a capital gain made by a discretionary trust (and distributed to the taxpayer) from the disposal of a dwelling was exempt from CGT under the main residence exemption (*Mingos v FCT*[3]).

The property was originally acquired in 1992 by a company on trust for the taxpayer absolutely and it was used as the main residence of the taxpayer and his family. In November 2006, the company transferred the property to the taxpayer, the consideration expressed in the transfer being "entitlement in equity". By another transfer made later in the same month, the taxpayer transferred all his estate in the property to his then wife, the consideration expressed in the transfer being "natural love and affection". Shortly after this, the marriage began to fail.

In November 2010, the taxpayer and his wife entered into a property settlement which resulted in final orders being made by consent by the Federal Magistrates Court on 23 December 2010. Under those orders, inter alia, the wife was to do all such acts and things and sign such documents at the expense of the taxpayer to transfer to him, or his nominated entity, all her right title and interest in the property. The taxpayer was obliged to discharge mortgages secured over the property.

On 27 May 2011, the wife, at the taxpayer's direction, transferred the property to Lemnian Investments Pty Ltd as trustee for the Lemnian Investment Trust. The property was sold in May 2014.

Davies J held that the taxpayer had failed to discharge the onus of proving that he had an ownership interest in the property.

One argument for the taxpayer was that the evidence showed that he occupied the property as his place of residence, rather than as a tenant, which supported an inference that he held either a licence or a right to occupy the property. Such licence or right was said to constitute an ownership interest for the purposes of the CGT main residence exemption.

Davies J said, however, that the relevant capital gain which had been assessed to the taxpayer related to the CGT event constituted by the contract of sale of the property to a third party in May 2014. That was a disposition by the trustee. Whether the taxpayer, rather than the trustee, made the capital gain on the disposal depended on whether the taxpayer had an absolute entitlement to the property as against the trustee. The taxpayer, however, had not established that he had such an absolute entitlement to the property.

The taxpayer has lodged an appeal to the Full Federal Court from the decision of Davies J.

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Tax Tips

by TaxCounsel Pty Ltd

Tax indemnities

A recent decision of the England and Wales Court of Appeal considered how tax indemnities and warranties contained in a contract for the purchase of shares were to be construed and applied.

Background

The decision was that of the England and Wales Court of Appeal in *Minera Las Bambas SA v Glencore Queensland Ltd*,[1] which was an appeal on certain points from a decision of Moulder J.[2]

The tax indemnities and warranties were contained in a contract for the purchase of shares in a company which owned a large copper mining project (the Las Bambas project) in Peru (and of a further deed of indemnity made pursuant to that contract).

The tax liabilities to which the contractual terms had to be applied were liabilities under Peruvian law for value-added tax (VAT). Although the relevant transactions and their subject matter had no other connection with the United Kingdom, the contracts were, through the parties' choice, governed by English law and provided that disputes were to be decided in the courts of England and Wales.

The Court of Appeal was constituted by the Chancellor of the High Court (Vos LJ) and Longmore and Leggatt LJJ. Leggatt LJ delivered a judgment with which the other members of the court agreed.

It is beyond the scope of this article to consider all of the various contentions and issues raised. Rather, several of the more significant points considered by the Court of Appeal are noted.

The basic facts

The Las Bambas project was a very large project to develop, construct and operate copper mines in the Apurimac region of Peru. At the time of the share purchase, the project was owned by a Peruvian company called Xstrata Peru SA through a wholly owned subsidiary, Xstrata Las Bambas SA.

Pursuant to a share purchase agreement dated 13 April 2014 (the SPA), a Peruvian company (the first purchaser) and the second claimant purchased (for approximately US$7b) all of the issued shares in Xstrata Peru SA from the first and second defendants (with the third defendant acting as their guarantor). Closing under the SPA took place on 31 July 2014.

On 31 December 2014, the first purchaser and Xstrata Peru SA were absorbed by merger into Xstrata Las Bambas SA, which was renamed Minera Las Bambas SA (MLBSA or the company). The company was therefore not only the operating company for the project, but also the corporate successor of: (1) its parent company, Xstrata Peru SA, whose shares were sold under the SPA; and (2) the first purchaser. The company was the first claimant in the case before the court. In the judgment, the claimants are collectively referred to as the "purchasers" and the defendants were referred to as the "sellers".

Peruvian VAT

Under the Peruvian tax system, VAT was levied in a broadly similar way to VAT in the UK. It was a tax charged on the supply of goods and services. There was a system of credits whereby a taxpayer could set off against the input tax which it charged and collected on its supplies of goods or services to others any output VAT that it paid on goods or services purchased from its own suppliers. A taxpayer with a surplus of output VAT in a given month could carry forward the credit to future months on a rolling basis to offset against its input VAT.

The Las Bambas project had a long development and construction phase before the production of copper commenced and income began to be earned. Construction started in October 2012 and was continuing at the time of the SPA. The project finally achieved steady state commercial production on 1 July 2016. During the construction phase, substantial sums were spent on goods and services purchased from third party suppliers. As a result, the company accumulated a large VAT credit balance. It was common ground that this accumulated VAT credit balance was an important asset and source of working capital for the project.

There was a scheme in Peru (the "early refund scheme") under which, during the construction phase of a large mining project, a taxpayer could obtain a cash refund of VAT credits instead of carrying them forward to future months. Under the early refund scheme, the company had claimed and received various cash refunds of VAT credits. It was common ground that such refunds represented a key source of cash inflow and funding for the project during the construction period and until the mine reached a steady state of commercial production.

The new town VAT

During the development and construction phase of the project, the company acquired land belonging to a rural community in exchange for building a new town for the community in a location away from the project site. The community was then resettled in this new town, which came into existence on 27 June 2014 (that is, before closing under the SPA).

After closing under the SPA, the Peruvian tax authority (SUNAT) conducted a number of audits which led ultimately to SUNAT issuing a tax assessment resolution dated 29 January 2016. By this resolution, SUNAT assessed the company as having incurred a liability to pay VAT in a principal sum of about £6.3m on 27 June 2014 when the new

town came into existence. SUNAT claimed to deduct this sum (referred to as the new town VAT) from the company's accumulated VAT credit balance as it had stood in June 2014. SUNAT also charged penalties and interest for the company's late payment of the new town VAT, which totalled about £3.5m at the time of the assessment.

The rejected VAT credits

The 29 January 2016 assessment resolution issued by SUNAT also determined that the company had claimed tax credits for taxable supplies purchased from third parties between January and November 2014 for which it could not produce adequate supporting documentation and which, for this reason, were disallowed. The amount which SUNAT concluded had been unduly refunded in respect of the period before closing under the SPA was about £4.2m. Of this amount (the "unduly refunded" VAT), about £2m had been paid out to the company before closing and the rest was paid after closing under the SPA took place.

Other credits of about £2.3m relating to the period before closing were also disallowed which had not been refunded to the company and which SUNAT again claimed to deduct from the company's accumulated credit balance.

SUNAT also assessed the company as liable to pay penalties for wrongly claiming the rejected VAT credits (and interest on such penalties) amounting in total to about £6m at the time of the assessment.

Appeals against the assessment

The tax assessment was appealed. The first appeal lay to SUNAT itself. SUNAT resolved this appeal by an "intendancy resolution" dated 1 December 2016, which confirmed its determinations. The second appeal would be to the Peruvian tax court. The company had lodged such an appeal, but the appeal had not yet been determined.

Conduct of the tax claims

Under cl 12.5.1(iv) of the SPA, the sellers had the right to take over the conduct of a claim by, or action against, a third party if it might give rise to a claim against the sellers under the SPA. To exercise this right, the sellers were required to give notice to the purchasers and "agree in writing to indemnify the Purchasers against the full amount (if any) payable under such Third Party Claim (if adversely determined)". Provided this was done:

> "… the Sellers shall be entitled at their own expense and in their absolute discretion … to take such action as it shall deem necessary to avoid, dispute, deny, defend, resist, appeal, compromise or contest the Third Party Claim … in the name of and on behalf of the Purchasers or member of the Purchasers' Group concerned and to have the conduct of any related proceedings, negotiations or appeals, subject to the Sellers not taking any action which could reasonably be considered to be likely to be materially prejudicial to the legitimate commercial interests of the Las Bambas Project or the Group Companies;"

In November 2014, the sellers exercised their right under this clause to take over the conduct of the claim relating to the new town VAT. For that purpose, the sellers entered into the further deed of indemnity with the purchasers.

The sellers had not taken over the conduct of the claim relating to the rejected VAT credits, which was therefore being handled by the company.

The graduality regime

Under Peruvian law, a tax assessment issued by SUNAT became enforceable when the time allowed for filing an appeal expired. If an appeal had been filed, the tax debt could not be enforced by any coercive measures until after the appeal had been determined (and then, of course, only if and in so far as the appeal was unsuccessful).

To encourage payment of sums which were the subject of an appeal, the Peruvian tax system operated a "graduality regime" under which the penalties charged by SUNAT (and interest on those penalties) were reduced if payment was made in full of the disputed tax liability before an appeal was filed. The size of the discount depended on the stage at which payment was made.

The company paid all the sums claimed by SUNAT in respect of penalties and interest on 22 January 2018 after its appeal to SUNAT had been determined and before filing its appeal to the tax court. The company therefore qualified for a 40% discount on any penalties and interest which were upheld on appeal.

The sums referable to the new town VAT were paid under the direction of the sellers (who, as noted, had taken over the conduct of this tax claim) and were ultimately funded by them. The payment referable to the rejected VAT credits was funded by the purchasers.

The tax indemnities

The clause at the centre of the dispute between the parties was cl 10 of the SPA, headed "tax indemnity". This provided:

> "The Sellers shall indemnify the Purchasers in relation to, and covenant to pay the Purchasers an amount equal to:
>
> 10.1.1 the amount of any Tax payable by a Group Company to the extent the Tax has not been discharged or paid on or prior to the Effective Time and it:
>
> (i) relates to any period, or part period, up to and including Closing;
>
> …; or
>
> 10.1.2 to the extent that any Indemnified VAT Receivable … is found to be cancelled, lost or unavailable as a result of the breach of any Sellers' Warranty set out in paragraphs 13.1.1(i), 13.1.2 and 13.1.3 of Schedule 2 (as if given at the date of this Agreement and at Closing), the amount of the repayment of VAT … which would otherwise have been obtained …;"

The definition of "tax" in the SPA was very wide and covered all forms of taxation, including VAT. It also encompassed penalties and interest. The "effective time" (used in cl 10.1.1) was defined as the time immediately prior to closing. The phrase "Indemnified VAT Receivable" (used in cl 10.1.2) was defined to mean "a right to repayment of VAT to the extent that such right to the repayment has been taken into account in the Completion Statement". This was a reference to the company's accumulated VAT credit balance, which was an important asset taken into account in calculating the consideration for the share purchase.

In addition, by cl 3.1 of the deed of indemnity, the sellers had undertaken "to indemnify the Purchasers against the full amount (if any) payable by the Purchasers' Group under each of the Assumed Tax Matters (if adversely determined)". The "assumed tax matters" were, in substance, the "claim or liabilities sought by SUNAT in relation to" the new town VAT.

Approach to contractual interpretation

The SPA was a long and detailed contractual document, which ran to 96 pages and contained an interpretation clause that specified no fewer than 166 definitions of terms used in the contract.

Leggatt LJ said that the principles of English law which the court must apply in interpreting the relevant contractual provisions were not in dispute and had most recently been summarised by the Supreme Court in *Wood v Capita Insurance Services Ltd*.[3] In short, the court's task is to ascertain the objective meaning of the relevant contractual language. This requires the court to consider the ordinary meaning of the words used, in the context of the contract as a whole and any relevant factual background. Where there are rival interpretations, the court should also consider their commercial consequences and which interpretation is more consistent with business common sense. The relative weight to be given to these various factors depends on the circumstances. His Lordship then said:

> "As a general rule, it may be appropriate to place more emphasis on textual analysis when interpreting a detailed and professionally drafted contract such as we are concerned with in this case, and to pay more regard to context where the contract is brief, informal and drafted without skilled professional assistance. But even in the case of a detailed and professionally drafted contract, the parties may not for a variety of reasons achieve a clear and coherent text and considerations of context and commercial common sense may assume more importance."

When was tax "payable"?

A central issue in dispute was at what point in time an amount of tax would become "payable" within the meaning of cl 10.1.1 of the SPA and cl 3.1 of the deed of indemnity. This was not a question that had been addressed in the extensive definition provisions in the SPA.

Leggatt LJ said that the context in which this issue arose was that under Peruvian law an assessment resolution issued by SUNAT established a tax liability which was an actual, and not merely contingent, liability and remained an actual liability unless and until there was a decision of the tax court which set it aside. However, the liability was not enforceable in that the tax could not be collected through any coercive procedure while the assessment was under appeal to the tax court.

The purchasers contended that tax would become "payable" (within the meaning of cl 10.1.1) when the existence and amount of a liability was established. The sellers, on the other hand, contended that tax would become "payable" only when an enforceable obligation to pay the relevant amount arose — which would not occur before the appeal to the tax court had been decided.

Leggatt LJ said that the sellers' interpretation was correct. As Slade LJ observed in *Morton v Chief Adjudication Officer*,[4] the word "payable" is not a legal term of art: it is a word which is capable of bearing different meanings in different contexts. As has repeatedly been said, every document must be construed in accordance with its particular terms and in its unique setting. Nor was any assistance to be derived from examining how the word "payable" was used elsewhere in the SPA.

His Lordship said that he accepted that, as a matter of ordinary language, the word "payable" was capable of being used in either of the two senses for which the parties respectively contended. But, in the setting of cl 10.1.1, the word was reasonably understood to mean that there was an enforceable obligation to pay an amount of tax and not merely that a liability to pay an amount of tax had been established. This conclusion was supported by the following two main reasons:

- the obligation imposed by cl 10 was one of indemnity. In English law, an indemnity is a promise to prevent the indemnified person from suffering loss. If the existence and amount of a debt have been established but the indemnified person has not yet come under an enforceable obligation to pay the debt, it cannot be said that any loss has been suffered which the indemnifier has failed to prevent or to hold the indemnified person harmless against. To treat the sellers' obligation to pay an amount of money to the purchasers as triggered in such a situation therefore was inconsistent with the general nature and purpose of an indemnity; and
- it did not make commercial sense to require the sellers to pay an amount of money to the purchasers which was not at present needed, and may never be needed, to satisfy a liability to pay tax. Thus, in the case of the new town VAT, if the appeal to the tax court were to succeed and SUNAT's assessment was set aside (assuming no further appeal), the company would never come under an enforceable obligation to pay the sum claimed by SUNAT. It was commercially unreasonable to interpret cl 10 as obliging the sellers to put the purchasers in funds for an amount of money which they may, or may not, come under an enforceable obligation to pay in the future.

The consequences of the purchasers' interpretation were particularly stark in relation to the VAT credits which SUNAT had assessed as having been unduly refunded. Pending its appeal to the tax court, the company still had the money which was refunded and had not been compelled to pay any of it back to SUNAT. If, as it expected, the company succeeded on its appeal, it would never be required to pay the money back to SUNAT. Yet the purchasers' case was that cl 10.1.1 of the SPA entitled them to be paid by the sellers an amount equal to the refunded amount now, even though the company had not paid it, need not pay it and expected never to pay it to SUNAT. That would result in the company having the benefit of the money twice over for the duration of the court proceedings, which was not an arrangement that would serve any legitimate commercial purpose.

Leggatt LJ also rejected other arguments advanced by the purchasers. One of these arguments relied on the time limit

for claims in cl 11.1.1 of the SPA, which excluded liability for any tax claim unless notice of the claim is given by the purchasers to the sellers within six years following closing. The purchasers submitted that, given the length of time that audits, assessments and subsequent appeals may take before the existence and amount of a tax liability are finally determined and the liability becomes enforceable, the sellers' interpretation of cl 10.1.1 could have the effect that a claim for an indemnity under that clause would be time-barred before it could be brought.

In rejecting this contention, Leggatt LJ said that there was nothing to prevent the purchasers from giving notice of a claim under the SPA and bringing proceedings to establish their right to be indemnified in respect of an amount of tax before the tax had actually become "payable" and the right had accrued. Indeed, that was what they had done in the present case. This was reinforced by cl 11.5, which dealt with contingent liabilities.

Rejected VAT credits

Do they amount to "tax payable"?

Leggatt LJ agreed with the view that the disallowance of a VAT credit which had not been refunded and which resulted only in the reduction of an accumulated credit balance was not covered by cl 10.1.1 and attracted an indemnity only if it fell within cl 10.1.2.

The claim under cl 10.1.2

To establish a right of indemnity under cl 10.1.2, the purchasers would need to show that (1) an "indemnified VAT receivable" (2) is found to be cancelled, lost or unavailable (3) as a result of a relevant breach of warranty by the sellers. The meaning and effect of each of these three requirements was in issue.

What constitutes an "indemnified VAT receivable"?

As mentioned, the expression "indemnified VAT receivable" was defined in the SPA to mean "a right to repayment of VAT to the extent that such right to the repayment has been taken into account in the Completion Statement".

After considering various arguments, Leggatt LJ said that it was clear from the wording of the definition that what must be taken into account in the completion statement was "a right to repayment of VAT". There was no other way in which such a right could be taken into account except by including it in the VAT receivable balance: if an amount was not part of that balance, according to the completion statement there was no right to repayment of VAT in that amount, and ex hypothesi therefore no such right is capable of being taken into account anywhere else in the completion statement.

His Lordship further said that the evident commercial purpose of cl 10.1.2 was to protect the purchasers against the risk that (any part of) the accumulated VAT credit balance at the time of closing, which represented a valuable asset included in the amount of the consideration paid to purchase the shares, might turn out to be illusory. Interpreted in that light, the definition of an "indemnified VAT receivable" was concerned solely with what was taken into account in the completion statement and not with what has happened after closing. Nevertheless, VAT credits which were included as receivables in the completion statement (and therefore fell within the contractual definition) could not be the subject of a right of indemnity under cl 10.1.2 if they had in fact been refunded. That is because a right to repayment could not be said to have been cancelled, lost or unavailable if repayment has actually been obtained. Furthermore, the amount which the sellers are obliged to pay the purchasers where cl 10.1.2 is engaged is "the amount of the repayment of VAT … which would otherwise have been obtained". There was therefore no amount which the sellers are obliged to pay if repayment has in fact been obtained. This conclusion did not give rise to any gap in the contractual scheme because a VAT credit which has in fact been repaid will fall within cl 10.1.1 if the company were to come under an enforceable obligation to pay it back to SUNAT.

Accordingly, the "unduly refunded" VAT was not within the scope of cl 10.1.2 of the SPA.

The trigger event under cl 10.1.2

Leggatt LJ agreed with the view of Moulder J at first instance that the words "is found" should be interpreted as requiring a definitive finding such that the issuance of an assessment resolution by SUNAT was not sufficient to trigger a right of indemnity while it remains under challenge in the tax court.

The meaning of the relevant warranties

A claim made under cl 10.1.2 also depended on establishing a breach of one of the warranties set out in para 13.1 of Sch 2 to the SPA. After considering the relevant warranties, Leggatt LJ concluded that Moulder J had interpreted the warranties correctly and was entitled to find that the purchasers had failed to establish any breach of warranty on which they could rely to claim an indemnity under cl 10.1.2 of the SPA.

The loss of the 60% discount

Moulder J rejected an argument made by the sellers that the failure to take advantage of the full 60% discount in respect of the penalties and interest charged by SUNAT in connection with the rejected VAT credits (but did qualify for a 40% discount by making the requisite payment before filing its second appeal to the tax court) amounted to a breach of the purchasers' obligation under cl 11.12 of the SPA to take reasonable steps to mitigate its losses. Clause 11.12 provided:

> "Mitigation of Losses
>
> The Purchasers shall procure that all reasonable steps are taken and all reasonable assistance is given to avoid or mitigate any Losses which in the absence of mitigation might give rise to a liability in respect of any claim under this Agreement."

Leggatt LJ said that he accepted that the effect of cl 11.8.2 was to allocate more risk to the purchasers than they would bear under common law rules, which enable a claimant to recover losses that it could have avoided, provided that it has not acted unreasonably. His Lordship went on:

> "But it could not be assumed that a clause included in the contract under the heading 'Limitation of Sellers' Liability' is intended simply to replicate or restate limitations on the extent of liability that would anyway exist at common law, rather than imposing further and greater

restrictions. In a contract for the sale of a business the extent to which the risk of losses or liabilities arising after the sale is assumed by the purchaser or retained by the seller is a matter for negotiation between them. There is no inherently right or reasonable allocation of the risk, particularly given that the extent of the warranties which the seller is prepared to grant depends in large measure on what price the purchaser is willing to pay. Within very wide limits, English law leaves the parties free to make their own bargain and affords them the respect, when they have entered into a formal, professionally drafted and commercially negotiated agreement, of treating them as having meant what they said. An agreement which exempts the seller from liability for losses which the purchaser could have avoided cannot be considered irrational and there is no basis on which the court can or should infer that it is not an agreement the parties intended to make."

Some comments

It is not uncommon for commercial agreements to include a provision to the effect that one party to the agreement will indemnify another party to the agreement for a tax liability that may arise to the other party as a result of the transaction.

As illustrated by the decision of the Court of Appeal in the *Minera Lasa Bambas* case, care needs to be taken to ensure that, to the extent possible, a tax indemnity provision does not give rise to disputes between the parties which require litigation to settle. The central concept of "tax payable" was one that invited some elucidation given the central importance of the term. And, of course, where the potential amounts involved are large, litigation may become correspondingly likely and extensive. Will there be an appeal to the Supreme Court from the decision of the Court of Appeal in the *Minera Lasa Bambas* case?

Depending on the circumstances, it may be useful to include in a tax indemnity provision a statement of objects which sets out what is being sought to be achieved.

And the potential for any compensation to itself be subject to tax (for instance, CGT or GST), and, indeed, tax on tax, must also be considered and appropriately covered; and if there is any doubt at all in relation to this possibility, a precautionary provision should be included.

For a decision of the New South Wales Court of Appeal in which an indemnity provision in a lease was considered, see *CBA Investments Ltd v Northern Star Ltd.*[5]

TaxCounsel Pty Ltd

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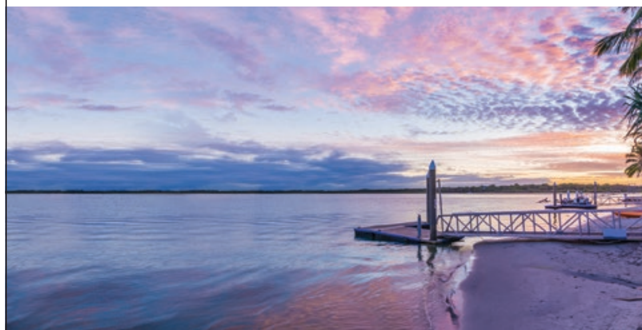

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Mid Market Focus

by Anthony Forsyth, HLB Mann Judd

ESIC tax incentives: how well are they understood?

Considering the impressive tax benefits that ESIC tax incentives can provide investors, it is surprising that these rules are still not well-known and are often misunderstood.

Introduction

As part of the Australian Government's National Innovation and Science Agenda to encourage innovation by encouraging entrepreneurship and risk-taking, the Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016 was introduced and received royal assent on 5 May 2016.

As part of this legislation, effective from 1 July 2016, the concept of an early stage innovation company (ESIC) was introduced which allows for investors to receive tax incentives to encourage them to undertake the risk of investing in start-up companies that were focused on innovation and high growth.

Although the utilisation of the ESIC tax incentives has been increasing over time, it is still apparent that there is a lack of awareness among many start-ups (and advisers) of the benefits and eligibility for an investor in a company to access these tax incentives. In addition, the eligibility requirements for both investors and companies are commonly misunderstood.

Tax incentives for investors

For any start-up company, one of the main challenges is to attract investors to provide sufficient capital to continue to grow and develop. The competitive advantage for a company which qualifies as an ESIC over one that does not is that eligible investors may receive the following tax incentives:

- a tax offset equal to 20% of what the investor paid for the qualifying shares[1] which can be utilised to offset other taxable income. It is noted that this is not a refundable offset but can be carried forward to future years to offset future taxable income; and
- the investor can disregard any capital gains arising in relation to the qualifying shares for shares held for more than 12 months up to 10 years. Where the shares are held for greater than 10 years, the cost base of the share will be the market value of the share on the 10-year anniversary date.[2]

Hence, this can be a major marketing tool for an ESIC as it may make the investment proposition more attractive to investors over investing in a company which is not an ESIC.

Therefore, it should be considered imperative that any start-up company considers its ESIC status in seeking new investors.

Early stage test

For a company to be an ESIC, it must pass the early stage test which will determine if the company is at an early stage in its development. Broadly, the company (and its 100% subsidiaries where relevant) must satisfy the following requirements at a time in an income year:[3]

- recent incorporation (within three years or within six years subject to income tests) or registration in the Australian Business Register (within three years);
- total expenses of $1m or less in the income year before the current year;
- assessable income of $200,000 or less in the income year before the current year; and
- the company must not be listed on a stock exchange.

Although the above tests are relatively straightforward, they should be considered before any further tests below are applied because, if they are not satisfied, the company is unable to be considered as an ESIC regardless of the innovation developed. In addition, it is noted that the above conditions require the entity to be a company and therefore a trust will not be eligible to be an ESIC.

Innovation test

100-point innovation test

In addition to the early stage test above, the innovation test must also be satisfied. This can be done by satisfying either the 100-point innovation test or the principles-based test. As the 100-point innovation test is an objective test, it is generally considered much easier to satisfy than the principles-based test (which is a subjective test). This means that start-up companies can feel more confident in applying the 100-point innovation test without the need for confirmation from the Australian Taxation Office that it is satisfied. It is generally recommended, in the author's opinion, that a private ruling with the ATO is sought where the principles-based test is being applied.

To qualify as an ESIC under the 100-point innovation test, a company must obtain at least 100 points from an innovation test table.[4] Although the conditions for each point section can be quite detailed, Table 1 provides a high-level summary.

As the innovation test table provides for up to 75 points out of 100 for accessing the research and development (R&D) tax incentive, this should be considered a key aspect when determining whether a company will be likely to satisfy the 100-point innovation test. If the R&D tax incentive has been accessed by the company in the prior year, the 100-point innovation test is more likely to be passed (although it can be passed without R&D tax incentives being accessed).

The 100-point innovation test should always be utilised in favour of the principles-based test below. It is generally

Table 1. 100-point innovation test

Points	Criteria
75 points	At least 50% of the company's total expenses for the previous income year are eligible notional deductions for the research and development tax incentive.
75 points	The company has received an accelerating commercialisation grant at any time.
50 points	At least 15% but less than 50% of the company's total expenses for the previous income year are eligible notional deductions for the research and development tax incentive.
50 points	The company has completed or is undertaking an eligible accelerator programme (with certain further conditions to be satisfied).
50 points	A total of at least $50,000 has been paid (by entities that are not associates) for equity interests that are shares in the company (with further conditions to be satisfied).
50 points	A company has enforceable rights on an innovation through either a standard patent, plant breeder's right or equivalent right overseas (with further conditions to be satisfied).
25 points	A company has enforceable rights on an innovation through either an innovation patent granted in Australia in the last five years, a design right granted in Australia in the last five years or an equivalent intellectual property right granted in another country. Only available if the company did not receive 50 points for the previous criteria.
25 points	The company has a written agreement to co-develop and commercialise an innovation with either: – an institution or body listed in Sch 1 to the Higher Education Funding Act 1988 (Cth); or – an entity registered as a research service provider under s 29A of the *Industry Research and Development Act 1986* (Cth).

considered to be easy to apply and the threshold of what is "innovative" appears to be lower than what is considered in the principles-based test. However, when a company has been newly incorporated, it may be practically difficult to satisfy the 100-point innovation test and therefore the principles-based test may necessarily be required to be considered.

Principles-based test

To satisfy the principles-based test, a company must meet five requirements at a time immediately after the relevant new shares are issued to the investor. Broadly, the five requirements of the principles-based test are:[5]

- the company is genuinely focused on developing one or more new or significantly improved innovations for commercialisation;
- the business relating to that innovation must have a high growth potential;
- the company must demonstrate that it has the potential to be able to successfully scale up the business relating to the innovation;
- the company must demonstrate that it has the potential to be able to address a broader than local market, including global market, through that business; and
- the company must demonstrate that it has the potential to be able to have a competitive advantage for that business.

As discussed previously, whether a company satisfies the above is purely subjective, as a company may have a different opinion than the ATO. Therefore, in the author's opinion, it is recommended that a private binding ruling is obtained where the principles-based test is applied to receive certainty that the ATO agrees with the company's position. This differs to the application of the 100-point innovation test which, due to its objective nature, can be applied with certainty without a ruling from the ATO.

Due to the subjective nature of the above tests, it is recommended when considering them to refer to the explanatory memorandum (EM) to the legislation, the *Oslo manual*[6] (referred to in the EM) and the draft guide *A step-by-step guide to the principles-based innovation test*.[7] These all provide interpretations in relation to the five requirements above from the ATO perspective, which will assist in preparing a private binding ruling.

Key errors being made by companies and investors

In the author's experience, the following key errors in understanding the ESIC rules are being made by start-up companies and investors:

- founders of start-up companies want to access the tax concessions themselves. The ESIC tax incentives are for attracting new investors and are not intended to apply to founding shareholders (or their affiliates);
- founders of start-up companies want to sell a portion of their shareholding to the new investors. The ESIC tax concessions are only available in relation to newly issued shares. They are intended to create more working capital for the company and not to provide an exit option for the founding shareholders;
- all investors are told that they can access a tax offset of up to $200,000 without consideration of their individual circumstances. The maximum offset is only available to "sophisticated investors", whereas all other investors can only invest a maximum of $50,000 in the ESIC (with a maximum offset of $10,000);
- one investor is provided with greater than 30% equity in the company. An investor cannot hold more than 30% of the equity in a company if they want to be eligible for the ESIC concessions;
- start-up companies who are not eligible for the 100-point innovation test are self-assessing under the principles-based test. While there is no technical reason that this is not allowed, it is generally not recommended as ultimately the ATO will form its own opinion as to whether a company is an ESIC or not. Therefore, in the author's opinion, where the principles-based test is applied,

a company should seek confirmation from the ATO by way of a private binding ruling;

- where the principles-based test is applied, start-up companies often state that they have a new or significantly improved innovation because they believe that they do. Often, not enough consideration and effort is being made to explore what other similar products or services are on the market. It is not uncommon for the ATO to perform its own research of similar innovations and ask the start-up company to explain how they are new or significantly improved;
- companies may seek to apply the principles-based test once an innovative idea has been made but no steps have been made to commercialise the innovation. In the opinion of the ATO, the innovation must be more developed than the pre-concept stage for a company to be "genuinely focused" on commercialising an innovation; and
- companies seek a ruling from the ATO in relation to the principles-based test do not provide enough information to prove the innovation has high growth potential, is scalable and can address a broader market. In the experience of the author, the ATO will need to view a business plan, forecasts of revenue and activity, marketing plans, supplier arrangements, and other similar documents to be satisfied that an innovation has high growth potential and is scalable.

The above errors are often a result of start-up companies and investors not being aware of the complexity of the ESIC legislation and instead being focused on the quite substantial tax benefits an investor of an ESIC can receive. Careful consideration and understanding of the rules in detail are required before the benefits can be accessed, especially where the principles-based test is applied instead of the 100-point innovation test.

Conclusion

Although the ESIC tax incentives have been in existence for over three years, they are still not as widely known as one would expect and they are also not well understood where they are known. The tax incentives provided under the ESIC rules are substantial and therefore all start-up companies should be at least considering at a high level if they may be eligible to be an ESIC when attracting investors. In addition, the start-up company needs to understand that the ESIC rules are complicated, especially if the 100-point innovation test is not available, and therefore need to consider their application in detail.

Anthony Forsyth
Manager
HLB Mann Judd

References

1. S 360-15 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).
2. S 360-50(4) and (5) ITAA97.
3. S 360-40(1)(a) to (d) ITAA97.
4. S 360-45(1) ITAA97.
5. S 360-40(1)(e) ITAA97.
6. Published by the Organisation for Economic Co-operation and Development.
7. Available on the ATO "Let's talk" website.

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Tax Education

by Revital Folan

Not just another program

The Tax Institute's 2018 study period 3 duces share their thoughts on The Tax Institute's programs.

ATL002 Commercial Law 1 Dux Award for study period 3, 2018

Name: Michael Mangion

Position: Senior Accountant

Company: Boroughs Chartered Accountants

State: New South Wales

Can you tell us about your background?

I started working as a cadet at Boroughs Chartered Accountants in Sydney in 2012. While working at Boroughs, I completed a Bachelor of Commerce (Distinction) at UNSW, and then completed the CA Program. My role in a business services team involves dealing with a wide variety of tax and accounting matters on a daily basis, and has exposed me to an extensive range of tax compliance and planning issues through the varying circumstances of clients and their various group structures.

How many years of experience do you have?

I have been working in accounting for seven years.

What is the most valuable aspect of studying ATL002 Commercial Law 1 that you have taken away?

The most valuable aspect of this subject would be the knowledge I have obtained in relation to contract law. The technical understanding of the many aspects of contract law which I have obtained from this subject is very valuable as I can now apply this knowledge to assist corporate clients when they are required to deal with various types of contracts. This aspect will also be valuable in my everyday life, as contracts and contract law are of great importance in a variety of everyday matters.

Have you gained confidence in new areas?

This subject covered a broad range of areas in relation to Australian legal systems, contract law and tort law, all of which I feel I am now more confident in understanding and dealing with as required. The module on Australian legal systems dealt with the organisation of government and the sources of law. The module on torts dealt with types of torts, with a focus on the tort of negligence. The module on contracts dealt with contract formation, as well as contents, performance and breach of contract.

Can you tell us about your main reason for undertaking the course?

Following from my previous studies and exposure to the legal issues of clients, I was keen to further expand my knowledge of commercial law. The strong understanding of Australian legal systems which I have taken away from this subject was essential to achieving this objective.

What is your next step with education?

This subject was the first subject undertaken as part of completing the Graduate Diploma of Applied Tax Law. I am currently studying ATL005 Commercial Law 2.

What are some challenges of juggling study and work? Do you have any tips for managing study and work?

Having previously completed university and the CA program while working, I have developed a strong ability to manage my time effectively to juggle not only study and work, but also maintain an active social life. One of the main challenges is making sure you study regularly throughout the duration of the module, so that you don't leave too much to the last week before the exam. It is all about being able to set aside enough time per week, whether it is after work or on the weekends, to ensure that you do not become stressed or overwhelmed by the content of the subject as the exam approaches, particularly if this is around the same time as a busy period at work. Use a schedule to ensure you stay on track, and reward yourself each time you complete an activity, chapter or module.

What advice do you have for other tax professionals considering The Tax Institute's subjects?

I would definitely advise studying this subject and would recommend it, especially for those undertaking the Graduate Diploma wishing to develop their knowledge of legal systems and commercial law. I have found this subject very valuable as a starting point to my Graduate Diploma of Applied Tax Law program, and I feel that I will be able to utilise the knowledge gained from this subject as I complete each of my remaining subjects.

ATL003 CTA2A Advanced Dux Award for study period 3, 2018

Name: Jenna Podolczak

Position: Manager

Company: Vincents

State: Queensland

Can you tell us about your background?

I started work at Vincents as a graduate in 2009 in the tax and business services department and enjoyed it so much I never left.

What is the most valuable aspect of studying ATL003 CTA2A Advanced that you have taken away?

I found it a good refresher on topics I knew and some I didn't know in depth.

Have you gained confidence in new areas?

The topic I gained the most from in this subject was superannuation. While I have a working knowledge of areas that directly impact my client base, I have enjoyed learning more in this area.

Can you tell us about the main reason for undertaking the course?

My work colleague enrolled and suggested I enrol as well.

What is your next step with education?

As tax is always changing and evolving, I don't think my tax education will ever stop. More specifically and immediately, I'll be doing CTA2B Advanced.

What are some challenges of juggling study and work? Do you have any tips for managing study and work?

Make sure you understand your learning and study style and stick to it. Also, make time to relax outside of study and work, you'll be more productive if you do.

ATL004 CTA2B Advanced Dux Award for study period 3, 2018

Name: Adéle Coetzee

Position: Superannuation Client Engagement Officer

Company: Australian Taxation Office

State: Queensland

Can you tell us about your background?

I have been working for the ATO for just over seven years. One of the benefits of working for the ATO is that I have been exposed to a number of different client groups, ranging from individual taxpayers and small businesses to SMSF trustees and auditors. My roles have also been varied and included providing advice and guidance, such as private binding rulings, auditing of SMSFs for compliance with the *Superannuation Industry (Supervision) Act 1993* (Cth) and review of approved auditors to ensure they meet the relevant independence and competency standards. I have also been given the opportunity to develop my management skills as well as IT skills through the development and management of databases.

How many years of experience do you have?

I have seven-and-a-half years' experience with the ATO, and prior to that, over 10 years as a small business owner responsible for the day-to-day compliance with tax and financial requirements.

What is the most valuable aspect of studying ATL004 CTA2B Advanced that you have taken away?

ATL004 CTA2B Advanced covers a wide range of topics which have broadened my understanding of different taxation issues that could affect a client. This has given me the ability to better understand clients and their circumstances and think more broadly on the implications of certain transactions or structures and how I can assist them.

Have you gained confidence in new areas?

The main area of new confidence for me covered in this subject is fringe benefits tax. I have had little exposure to this topic in the past and found it both interesting and challenging.

Can you tell us about the main reason for undertaking the course?

At the ATO, we are encouraged to take part in learning and development opportunities. ATL004 CTA2B Advanced is part of the Chartered Tax Adviser Program and the ATO has partnered with The Tax Institute to provide a pathway for ATO staff to become a Chartered Tax Adviser. Apart from the qualification as a Chartered Tax Adviser, I saw this as a great opportunity to expand my tax technical knowledge and get a better understanding of clients to provide a better client experience.

What is your next step with education?

My immediate goal is to finish the last subject, CTA3 Advisory in October this year to become a Chartered Tax Adviser.

What are some challenges of juggling study and work? Do you have any tips for managing study and work?

Working full-time in tax and then going home at night to study even more tax is hard. I therefore did most of my study over the weekend. I found the webinars very useful and tried to attend the live webinars so I could participate and post questions. And always keep in mind that it is short-term pain for long-term gain.

What advice do you have for other tax professionals considering The Tax Institute's programs?

Get the most out of studying the topics presented. You may think that you will never come across some of the scenarios or topics presented in the material, but you never know. I have already had several times where I would say, "I'm sure there was something about that in my study notes". The study notes have become a valuable one-stop reference guide for me that point me to all the relevant legislation and court decisions.

ATL005 Commercial Law 2 Dux Award for study period 3, 2018

Name: Zhien (Marco) Zhou

Position: Senior Tax Advisor

Company: TSG Advisory Group Pty Ltd

State: New South Wales

Can you tell us about your background?

I started my tax career at a chartered firm located in Liverpool in 2011. Two years later, I moved to another chartered firm in the Inner West. Having worked with that

firm for five years, I was promoted to senior tax adviser. I specialised in providing tax advice for small businesses, high net value individuals and SMSFs.

What is the most valuable aspect of studying ATL005 Commercial Law 2 that you have taken away?

ATL005 Commercial Law 2 is a very well-structured subject. Compared with the tax modules in CA programs and CPA programs, the courses provided by The Tax Institute emphasise legislation rather than calculations. They seem to prepare the candidates to be tax lawyers, although as a tax accountant, I still benefit a lot from my Graduate Diploma of Applied Tax Law program studies. The course materials equipped me with a solid knowledge in tax legislation which rewarded me with skills and confidence in serving my clients and dealing with the tax authorities.

My favourite part of ATL005 Commercial Law 2 was appendix 1 at the end of module 2, which gave me a comprehensive snapshot of the characteristics of various entity structures. The CCH eBook is a useful supplementary to the subject notes. It added to my understanding of the subject materials via detailed explanations and cases.

Have you gained confidence in new areas?

Although there are not many insolvency cases in my daily tax practice, the insolvency module enabled me to distinguish the different types of insolvency. After studying this subject, I am more confident in advising my clients of the most suitable choice for their insolvency, explaining to them the legal implications, benefits and disadvantages.

What is your next step with education?

ATL005 Commercial Law 2 is my last subject in the Graduate Diploma of Applied Tax Law program. My next step is to study CTA3 Advisory, which will be another great challenge.

What advice do you have for other tax professionals considering The Tax Institute's programs?

Looking back at all the subjects I have undertaken, I strongly recommend the Graduate Diploma of Applied Tax Law program to professionals working in the tax area due to the high quality of study materials.

I suggest that candidates spread the workload of the subject study over the whole study period, while leaving two weeks to prepare for the final exam.

Attempting activities, referring to required readings, attending webinars and participating in forum discussions will all assist you in successfully completing ATL005 Commercial Law.

Above all, applying what we learned from the textbooks to our daily work is the ultimate purpose of our study.

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Andy Milidoni, CTA
Partner, Tax Lawyer and CTA3 Advisory Lecturer for The Tax Institute

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Member Profile

This month's column features The Tax Institute's 2019 Chartered Tax Adviser of the Year, Paul Sokolowski, CTA, Arnold Bloch Leibler.

Member since

1998

Areas of specialty

You could say I'm a specialist tax generalist. At one time or another, I have considered or dealt with most tax issues, and the general law and the administrative framework from which they emerge. I am passionate about tax, and that passion informs the approach to my work for the broad range of domestic and foreign clients I act for: high wealth individuals and families, corporate leaders, entrepreneurs, major corporations, not-for-profits, and the disadvantaged in our community.

Why are you a member of The Tax Institute?

The Tax Institute is a meeting place, virtual and actual, for those professionals who take tax seriously. As members, we learn from and teach each other about the rules and practices that enable us to better serve our clients, and the Australian community. Members of the Institute are the glue that keeps our, at times, crazy tax system together.

How is your membership beneficial to your practice and clients?

Through our member contacts and the Institute's education programs, publications and seminars, we can tap into the minds and experiences of thousands of practitioners to help with the questions and problems our clients present. It allows us to look at things differently to get the best result for our clients. From a practice perspective, we can get relevant and targeted training, and opportunities for all our professionals to write and present on tax, where we learn as much as we teach.

How did you end up in tax?

Most good things that happen are not planned out in advance. Well, it certainly seems like that sometimes, as I reflect on the seemingly random events that got me here.

Why, on leaving school, did I accept a position in the ATO (on my application form, I emphasised taxation as the place I did not want to work)? Why did I then complete a commerce degree? I can't recall the reasons. What made me pick up a week-old newspaper (as I was nursing our second child to sleep) and look at that small advertisement for the Deakin University law program? What got me to my first lecture and all the others which followed? I don't know. After many interesting years as a tax bureaucrat, what made me want to be a lawyer? Why did I resign from the ATO (and give up an indexed pension for life)? Once again, I don't know the reasons.

What made me ignore the large firms and choose Arnold Bloch Leibler? Whatever the reason, it was the best decision I ever made (except, of course, for marrying a wonderful person and having four beautiful children).

I do know one thing though: no one chooses a career in tax, it chooses you.

The ATO, law school and ABL partner. So far, it's been an excellent adventure. That's got to be the reason.

What are the challenges for tax practitioners this year?

Uncertainty. A seemingly perpetual issue for us, but this year particularly so. A truckload of announced but unenacted measures, a federal election and competing tax policies of the major parties, and the ATO trying to fill in the gaps (mostly sensibly but sometimes not so).

Most memorable career moment to date

Joining ABL, and then becoming a partner. The best clients, great people (you couldn't hope to get a better collection of minds) and a culture of attracting, rewarding and delivering excellence.

How do you relax?

If I can, by not thinking about tax. Being with my family. Listening to my vinyl, reading as widely as possible, watching movies and soccer, building scale models, and generally pottering in my shed and using my hands to make stuff. Also, my daughters have recently put me onto some amazing podcasts.

Advice to those entering the profession

Be inquisitive and patient. Expect change, uncertainty and, importantly, technological and structural disruptors that will alter how you work and the work you do. Learn constantly about the rules, the system and how decision-makers think. A deep understanding of the general law (eg trusts, contracts, property and corporations law) is critical to be an effective tax adviser.

What does winning the 2019 Chartered Tax Adviser of the Year award mean to you?

To be recognised by my peers in this way is the pinnacle for me. But it is also a recognition of the great work we do for our clients. This recognition, which I hope inspires, is not from my efforts alone. I am carried in the slipstream created by the thinking and efforts of the marvellous ABL tax team. We work together, where everyone can have input. We share, and have pride in, our successes.

No restrictions to negative gearing? Think again!

by David Krunic, CTA, Principal – Taxation Advisory, DKP & Co

Significant changes to negative gearing are on the horizon for individual, family trust and self-managed superannuation fund taxpayers. Adverse tax consequences during construction phase involving involuntary destruction, significant damage and otherwise legitimately vacant rental properties are raised for consideration. The article discusses new concepts proposed to apply from 1 July 2019, including an unexpected and expanded meaning given to "vacant land" and "substantial permanent structure". There are practical examples of how the proposed measures apply in the simple case of a residential property investor building on vacant land, and an individual or family trust taxpayer purchasing a basic house and land package for rental purposes. There is an exemption for assets used in business, and the not-so-transitional application dates are also looked at. This is an important legislative proposal that all advisers of residential property investors need to be aware of.

Introduction

Negative gearing has been a hot-button issue in the recent federal election with significant focus on proposals released by the Opposition (ALP). However, a draft Bill proposed by the government seemed not to attract anywhere near the same amount of attention.

The proposals released by government seek to address tax integrity concerns (para 1.5 and 1.6 of the explanatory memorandum (EM)) involving:

> "… some taxpayers … claiming deductions for costs associated with holding vacant land when it is not genuinely held for the purpose of gaining or producing assessable income.
>
> … there is often limited evidence about the taxpayer's intent other than statements by the taxpayer. The reliance on taxpayer's assertions about their current intention leads to compliance and administrative difficulties."

In response to these concerns, the government introduced the Treasury Laws Amendment (Measures for a later sitting) Bill 2018: Limiting deductions for vacant land (the 2018 Bill), which was included in the May 2018 federal Budget.

On face value, many advisers would read the headlines of this proposal and consider it no more than what is the current state of affairs, and not claim costs relating to the holding of "vacant land".

However, a detailed reading of the 2018 Bill and its associated EM shows that there is a new and significantly wider meaning given to "vacant land" with a much broader application to many non-business taxpayers, particularly individuals, family trusts and self-managed superannuation funds (SMSFs) that own residential property.

New concepts

The 2018 Bill effectively introduces three new tests requiring consideration before outgoings and losses (such as holding costs) can be claimed as income tax deductions.

Those tests are broadly as follows:

- consider first whether there is a substantive permanent building, or other substantive permanent structure on the land, that is in use or ready for use (proposed s 26-105(1) of the *Income Tax Assessment Act 1997* (Cth) (ITAA97));
- a blanket exclusion is provided from measures where the land is being used in carrying on a business for the purpose of gaining or producing the assessable income of the taxpayer or certain related entities (s 26-105(1) and (2)); and
- a requirement to disregard a building that is residential premises and has been constructed, or substantially renovated, while you hold the land unless:
  - the residential premises are lawfully able to be occupied; and
  - the residential premises are:
    - leased, hired, or licensed; or
    - available for lease, hire or licence (s 26-105(3)).

There are many aspects of the 2018 Bill warranting attention as the measures seem to go well beyond integrity concerns and actually appear to be a response to *Steele v FCT*.[1]

Lack of Commissioner discretion

Unlike measures dealing with the integrity concerns surrounding non-commercial losses, the 2018 Bill does not provide for any Commissioner discretion (as contained in s 35-55 ITAA97).

It is not explained why, on the one hand, non-commercial losses allow for the use of "evidence from independent sources" (s 35-55(1)(b)(ii)) to help override the denial mechanisms, whereas no such scope exists within the 2018 Bill for similar integrity concerns with legitimate residential rental property investments.

Division 35 ITAA97 includes a real property test, profits test and assessable income test — none of which are contemplated in the 2018 Bill.

Consistency within the ITAA97 would require the 2018 Bill to consider objective tests and evidence from independent sources. It is hoped this could be included in future drafts of this legislation.

New tax treatment – building a rental property on vacant land

A relatively common situation involves a "plain vanilla" case involving mum and dad taxpayers purchasing a vacant block of land and deciding to build a new rental property on it.

Under current rules, the holding costs (eg interest) would be tax deductible, as there would be an objective plan to generate assessable income (ie residential rental income).

Under the 2018 Bill, these holding costs would not be an allowable income tax deduction until after the rental property is legally available for occupation and available for lease, as shown in example 1.5 of the EM:

> "**Example 1.5: New residential premises available for rent**
>
> Anna purchased a block of vacant land and built new residential premises on it. Occupancy permits are issued for the residential premises once the building is considered suitable for occupation.
>
> The building is available for lease and advertised in various property websites which give it broad exposure to potential tenants. Anna can deduct the cost of holding this block of land to the extent expenses relate to the period when the property is legally available for occupation and is leased etc or otherwise available for lease etc."

Effectively, holding costs during planning, construction and prior to receiving an occupancy permit would now cease to be allowable income tax deductions.

Importantly, corporations, public and managed investment trusts and non-SMSFs are specifically excluded (s 26-105(4) ITAA97) from these loss denial measures, even though they would undertake the same process in constructing the same asset. This is an unusual and unequal treatment for the same type of expenditure by different classes of taxpayers.

Early deposit for new residential house/land package purchases

Similar to example 1.5 provided in the EM, where mum and dad borrow funds to pay for a deposit on a house/land rental property under construction, it appears that these holding costs would not be allowable income tax deductions until mum and dad have received an occupancy permit, and the property is available for lease, hire or licence.

This is quite a significant change to the current income tax regime.

Who are the target taxpayers?

These measures specifically target non-business taxpayers, including individuals, family/discretionary trusts, closely held unit trusts and SMSFs not in business.

The following taxpayers are excluded from these measures (s 26-105(4)):

- a corporate tax entity;
- a superannuation plan that is not an SMSF;
- a managed investment trust;
- a public unit trust (within the meaning of s 102P of the *Income Tax Assessment Act 1936* (Cth) (ITAA36)); or
- a unit trust or partnership, if each member of the trust or partnership is listed above during the income year.

There is no Commissioner discretion available to extend the class of taxpayer excluded from these measures.

Use by associates in business

In order to provide some flexibility with business structuring, the 2018 Bill does not prohibit deductions to the holder of vacant land for the costs of holding that land to the extent they are incurred in carrying on a business by the taxpayer, or for costs incurred in holding land that is used in carrying on such a business by certain entities related to the taxpayer.

The related entities include:

- your affiliate, or an entity of which you are an affiliate;
- if you are an individual, your spouse, or any of your children under 18 years of age; or
- an entity connected with you (s 26-105(2)).

Importantly, the related party test is not as broad as the meaning given to "associate" as defined in s 318 ITAA36, nor is it quite the same as those contained within Div 152 ITAA97 which connects small businesses.

The following example from the EM illustrates the measure:

> "**Example 1.4: Expenditure incurred in carrying on a business by a related party of the holder of land**
>
> Gina owns vacant land in New South Wales which she rents to her spouse Robin for use in a farming business he carries on. Robin, as Gina's spouse, forms part of the class of related parties (spouses, children under 18 years old, affiliates and connected entities) that allow Gina to deduct her costs of holding the land. This is because Robin is carrying on a business on it to produce assessable income."

What type of substantive permanent building/structure is required?

The 2018 Bill requires there be a "substantive permanent building" or other "substantive permanent structure" on the land, but does not provide a specific statutory definition, nor does the EM provide a minimum threshold level.

Questions therefore arise as to how the Commissioner/courts will interpret this new term: must the taxpayer spend a certain sum of money? Must the building be of a certain minimum size? Will the building/structure be proportionate relative to the size of the underlying land on which it was constructed? Clarification and further explanation would be required.

How would the measures apply while the residential rental property remains vacant?

In order to claim those holding costs, the tests require that the residential premises:

- are lawfully able to be occupied; and
- are leased, hired, or licensed; or
- available for lease, hire or licence.

Therefore, although the property is "vacant", provided it is available for lease, hire or licence, the holding costs would be deductible.

Ensure that a lease authority is executed with a real estate agent to satisfy this test.

What about when the residential rental property is significantly damaged/destroyed?

It appears that residential properties that are destroyed would not satisfy the tests relating to:

- having a substantive permanent building; and/or
- being in use, ready for use or capable of lawful occupation.

Therefore, holding costs do not appear to be allowable income tax deductions even in the cases of involuntary damage following natural disaster — even where the taxpayer/property has a long history of income generation.

What about during unoccupied periods involving renovation?

It seems very difficult for the residential property to satisfy either the use, ready for use or lawful occupation test during unoccupied periods of renovation, and therefore we need guidance and clarity as to why there are integrity concerns during periods of genuine renovations to older houses undertaken for enhanced income generating capacity in the future.

Again, there is no Commissioner discretion available in this circumstance.

> *"... holding costs during planning, construction and prior to receiving an occupancy permit would now cease to be allowable ..."*

How are holding costs treated when a deposit is paid for a leased residential property?

The holding costs relating to holding land would be satisfied as required by s 26-105(1)(a).

Provided the building is a substantive permanent building/structure, 26-105(1)(b) would not be triggered, therefore the deductions would not be denied under this provision.

Finally, the requirement to disregard the building, s 26-105(3), would appear not to be triggered as the residential premises are lawfully able to be occupied and are leased (s 26-105(3)(b)).

Therefore, the holding costs would continue to be allowable income tax deductions.

How are holding costs treated when a deposit is paid for a residential property which is available for lease?

As there is a substantive permanent structure in place, s 26-105(1) would be satisfied and so the requirement to incur a loss would be satisfied.

Provided the building is lawfully able to be occupied and available to lease, hire or licence, then s 26-105(3) would be satisfied and the holding costs would be deductible.

Importantly, the key test is that the owner of the land at the time the deposit is paid must ensure the property is available for lease, hire or licence.

How do we treat these non-deductible costs?

The EM advises that the non-deductible costs would form part of the cost base of the asset for CGT purposes; they are not able to be deducted in later income years.

There are many legitimate reasons why a property is not income producing during certain periods of time, and it may be a more equitable outcome that these holding costs are "combined" and amortised on terms similar to the usual borrowing costs provisions (refer s 25-25 ITAA97).

How about costs incurred in the same income year as the income is generated?

Even when the relevant holding costs (eg interest) are incurred in the same financial year, the provisions are drafted in such a way that deductions are only allowed to the extent they relate to a period when the property is legally available for occupation and is leased or available for lease.

Are any assets grandfathered?

None of the assets are grandfathered as the Bill is intended to apply from 1 July 2019, regardless of whether the land was held prior to 1 July 2019 (para 1.31 of the EM).

Conclusion

The Bill proposes significant changes to the way holding and other costs are treated during the construction phase and during vacancy periods of residential rental properties for many non-business taxpayers.

There are significant legislative uncertainties and inequities which will surely be subject to discussion as the draft bill progresses through the legislative consultation process.

As for the idea that the negative gearing rules are not changing following the recent federal election result — think again!

David Krunic, CTA
Principal – Taxation Advisory
DKP & Co

Reference

1 [1999] HCA 7.

Elections: outlays by candidates, and gifts and donations for candidates

by Chris Wallis, CTA, Barrister, Victorian Bar, Greens List

Many practitioners are about to wrestle, perhaps for the first time, with the deductibility of outlays incurred in relation to elections, whether as gifts or donations for candidates, whether by candidates themselves and whether in relation to federal, state or municipal elections. In the first part of the article, the author examines the tax treatment of donations or gifts made for, by or on behalf of candidates in the May 2019 federal election. The relevant tax provisions were last amended in 2010. In the second part of the article, the author considers the deductibility of outlays made by candidates themselves and the consequences of a recoupment. The article does not consider outlays in relation to elections conducted for internal positions within political parties or for elections conducted by trade unions or similar bodies.

Introduction

Many practitioners are about to wrestle with the deductibility of outlays incurred in relation to:

- the federal election on 18 May 2019;
- the Victorian state election on 24 November 2018;
- the New South Wales state election on 23 March 2019; and
- numerous municipal elections during the 2019 financial year.

The outlays may be:

- as gifts or donations for an individual standing for election; or
- made by an individual who contested the election.

For a significant number of practitioners it will be their first encounter with such outlays, and consequently the first time they will have considered the operation of the provisions. The tax treatment of recouped amounts is also relevant.

Political donations and gifts

Whether donation or gift is deductible?

Section 26-22 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) prohibits a deduction for donations or gifts:

- to political parties; or
- to individuals who satisfy the criteria of being a candidate or a member.

Section 26-22 was inserted by Act No. 16 of 2010 after a tortuous path through parliament, which commenced with Tax Laws Amendment (2008 Measures No. 1) Bill 2008 (the first Bill) and culminated with parliament enacting the Tax Laws Amendment (Political Contributions and Gifts) Bill 2010 (the third Bill) as Act No. 16 of 2010.[1]

Act No. 16 of 2010 both denied deductions and allowed limited deductions to individuals other than individuals carrying on businesses.[2]

Section 26-22 provides:

> "**Political contributions and gifts**
>
> You cannot deduct political contributions or gifts
>
> (1) You cannot deduct under this Act (other than Subdivision 30-DA):
>
> (a) a contribution (including a membership fee) or gift to a political party that is registered under Part XI of the *Commonwealth Electoral Act 1918* or under corresponding State or Territory legislation; or
>
> (b) a contribution or gift to an individual when the individual is a candidate in an election for members of:
>
> (i) an Australian legislature; or
>
> (ii) a local governing body; or
>
> (c) a contribution or gift to an individual who is a member of:
>
> (i) an Australian legislature; or
>
> (ii) a local governing body.
>
> Exception for employees and office holders
>
> (2) However, subsection (1) does not apply to a loss or outgoing incurred in gaining or producing assessable income from which an amount is required to be withheld under section 12-35 or 12-45 in Schedule 1 to the *Taxation Administration Act* 1953.
>
> …
>
> Starting and stopping being a candidate
>
> (3) For the purposes of this section, an individual:
>
> (a) starts being a candidate when the individual's intention to be or to attempt to be a candidate for the election is publicly available; and
>
> (b) stops being a candidate at the earlier of:
>
> (i) the time when the result of the election is declared …; and
>
> (ii) the time (if any) when the individual's intention to no longer be a candidate for the election is publicly available.
>
> Starting being a member
>
> (4) An individual who becomes a member as a result of an election (including an election that is later declared void) is taken to start being a member when the individual's election as a member is declared or otherwise publicly announced by an electoral official."

Section 995-1 ITAA97 relevantly provides:

> "**_'Australian legislature'_** means:
>
> (a) the Parliament of the Commonwealth of Australia; or
>
> (b) the Parliament of a State; or
>
> (c) the Legislative Assembly for the Australian Capital Territory; or
>
> (d) the Legislative Assembly of the Northern Territory of Australia.
>
> ...
>
> **_'local governing body'_** means a local governing body established by or under a State law or Territory law."

Section 26-22 compels consideration of:

– whether an entity is a political party;

– when an individual is a candidate; and

– when an individual is a member.

Whether entity is a political party. Section 4 of the *Commonwealth Electoral Act 1918* relevantly provides:[3]

> "**_'Political party'_** means an organization the object or activity, or one of the objects or activities, of which is the promotion of the election to the Senate or to the House of Representatives of a candidate or candidates endorsed by it.
>
> …
>
> **_'Registered political party'_** means a political party that is registered under Part XI.
>
> **_'Register of Political Parties'_** means the Register of Political Parties established under section 125."

The register, which currently lists 82 parties, may be viewed online[4] and has a search function.

Whether individual is a candidate or member. For the purposes of s 26-22, an individual starts being a candidate when the individual's intention to be, or to attempt to be, a candidate for the election is publicly available.[5]

Whether the individual's intention to be a candidate, or to attempt to be a candidate, is (was) publicly available requires an assessment of the evidence at the time of the donation or gift.

Individual contesting a party pre-selection. For an individual contesting a party pre-selection process, it is at least arguable that the evidentiary requirement of their intention would be satisfied by publicly available evidence of the steps the individual took to initiate the pre-selection process, whether or not the individual succeeded in securing pre-selection.

Evidence of the steps the individual took to obtain pre-selection by a party satisfies the alternative requirement within s 26-22(3) "to attempt to be a candidate".

For an individual who succeeded in a party pre-selection process, and who was endorsed by the party, the evidence of the individual's intention would be satisfied by a copy of the party's announcement of the individual's endorsement. However, the individual's status as a candidate for the purposes of s 26-22 would have existed from the time the individual first took steps to initiate the pre-selection process, on the basis that the initiating action was publicly available evidence.

The consequence of being a candidate from that earlier time is that s 26-22 denies deductions for gifts or donations from that earlier time.

Individual contesting as an independent. For an individual campaigning as an independent, the need for publicly available evidence of the requisite intention may be found in a statement in an interview, a newspaper advertisement or objective evidence, including the commissioning of:

– design work;

– a photographer;

– printed literature; or

– a website.

Individual seeking to establish s 44 eligibility. The operation of s 44 of the Constitution makes an individual ineligible to sit as a member or senator if certain criteria are met.

Generally, an individual would seek to establish their eligibility, under s 44, to be chosen for federal parliament only after the individual had decided to seek election to federal parliament.

The Australian Electoral Commission (AEC) now includes numerous questions and a qualification checklist on the nomination form to prevent repeat s 44 ineligibility problems.

Once an individual has completed the answers on the AEC nomination form, and has answered the mandatory questions in the AEC qualification checklist, the AEC is legally required to accept the nomination.

Neither the questions nor the checklist items, at least one of which contained a triple negative, are easily or quickly answered. Many individuals are likely to require legal advice to determine their eligibility.

The author's view is that an individual whose intention is to establish their eligibility (under s 44) to become a candidate qualifies as a person "who attempts to be a candidate".

It is unclear whether evidence of the individual seeking confidential legal advice in relation to completing the nomination form and checklist is, or can be, publicly available evidence of the individual's intention to be, or to attempt to be, a candidate for election, even if the individual subsequently waives their legal professional privilege.

Individual changes status. In the May 2019 federal election, political parties disendorsed numerous endorsed candidates. It is not clear how s 26-22 applies to those individuals and whether they are to be treated as an independent candidate, and if so, from what date.

When an individual stops being a candidate

For the purposes of s 26-22, an individual stops being a candidate when the writs are returned and the election results are officially announced.

The electoral process timetable

At the federal level, the processes for the Senate and the House are slightly different and each imposes strict timetables.[6]

The Constitution bounds the timetable for a general election at the federal level with many of the specifics left to the *Commonwealth Electoral Act 1918*, as summarised below.[7]

Table 1. 2019 federal election timetable

Stage	Limitation (a)	Constitutional or statutory provision	Relevant date in the May 2019 election
Dissolution[8]	–	Ss 5 and 28 of the Constitution	Thursday, 11 April 2019
Issue of writs (at 6 pm)	Within 10 days of dissolution	S 32 of the Constitution; ss 152 and 154 of the *Commonwealth Electoral Act 1918* (CE Act)	Thursday, 11 April 2019
Close of electoral rolls (at 8 pm)	Seven days after date of writ	S 155 CE Act	Thursday, 18 April 2019
Nominations close (at 12 noon)	Not less than 10 days nor more than 27 days after date of writ	Ss 156 and 175 CE Act	Tuesday, 23 April 2019
Declaration of nominations		S 176 CE Act	Wednesday, 24 April 2019[9]
Date of polling (a Saturday)	Not less than 23 days nor more than 31 days from date of nomination (b)	Ss 157 and 158 CE Act	Wednesday, 24 April 2019
Early voting commences			Monday, 29 April 2019[10]
Election advertising black out commences			Wednesday, 15 May 2019[11]
Polling day		S 152(e) CE Act as controlled by ss 157 and 158 CE Act[12]	Saturday, 18 May 2019
Return of writs	Not more than 100 days after issue	S 159 CE Act	Friday, 28 June 2019[13]
Meeting of new parliament	Not later than 30 days after the day appointed for the return of writs	S 5 of the Constitution	

Prior to an election being called, political parties may conduct a candidate pre-selection process (see Table 1).

The writs issued must specify a date for the return of the writs and the new parliament must meet within 30 days after the return of the writs.

Consequently, the maximum period that can exist (during which the outgoing government continues, albeit in caretaker mode) is 140 days (10 + 100 + 30 days).

The timetables may also be helpful in determining when an individual starts being a candidate or stops being a candidate or becomes a former member, and in interpreting the various provisions within the *Commonwealth Electoral Act 1918*.

Limited deductions for gifts and donations

Section 30-242 within Subdiv 30-DA ITAA97 allows deductions for some gifts and donations.

Subdivision 30-DA distinguishes between political parties, independent candidates and parliamentary members, and provides a limited deduction to some individuals for some contributions and gifts.

Section 30-242 provides as follows:

"**Deduction for political contributions and gifts**

(1) You can deduct any of the following for the income year in which they are made:

(a) a contribution or gift to a political party that is registered under Part XI of the Commonwealth Electoral Act 1918 or under corresponding State or Territory legislation;

(b) a contribution or gift to an individual when the individual is an independent candidate for a Commonwealth, State, Northern Territory or Australian Capital Territory election;

(c) a contribution or gift to an individual who is, or was, an independent member of the Commonwealth Parliament, a State Parliament, the Legislative Assembly of the Northern Territory or the Legislative Assembly for the Australian Capital Territory.

(2) The contribution or gift must be of:

(a) money; or

(b) property that you purchased during the 12 months before making the contribution or gift.

(3) The value of the contribution or gift must be at least $2.

(3A) You can deduct the contribution or gift only if:

(a) you are an individual; and

(b) you do not make the gift or contribution in the course of carrying on a business.

(4) You cannot deduct a testamentary contribution or gift under this Subdivision.

(5) A contribution or gift to an individual who is, or was, an independent member must be made:

(a) when the individual is an independent member; or

(b) if the individual ceases to be an independent member because:

(i) a Parliament, a House of a Parliament or a Legislative Assembly is dissolved or has reached its maximum duration; or

(ii) the individual comes up for election;

after the individual ceases to be a member but before candidates for the resulting election are declared or otherwise publicly announced by an entity authorised under the relevant electoral legislation."

Subdivision 30-DA operates in relation to each tax year, rather than each election cycle, so that in respect of a particular individual who is a candidate, the taxpayer may be able to claim more than a single donation.

Section 30-242: whether individual is a candidate or member

Section 30-244 ITAA97 determines when an individual is a candidate for the purposes of s 30-242:

> "**When an individual is an independent candidate**
>
> (1) An individual is an ***independent candidate*** if:
>
> (a) the individual is a candidate in an election (including an election that is later declared void) for members of the Commonwealth Parliament, a State Parliament, the Legislative Assembly of the Northern Territory or the Legislative Assembly for the Australian Capital Territory; and
>
> (b) the individual's candidature is not endorsed by a political party that is registered under Part XI of the Commonwealth Electoral Act 1918 or under corresponding State or Territory legislation.
>
> (2) However, an individual does not start being an independent candidate until the candidates for the election are declared or otherwise publicly announced by an entity authorised under the relevant electoral legislation.
>
> (3) An individual stops being an independent candidate when the result of the election is declared or otherwise publicly announced by an entity authorised under the relevant electoral legislation …"

The internal definitions of "independent candidate" in s 26-22 and Subdiv 30-DA (together referred to as the "election deduction provisions") are not synchronised even though they jointly:

- deny a deduction for a gift or contribution to an "independent"; and
- allow a deduction for "an independent candidate".

Curious exploitable and arguably undesirable outcomes

"Candidate" or "independent candidate"

A person will be:

- an *independent candidate* for the purposes of s 26-22 from the time their intention to be or to attempt to be a candidate for the election is publicly available; and
- an *independent candidate* as defined by s 30-244 from the time the election is publicly announced.

None of s 26-22 or ss 30-242 or 30-244 has been considered judicially or at the tribunal.

The window during which s 26-22 denies a deduction, in respect of a donation or gift for an individual, will almost always be longer than the period during which s 30-242 allows a deduction for a gift or donation for an individual. Consequently, donations or gifts:

- made too early in relation to an independent candidate will not be deductible; and
- made on the same date to a political party will be deductible whether or not a candidate had been pre-selected.

Continuing deductible gifts to former independent members

The disjunctive nature of s 30-242(1) coupled with the use of the past tense ("was") in s 30-242(1)(c) and use, in the tail of s 30-242, of the unqualified expression "member" and the causative expression "resulting election" may bring about the result that a person who makes a gift or donation to an individual, who was an independent member of parliament at any time, is entitled to a deduction of up to $1,500 for that gift or donation annually and on an ongoing basis.

Currently, there are a number of individuals who have been independent members of parliament at some stage, some of whom are now members of registered political parties and in respect of whose "jumping ship" there was no resulting election.

That result is an undesirable outcome for an independent member who "jumps ship" to become a member of a party mid-term, as occurred during the 44th parliament, and likely not envisaged or intended by parliament.

If parliament had wanted to limit deductibility of donations or gifts made to an independent member for the years during which that individual was an independent member, it ought to have said so expressly.

Gifts or donations to intermediaries are legal

The alleged expenditure of in excess of $50m on outlays by the United Australia Party (UAP) to secure 389,888 votes, but not a single seat, continues to provoke discussion about the tax benefits that "must be available".

Further discussion has been provoked by the significant election outlays of high profile entities other than registered political parties ("intermediaries").

Section 50-1 ITAA97 provides that the income of an entity listed within Subdiv 50-A ITAA97 is exempt from income tax.

The lists in Subdiv 50-A describe charities, employer organisations, employee organisations, unions, ancillary funds and sporting clubs, all of whom derive exempt income.

An amount that is exempt from income tax is not an assessable amount and a gift or donation cannot be deducted against that amount — refer to the notes following s 6-15(2) ITAA97.

Intermediaries quite legitimately may prefer to, and often do, spend the gifts and donations received according to their own priorities, which may be sympathetic to the goals of one or other political parties.

During the May 2019 federal election, the most obvious outlays by an intermediary were by the Australian Conservation Foundation for its "climate change election" material.[14]

Gifts of more than $2 to the Australian Conservation Foundation, which self-describes[15] its taxation status in the manner set out below, are tax deductible:[16]

> "The Australian Conservation Foundation receives the Income Tax Exemption, GST Concession and FBT Rebate."

Outlays by unions and representative bodies (generally not for profit entities) were also prominent. Membership fees paid by members to unions are tax deductible.

A union can self-assess that it is exempt from tax,[17] whether as a trade union or as an organisation registered under the *Fair Work (Registered Organisations) Act 2009* (Cth).[18]

Schemes involving intermediaries can go wrong

Section 50-47 ITAA97 provides that an entity described in Subdiv 50-A, that is also an Australian Charities and Not-for-profits Commission (ACNC) type of entity, is not exempt from income tax unless the entity is registered under the *Australian Charities and Not-for-profits Commission Act 2012* (ACNC Act).

Section 995-1 relevantly provides:

> "***'ACNC type of entity'*** means an entity that meets the description of a type of entity in column 1 of the table in subsection 25-5(5) of the Australian Charities and Not-for-profits Commission Act 2012."

Accordingly, a decision that an entity listed in Subdiv 50-A is not entitled to a deduction for a gift or donation by the entity for an individual contesting an election ought not be made without an initial assessment of:

- whether the entity is an ACNC type of entity; and
- whether the entity is registered under the ACNC Act.

> *"… schemes involving intermediaries … raise the potential application of Pt IVA … and also the promoter penalty provisions."*

Whether Pt IVA is relevant to intermediary schemes

Significant donations intended for political parties are regularly directed through intermediaries or applied at the direction of a political party, rather than being made donated directly to a political party.

An internal political party process akin to, what in accounting jargon might be termed, a "journal entry" ensures the "correct pathway" is recorded for the portion of the gift or donation that will not be deductible under Subdiv 30-DA. The tax legislation nourishes such schemes.

On most occasions, the intermediary will be an entity that is tax exempt and therefore not disadvantaged by not being able to claim a deduction at the time it applies the gift at the direction of the political party or donates the gift to the political party.

Arrangements or schemes involving intermediaries squarely raise the potential application of Pt IVA of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) and also the promoter penalty provisions.

Indirectly, the schemes raise the independence of the Commissioner.

Sham claims for deductions

All of the gifts or donations need consideration of the status of the recipient. Twelve months ago, a practitioner's claim for a $200,000 workplace-related deduction for an individual surfaced during an ATO private group and high wealth review. The donation claimed as a workplace-related expense was for an employed individual who was also registered for GST.

Recourse to ABN Lookup revealed the named recipient of the $200,000 was a registered political party, the basis of the claim formulated by the tax agent being that the employee benefited because the employer benefited from the contacts the donation facilitated.

Deductions for a candidate

Outlays incurred by an individual contesting an election

An individual contesting an election may incur the ordinarily expected range of outlays:

- in a federal election, the $2,000 election bond required under the *Commonwealth Electoral Act 1918*;
- graphic design;
- a website;
- photography;
- travel;
- rent;
- parking fees;
- printing of flyers, fridge magnets, corflutes;
- wrap signage for a car or shopfront;
- metal "A-frames";
- items of clothing (subject to a dominant purpose test); and
- donations (which may or may not be otherwise deductible) to charities who seek patronage.[19]

A candidate may incur further unusual or unexpected outlays:

- proof of Australian citizenship (the onerous nature of which will reflect the age and country of birth of the candidate's parents and grandparents);
- a number of cheap combination bike locks to secure dumped bikes on which were affixed corflutes;
- a basic circular saw to recycle plywood off-cuts from building waste as counterweights for more than 50 corflute A-frames to be used at polling booths;
- hundreds of cable ties to construct the corflute A-frames and to affix signage at polling booths;
- plastic DL flyer tubs to affix to A-frames at polling booths for self-service "How to vote" cards;
- a bike basket to carry leaflets for delivery;
- a replacement basket and helmet after a long day letterboxing a very tired author left the first basket and helmet on the ground at the back of his car after placing the bike on the roof rack of the car (it wasn't there the next day);
- grooming; and
- sustenance for volunteers on polling day.

Deduction available for candidate's outlays

Division 25 ITAA97 provides a deduction (subject to any recoupment) for the person who incurs expenditures when that person contests certain elections:

"**25-60 Parliament election expenses**

(1) You can deduct expenditure you incur in contesting an election for membership of:

(a) the Parliament of the Commonwealth; or

(b) …

Note 1: Entertainment expenses are excluded: see section 25-70.

Note 2: If you receive an amount as recoupment of the expenditure, the amount may be included in your assessable income: see Subdivision 20-A.

…

25-70 Deduction for election expenses does not extend to entertainment

(1) To the extent that you incur expenditure in respect of providing entertainment, you cannot deduct it under section 25-60 or 25-65.

(2) However, subsection (1) does not stop you deducting expenditure to the extent that you incur it in respect of:

(a) providing entertainment that is available to the public generally; or

(b) providing food or drink to yourself, unless it would be concluded that you have a purpose of enabling or facilitating entertainment to be provided to someone else."

Section 25-60 ITAA97:

- requires the candidate to have incurred the outlay for which a deduction is sought; and
- does not provide any deductions to related parties of the candidate, although related individuals will be able to claim limited deductions under Subdiv 30-DA.

The substance of s 25-60 was previously encapsulated in s 74 ITAA36 which allowed expenditure incurred in contesting an election for membership of a state parliament to be an allowable deduction.

In *FCT v Wilcox*,[20] the expenses were incurred during the two years after the taxpayer's endorsement by his party and the date of the election.

Section 74(1) provided as follows:

"74(1) Expenditure incurred in the year of income by the taxpayer in being elected as a member, or in contesting an election for membership, of the Parliament, of the Parliament of a State or of the Legislative Assembly of the Northern Territory of Australia shall be an allowable deduction."

Toohey and Fitzgerald JJ said:[21]

"We accept the Commissioner's submission that ... expenditure must have been incurred in the course of contesting an election ..., to be deductible ... That, however, is not the same thing as saying that the expenditure must have been incurred in the course of an election in the sense contended for by the Commissioner, i.e. during a period delineated by reference to the issue and return of the writ for the election. The central feature of an election ... is the voting ... initiated by the issue of the writ and terminated by its return. We see no reason ... for denying that a contest in respect of ... election which must occur, may begin notwithstanding that the formal election process has not commenced."

The principal dispute was whether expenditure was incurred too early to be deductible under s 25-60, more specifically whether there can be an election before the issue of the writs.

Case H33

The candidate in *Case* H33[22] successfully claimed deductions under s 74 for items including:

- dry cleaning;
- replacement of an umbrella;
- glasses, sugar basins and a fruit bowl;
- home cleaning expenses; and
- a champagne gift.

The candidate was unsuccessful in his claim for nappy washes because, as P Gerber (Member) said:

"… continued use of a service already utilised by the taxpayer before he had been selected to contest his seat, while no doubt a comfort to his wife, who assisted with his campaign, is nevertheless too remote to bear the characteristic of a 'campaign expense'."

When a deduction was denied

However, in *Flegg and FCT*,[23] the dispute was over the deductibility of expenses incurred by Flegg in defending a challenge to his pre-selection. The tribunal observed:

"[18]. The principle to be applied here is one that limits deductibility to expenditure to that incurred in the course of the election; it is not enough that the expenditure be incurred for the purpose of the election.

…

[22] [The expenditure] may have been necessary in the sense of being required however it seems to me that that is not sufficient to allow a conclusion that it was incurred 'in contesting' the election; it was incurred in a contest that was merely incidental to the election.

[24]Whilst party endorsement or pre-selection may, in a practical sense, be required for election it is, as a matter of law, irrelevant to what Toohey and Fitzgerald JJ. in Wilcox described as the 'central feature' of an election, the voting at the poll. Dr Flegg was not engaged with the electors, seeking their votes either directly or indirectly, when engaged in the internal machinations of the Liberal Party. The legal expenses in issue here were concerned with matters internal to the political party; they were not concerned with matters referable to the electoral process. They were thus not incurred in contesting an election."

The author's view is that the Commissioner ought to disallow outlays incurred by a party member preparing for and contesting pre-selection to contest an election. Those outlays were not incurred by the candidate in contesting the election for which pre-selection was obtained.

Disclosure of election expenditure

Section 309 of the *Commonwealth Electoral Act 1918* compels disclosure of expenditure incurred by or with the authority of a candidate (or group) in relation to an election to be disclosed by providing a return to the Electoral Commission before the expiration of 15 weeks after the polling day in the election.

The disclosure must be:

- of all expenditure incurred by or with the authority of the candidate; and
- made in an approved form and in accordance with s 309.

Section 309 provides for substantial civil penalties for non-compliance.

Section 287AB of the *Commonwealth Electoral Act 1918* defines "electoral expenditure" in comprehensive fashion in purposive terms that will be familiar to tax practitioners:

> "**Meaning of electoral expenditure**
>
> (1) ***Electoral expenditure*** means expenditure incurred for the dominant purpose of creating or communicating electoral matter, except to the extent that:
>
> (a) the expenditure is, or is to be, paid or reimbursed by the Commonwealth (except under Division 3 (election funding)) to or in relation to a person who is or was a member of the House of Representatives, a Senator or a Minister, because that person is or was such a member, Senator or Minister; or
>
> (b) the expenditure is incurred by a person or entity (the ***service provider***):
>
> (i) in providing a communication service or communication platform that is used to create or communicate electoral matter; or
>
> (ii) in providing a service for another person or entity that engaged the service provider, on a commercial basis, to create or communicate electoral matter.
>
> **Note 1:** For example, expenditure incurred in relation to the communication of electoral matter for which particulars are required to be notified under section 321D is electoral expenditure.
>
> **Note 2:** Expenditure by a person who creates matter that is covered by an exception under subsection 4AA(5) is not electoral expenditure. However, as each creation or communication of matter is treated as separate matter under subsection 4AA(2), expenditure incurred by another person who communicates the same matter for the dominant purpose referred to in subsection 4AA(1) may be electoral expenditure.
>
> **Note 3:** For deemed electoral expenditure for political campaigners, see section 287J.
>
> (2) Expenditure may be electoral expenditure whether the expenditure is incurred for the dominant purpose of creating or communicating particular electoral matter or electoral matter generally.
>
> **Expenditure in relation to an election**
>
> (3) In addition, any expenditure incurred by or with the authority of a political entity, a member of the House of Representatives or a Senator in relation to an election is ***electoral expenditure***, except to the extent that the expenditure is, or is to be, paid or reimbursed by the Commonwealth (except under Division 3 (election funding)) to or in relation to a person who is or was a member of the House of Representatives, a Senator or a Minister, because that person is or was such a member, Senator or Minister."

Section 4 of the *Commonwealth Electoral Act 1918* provides:

> "'***electoral matter***' means matter which is intended or likely to affect voting in an election."

The disclosure made under s 309 sets the outer limits of the amount that would be deductible under s 25-60 for an individual who contested the federal election. However, an amount of electoral expenditure is not necessarily deductible by the individual who contested the election. It could be anticipated that the Commissioner will access the s 309 disclosures.

Recoupment

An endorsed candidate may receive recoupment through their party and any candidate may receive a distribution from the AEC. After each federal election or by-election, the AEC distributes money to eligible political parties, candidates and Senate groups to reimburse them for electoral expenditure.

Every candidate who receives more than 4% of the first preference votes cast in the relevant contest, during the period 1 January 2019 to 30 June 2019, will receive:

- a refund of the $2,000 deposit;
- a initial distribution from the AEC of $10,808; and
- on the candidate substantiating expenditure incurred, a distribution equal to $2.756 per first preference vote received less the $10,808 distribution.

Thinking clearly

It is unlikely that a practitioner preparing and lodging a tax return in which outlays in relation to a candidate for a federal election are claimed could satisfy the requirements of the Code of Professional Conduct in the *Tax Agent Services Act 2009* (Cth) unless the candidate had provided a copy of the s 309 return to the practitioner and considered any recoupment.

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Important note

The author contested the May 2019 federal election as an independent candidate in the Division of Macnamara, and in doing so, developed a keen appreciation of the nuances in the tax legislation and the intersection of the tax legislation with the *Commonwealth Electoral Act 1918*.

Acknowledgment

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References

1 The first Bill proposed the insertion of s 26-22 ITAA97 and the repeal of Subdiv 30-DA ITAA97 and was referred to the Joint Standing Committee on Electoral Matters (JSCEM).

Coalition Senate members of JSCEM provided a minority report that resulted in some provisions being removed and the first Bill being reintroduced as the Tax Laws Amendment (Political Contributions and Gifts) Bill 2008 (the second Bill) to insert s 26-22 and the repeal of Subdiv 30-DA.

The second Bill was referred to the Senate Standing Committee on Economics and the second Bill was deferred pending the release of the "Electoral reform green paper: strengthening Australia's democracy".

On 18 June 2009, the Senate unsuccessfully proposed amendments to the second Bill and in the House the House removed the repeal of Subdiv 30-DA from the Bill. The revised Bill is the Tax Laws Amendment (Political Contributions and Gifts) Bill 2010.

On 25 February 2010, the Senate agreed to the amendments proposed by the House of Representatives that permitted taxpayers, other than those carrying on a business who may be able to otherwise claim the deduction, to claim deductions of up to $1,500 for political contributions and gifts.

2 Likely to be individuals registered for GST.

3 Section 125 of the *Commonwealth Electoral Act 1918* provides as follows:

"**Register of Political Parties**

(1) The Electoral Commissioner must establish and maintain a Register, to be known as the Register of Political Parties, containing a list of the political parties that are registered under this Part.

(2) The Register may be included on the Transparency Register under section 287N."

4 AEC, "Current register of political parties". Available at www.aec.gov.au/parties_and_representatives/party_registration/Registered_parties.

5 S 26-22 ITAA97.

6 State and municipal processes are different again.

7 General election relates to the election of the House. By s 12 of the Constitution, state governors issue the writs for Senate elections which could, through this mechanism, be held at different times.

8 The 45th Parliament of Australia was prorogued at 8.29 am on Thursday 11 April 2019 and the House of Representatives was dissolved at 8.30 am on the same day.

On dissolution of the House, all business on the Notice Paper lapses but may be introduced in the next parliament in the usual way.

House committees and joint committees established by Act or resolution cease to exist but may be re-established in the next parliament. Any inquiries that were not completed have lapsed and submissions cannot be received.

Section 28 of the Constitution provides that the House of Representatives lasts for three years from its first meeting. The life of the House (and the last possible date of the next election) is not tied to the time of election but to the time when the House meets after an election.

9 24 hours after the declaration of nominations.

10 Commences five days after the declaration of nominations.

11 Under Sch 2 to the *Broadcasting Services Act 1992* (Cth), there is an election advertising blackout on all electronic media from the end of the Wednesday before polling day to the end of polling on the Saturday.

12 The *Commonwealth Electoral Act 1918* nominates a minimum 33-day period between the issue of the writs and polling day.

13 The writs are due to be returned 41 days after polling day, in time for the new Senators to commence their terms on Monday 1 July 2019.

14 The UAP is a political party rather than an intermediary.

15 Australian Conservation Foundation, "Information for solicitors". Available at www.acf.org.au/info_for_solicitors.

16 It is likely that the ACF also enjoys substantial relief from one or more of municipal rates, payroll tax and land tax throughout Australia.

17 ATO, "Employment organisations". Available at www.ato.gov.au/Non-profit/Your-organisation/Do-you-have-to-pay-income-tax-/Types-of-income-tax-exempt-organisations/Employment-organisations.

18 It is likely that the CFMEU also enjoys substantial relief from one or more of municipal rates, payroll tax and land tax throughout Australia.

19 In para 186 of TR 1999/10, the Commissioner's expresses the following view about similar expenditure by a member of parliament: "191. A deduction is not allowable for the cost of goods, such as food and clothing, purchased at fetes and fairs. These expenses are considered to be of a private or domestic nature."

20 1982 ATC 4411.

21 Ibid at 4413.

22 76 ATC 285.

23 [2007] AATA 1336.

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The onus of proof following the Cassaniti decision

by Gareth Redenbach, CTA, Barrister, Victorian Bar, Foley's List

The Full Federal Court decision of Steward J (Greenwood J agreeing and Logan J concurring with additional reasons) in *FCT v Cassaniti* notably clarifies the law in relation to what is necessary for a taxpayer to discharge their burden of proof on review in a tribunal or court. The practical effect of this clarification may be that taxpayers are more likely to succeed in meeting their burden of proof on review. For corporations, both large and small, individuals and small-to-medium enterprises, the commentary in the case provides an effective roadmap to assist them in discharging the burden of proof.

Introduction

The Full Federal Court decision of Steward J (Greenwood J agreeing and Logan J concurring with additional reasons) in *FCT v Cassaniti*[1] (*Cassaniti*) notably clarifies the law in relation to what is necessary for a taxpayer to discharge their burden of proof on review in a tribunal or court. *Cassaniti* sets out, in concise terms,[2] a series of five propositions relevant[3] to determining whether a taxpayer has discharged their burden of proof. The practical effect of this clarification may be that taxpayers are more likely to succeed in meeting their burden of proof on review.

For corporations, both large and small, the decision highlights the operation of s 1305 of the *Corporations Act 2001* (Cth) (Corporations Act) which may have the effect of practically discharging the burden of proving underlying facts if the matters are recorded in the financial records[4] of a company. This should have the effect of making the process on review quicker, more certain and consequently cheaper for litigants (subject to proving the documents were kept by the company for the purposes of the Corporations Act — see the discussion of *Price v FCT*[5] below).

For individuals and small-to-medium enterprises (SMEs), the commentary on what is necessary to meet the burden of proof will assist them in preparing matters so as to discharge their burden of proof where record-keeping was not flawless (for example, in SMEs, trust and intra-family dealings). For larger taxpayers, there is also an opportunity to utilise elements of the decision to reduce the scope of dispute as to material facts which could also have the effect of greatly reducing the cost and duration of disputed facts in court.

This article sets out the recent history of burden of proof issues, the facts, the submissions on appeal and the decision in *Cassaniti*, and thoughts on practical consequences for future tax cases.

The burden of proof in tax cases

A taxpayer always has the burden of proof in tax proceedings regardless of whether it is a review of an objection decision[6] under Pt IVC of the *Taxation Administration Act 1953* (Cth) (TAA), an application[7] for declaratory relief pursuant to s 39B of the *Judiciary Act 1903* (Cth), or a review under the *Administrative Decisions (Judicial Review) Act 1977* (Cth) (ADJR Act) processes (or their state[8] law counterparts). It should be noted that the burden of proof is a different concept to the standard of proof (which is discussed below as it forms part of the taxpayer's burden). The taxpayer's burden of proof under ss 14ZZO and 14ZZK TAA really comprises two parts:

– establishing, with evidence, the underlying facts on which the law is to operate (and in this regard, the standard of proof to which each fact must be proved is relevant);[9] and
– that the operation of the law when applied to those facts establishes that the assessment is excessive.[10]

It is not unfair[11] for the Commissioner, on application for review or declaration, to rely on this burden of proof and require a taxpayer to prove each factual element of their claim. However, what is necessary to discharge this burden of proof arguably changed in practice between the early 1990s and recent times and, in particular, regarding when a taxpayer can be said to have discharged their burden of proving the facts on which they relied.

The starting point for the analysis of the burden of proof is often *FCT v Dalco*[12] (*Dalco*). In *Dalco*, the Commissioner issued a default assessment[13] to the taxpayer. The taxpayer sought to disprove the Commissioner's amended assessments by showing the Commissioner had wrongly treated the income of companies or trusts which the taxpayer or his family company acquired or controlled as assessable income of the taxpayer.[14] That is, the taxpayer sought to succeed by pointing to an error made by the Commissioner rather than establishing what their true taxable income was. A majority of the High Court, agreeing with separate concurring judgments by Brennan J and Toohey J, found for the Commissioner.

The formulation preferred by Brennan J, citing *George v FCT*,[15] was that to discharge the burden of proof, "the burden lies upon the taxpayer of establishing affirmatively that the amount of taxable income for which he has been assessed exceeds the actual taxable income which he has derived during the year of income"[15] and that "…in order to carry that burden he must necessarily exclude by his proof all sources of income except those which he admits. His case must be that he did not derive from any source taxable income to the amount of the assessment".[15] Brennan J found that the manner in which a taxpayer can discharge the burden varies with circumstances[16] and that:

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

While *Dalco* concerned a default assessment, the High Court subsequently confirmed the same principles governed standard assessments pursuant to s 166 of the *Income Tax Assessment Act 1936* (Cth) (ITAA36).[17]

The high-water mark for taxpayers came shortly after in 1992 in *FCT v Ma* (*Ma*).[18] Mr Ma, the former owner of restaurants, was a large-scale punter: evidence was provided by both a bookmaker's clerk and a bank manager and member of the Port Macquarie Race Club Committee to this effect.[19] From 1982 to 1985, the applicant deposited large sums of money in his various bank accounts. The Commissioner issued income tax assessments for these years on the basis that these deposits represented much more money than could be accounted for by the income returned from the applicant's known receipts of capital.

The applicant objected to these assessments, claiming that the deposits, withdrawals and re-deposits were for betting purposes. In finding Mr Ma had discharged his burden of proof, Burchett J provided that, "if a taxpayer denies any undisclosed source of income, provides acceptable evidence of how he spends his time, and demonstrates a reasonable explanation for any appearance of the possession of assets, he will generally discharge his burden of proof unless some positive reason is shown why he is to be disbelieved."[20]

Subsequently, *Ma* has been somewhat confined to its unique facts. In *Haritos v FCT* (*Haritos*), a five-member bench of the Full Federal Court said of a passage in *Ma*, in a not disapproving manner:[21]

"The proposition which the appellant sought to derive from this passage was that in performing its review function, the Tribunal may be required to make an estimate upon inexact evidence, and it cannot avoid its responsibility to make findings by relying on the burden of proof section. This proposition may be accepted for the present purposes."

However, in *Haritos*, the Full Court went on to say that the reason that the taxpayer must fail in that case was because:[21]

"… they are unable to identify the estimate they contend the Tribunal should have made and *the evidence by reference to which the estimate should have been made*." (emphasis added)

The Full Court then added that:[22]

"The Tribunal was not entitled to adopt what the appellants described as an 'all or nothing' approach. If an 'at least' figure was established on the evidence, then the Tribunal should have made a finding in accordance with that evidence.

We think that proposition is correct. If a taxpayer claims his or her expenses were $10, but fails to prove that fact because their evidence is rejected, this does not prevent the Tribunal from finding that the expenses were $5 where there is other satisfactory evidence establishing expenses of at least that amount."

The Full Federal Court also said in *Rigoli v FCT*[23] that the Federal Court below and the Administrative Appeals Tribunal at first instance were right to conclude that Mr Rigoli had not discharged his burden of proof by tendering a report prepared by an accountant as to what, approximately, his income should have been in the relevant years. The Full Federal Court[24] referred with approval to the tribunal's decision at first instance which provided:[25]

"While it is true to say that a taxpayer can discharge the burden of proof in a manner which may depend on the circumstances, *Mr Rigoli did not adduce any evidence of the amount or source of his income for any [of] the income years in issue. He simply sought to rely on the report prepared by Mr Kompos.* That report was prepared for the purpose of enabling the Commissioner to make an assessment of the amount upon which, in his judgment, income tax ought to have been levied. It was not intended to and did not establish, even on the basis of an estimate, the actual taxable income of Mr Rigoli from all sources for the income years in question." (emphasis added)

While many of the precedential cases involve natural persons and undisclosed income, decisions based on the burden of proof have been increasingly common in large corporate litigation. For example, the first instance decision in *Chevron Australia Holdings Pty Ltd v FCT (No. 4)*[26] concerned whether the consideration for a cross-border loan facility was arm's length consideration or less than arm's length consideration. In that case, at first instance, the case was disposed of by reference to the fact that Robertson J did not find the evidence given by the experts to be addressed to the correct statutory question, and therefore the applicant could not succeed in showing that the relevant consideration was arm's length or less than arm's length consideration[27] and the taxpayer could not discharge their burden of proof.

Accordingly, while the manner in which a taxpayer may discharge their burden of proof may vary — especially where particular issues are agreed to be determinative by the Commissioner — in a Pt IVC proceeding (and more generally), the Commissioner is entitled to, and often does, rely on taxpayers being unable to *prove with evidence* what their assessment should have been.

The facts, submissions and decision in Cassaniti

Mrs Cassaniti provided services as a bookkeeper. From about June 2010 to about April 2014 onwards,[28] she was employed by the trustee of three different trusts, each of whom hired her labour to an accounting practice with which her husband, Mr David Cassaniti, and her cousin-in-law, Mr Sam Cassaniti, were associated. Mr Sam Cassaniti was described as a "convicted tax fraudster"[29] in the Commissioner's submissions.

Mrs Cassaniti swore a total of three affidavits in the initial proceedings. She deposed that she had been paid a gross salary of $65,000 and her net pay deposited into a bank account. She exhibited in an affidavit the payslips she had received during the period in dispute. It was found as a matter of fact at first instance that she had only ever received the amount net of purported withholdings.[30] However, despite this, none of the employing trustees had:

- ever been registered for PAYG withholding as required by the TAA;
- lodged payment summaries as required;
- filed tax file number declarations; or
- ever remitted any amounts to the Commissioner.[31]

The three principals of the accounting practice (her husband, his cousin and another man) were not called as witnesses.[32]

The Commissioner's submissions on appeal

The Commissioner's position on appeal was that:

- the payslips, offers of employment and PAYG payment summaries were recent inventions;[33]
- an adverse inference (ie that no evidence they could have given would have assisted Mrs Cassaniti) should have been made, pursuant to the rule in *Jones v Dunkel*,[34] from the failure to call the three principals of the accounting practice; and
- the respondent had failed to discharge her onus of proof because she had not adequately proven the authenticity of the business records she relied on.

In respect of the submission on recent invention, the Full Court's view was that this amounted to an attack on the credibility of Mrs Cassaniti, and her evidence having been accepted as truthful below could not be sustained on appeal as the allegation had not been properly and fairly put to her on cross-examination below as required.[35] Additionally, the allegation was not mentioned in the objection decision or the summary of the case required to be provided by the Commissioner and was not, as should have occurred,[36] put to the taxpayer at the earliest opportunity.

In respect of the submission that Mrs Cassaniti had not sufficiently proved the authenticity of the documents, Mrs Cassaniti had sworn three affidavits deposing to the payslips being the documents she saw every week at the offices of the accounting firm and that she received those documents every week.[37] This was sufficient, in the Full Court's view, to establish the provenance of those documents as her evidence had been accepted as truthful. Further, the Full Court found that it was open for the tribunal to infer the authenticity of the PAYG payment summaries and payslips from their contents[38] and that they may be admissible as business records that provide evidence of the truth of the facts recited in the document without identifying the precise author of the document (ie as the person who made the representation in the document, whoever he or she is, had, or might reasonably be supposed to have had, personal knowledge of the asserted fact).[39]

The Full Court then also referred to the prima facie evidence provision in s 1305, which provides that a "*book kept* by a body corporate *under a requirement of this Act* is admissible in evidence in any proceeding and *is prima facie evidence of any matter stated or recorded in the book*" (emphasis added) and "a document purporting to be a book kept by a body corporate is, unless the contrary is proved, taken to be a book kept as mentioned in subsection (1)".

Relevantly, a *book*[40] includes *financial records*[40] which include "invoices, receipts…documents of prime entry … working papers and other documents needed to explain… the financial statements".[40] Under the Corporations Act, a corporation is required to keep written financial records that, "correctly record and explain its transactions and financial position and performance".[41] The Full Court concludes,[42] based on a number of authorities,[43] that the payslips and payment summaries tendered by Mrs Cassaniti were probably financial records required to be kept under the Corporations Act by the employing entities and operate to provide prima facie evidence of the matter stated or recorded in them.

The Commissioner's submissions provided that the evidence provided by Mrs Cassaniti was "insufficient". This prompted the Full Court to specifically remark that the Commissioner alleging the evidence was insufficient (in spite of three affidavits from Mrs Cassaniti and their exhibits) may suggest that the taxpayer bears a "special burden of proof" and that no such special burden of proof exists. The Full Court's reasons then provide, under both applications for declaratory relief and in Pt IVC reviews, five propositions of general relevance:[44]

- the degree or standard of proof required by a taxpayer is that which applies in an ordinary civil proceeding. Referring to the description by Justice Hunt in *Allied Pastoral*,[45] that can be described as, "…if the plaintiff succeeds… in weighing down those scales ever so slightly in his favour then he has discharged the burden he carries…";
- a taxpayer is not obliged to call all material witnesses and produce all material documents which support their proposition;
- there is no requirement that direct evidence by testimony or affidavit can only be accepted if it is corroborated;
- the first instance hearer of the case is free to accept the evidence of the taxpayer alone if they find it truthful; and
- while it would usually be prudent to corroborate the evidence of a taxpayer and adduce contemporaneous objective evidence, "prudence should not be confused with the requirements of the law".

Implications of the decision in Cassaniti

The five general propositions above represent the view of the Full Federal Court of Australia on how fact-finding must be approached in tax cases. That means that taxpayers should be able to rely on them when faced with a submission that they have not met their burden of proof. As such, the burden of proof should not be applied as if the taxpayer is required to undertake a Sisyphean task of recreating, from scratch, each individual transaction or component of a case with corroborating evidence. The potential opportunities for taxpayers to rely on some or all of the five principles, and the more general observations regarding businesses records and s 1305, tend to break into three observable groups.

For individuals with large or unexplained transactions (such as intra-family gifts), it should be possible to prove that such transactions do not have the character of income by provision of direct truthful evidence from the recipient. It may not be necessary to call every member of a family group to do so (particularly if they are overseas or involved in a dispute). While it would be prudent to be able to corroborate as many

factual integers of the case as possible, it is not necessary to corroborate each element *provided* the taxpayer's evidence is likely to be accepted as truthful and any corroborating evidence that does exist is capable of weighing the scale of probabilities ever so slightly in the taxpayer's favour.

For taxpayers in the SME space, where records are often not kept in accordance with the standards expected of large organisations, it should be possible to facilitate proof by identifying specific business records, or financial records required to be kept under the Corporations Act, to prove individual points. For example, where there is a question about whether a specific amount was actually paid (for example, so as to give rise to a deduction pursuant to s 8-1 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97), a book or financial record reflecting the payment was actually made, or at least committed to, should be a prima facie sufficient basis to then make the submission it had been incurred within the meaning of the tax law.

For taxpayers in the corporate space, where there is a dispute with the Commissioner about the aggregation of large or complex data sets, a financial record kept by the corporation may be proof of the relevant underlying facts (eg monthly management reports showing a summary of intra-group payables incurred during the income year or factory reports showing that particular quantities of inputs were actually consumed), either as a business record or under s 1305. This could have important implications in transfer pricing and intra-group financing disputes, as well as in more day-to-day operations (ie the rate of depreciation of plant and equipment). The term financial report has been interpreted broadly, including budgets,[46] documents recording gross margins and other documents required to be kept in order to discharge the obligation to "correctly record and explain its transactions and financial position and performance".[47]

Finally, regardless of the size and scope of the dispute, in a dispute conducted by an incorporated taxpayer, there may be the opportunity to curtail the fact-finding exercise by identifying *financial reports* required to be kept by a body corporate under the Corporations Act which prima facie discharge the taxpayer's burden of proof. This should reduce the taxpayer's task at trial to arguing on the relevant technical operation and application of the law (and responding to the Commissioner's attempts, if any, to disprove the relevant facts). In this respect, there are at least three important distinctions between the business records exception to the hearsay rule and s 1305 of the Corporations Act:

- first, the business records exception acts as an exception to the hearsay rule. It prevents the record being inadmissible as proof of the facts represented in the record. It does not go the step further that s 1305 does and makes the business record prima facie evidence of the truth of the contents;
- second, the business records exception only applies where it can be proved that the representation was made "by a person who had or might reasonably be supposed to have had personal knowledge of the asserted fact … or … on the basis of information directly or indirectly supplied by a person who had or might reasonably be supposed to have had personal knowledge of the asserted fact". By contrast, s 1305 applies to "a book kept by a body corporate under a requirement of this Act". There is no requirement to prove that the person who made the representation or supplied the information might be reasonably supposed to have had personal knowledge of a fact; and
- third, the business records exception contains an exception in s 69(3) of the *Evidence Act 1995* (Cth). The business records exception does not apply to representations in the documents if the records were "prepared or obtained for the purpose of conducting, or for or in contemplation of or in connection with, an Australian or overseas proceeding".[48] There is no such exclusion in s 1305 (presumably as the thing that called the document in existence was the requirement under the Corporations Act rather than a self-serving statement for the purposes of proof in litigation).

The second and third points illustrate an interesting avenue for taxpayers to facilitate satisfying their burden of proof. Facts recorded in a taxation workpaper may not satisfy the business records exception to the hearsay rule where the records are not prepared by a person with personal knowledge of the asserted fact and, in some circumstances, could arguably be prepared in contemplation of the proceeding in which they could be sought to be tendered. However, if such workpapers did meet the criteria in s 1305, they could be prima facie proof of the fact asserted.

> *"This should have the effect of making the process on review quicker, more certain and consequently cheaper for litigants …"*

The limits of the usefulness of s 1305 of the Corporations Act

There has also, helpfully, been a recent delineation of the limits of the usefulness of s 1305 in *Price v FCT*.[49] Mr Price was a long-haul truck driver employed by a series of companies — Allyma Pty Ltd (Allyma), Allyma Transport Pty Ltd, Allyma Transport Services Pty Ltd and later Sunrock Australia Trust (Sunrock) — managed by his brother Jim. It appears that at least some accounting services were supplied to these companies by David Cassaniti (ie the husband of Mrs Cassaniti). The Commissioner assessed Mr Price without the benefit of a PAYG credit for amounts he said were withheld from his wages by the relevant companies. Mr Price approached his case on the basis of the decision in *Cassaniti* and claimed that a series of payslips were prima facie proof of the amount and fact of withholding by operation of s 1305.

Justice Thawley found against Mr Price. Specifically, in doing so, he referred to the decision in *Cassaniti* and distinguishes the facts of Mr Price's case from the position of Mrs Cassaniti. Taking the employer in the years 2001 to 2003, Allyma, Justice Thawley found the relevant payslips were marked 14 November 2016 (or he could infer they were

produced at the same time as those marked 14 November 2016) and had been produced by an accounting firm associated with David Cassaniti. Allyma went into liquidation in 2009 and had actually been deregistered in 2011. Further, the liquidator of Allyma had no involvement in the creation of the documents. As such, the payslips, could not[50] be a *book kept* "by a body corporate under a requirement" of this Act as they were not produced by Allyma, nor maintained by Allyma, as Allyma did not exist at the time of their creation.

In the case of the last employer, Sunrock, it did exist at the time the documents were created and there was scope for the operation of s 1305 in respect of a PAYG payment summary. However, Justice Thawley rejected the prima facie proof offered by the PAYG payment summary as it did not correspond with Sunrock's general ledger, "payroll advices" given to Mr Price and Mr Price's bank statements.[51] As such, even where the payslips were prima facie proof of the facts recorded in them (ie the amount withheld and the fact of withholding), this was displaced by other evidence.

Finally, taxpayers should be careful not to confuse discharging the burden of proving the underlying facts with the entire burden of proving an assessment is excessive. Taking the earlier example of a s 8-1 dispute, a financial record or business record may be used to prove the fact that an amount was paid. However, that will not go the further step of proving that the legal analysis of the principles underpinning s 8-1 is satisfied (eg is it incurred *in earning your assessable income*?).

One particularly interesting area may involve trust distributions where the actual instruments recording entitlement have been lost, but the books of a trustee company record the entitlements arising. Whether an entitlement under a trust instrument was sufficient to be a present entitlement,[52] within the meaning of s 97 ITAA36, is often a complex mixed question of law applied to the facts, and what conclusions could be drawn by a court will vary greatly depending on the broader factual matrix (eg the trust deed, the direct evidence of the directors of a trustee, etc).

State tax matters

Cassaniti is a decision of the Full Federal Court in relation to income tax. It is not necessarily binding on state courts in respect of state tax matters. However, given the generality of the principles described, there is no reason why the principles should not be adopted and applied more broadly. In this instance, it may be noted there may be scope for applying the principles from *Cassaniti* in state tax cases where there is a dispute as to whether or not a burden has been discharged. In *CDPV Pty Ltd v Commissioner of State Revenue (Vic)*, Justice Croft remarked:[53]

> "The Commissioner is, as observed in the Commissioner's submissions, at an evidentiary disadvantage inasmuch as those who are seeking an exemption have within their control almost all of the evidence in relation to what is occurring on the Land and why things were or were not done on the Land. The Commissioner can only really point to objective circumstances with a view to determining the position. *Consequently, I accept that, when the Court is faced with a case of this nature, and particularly where, as in this case, the Court is faced with very uncertain evidence, a focus must be maintained on whether the onus has been met.*" (emphasis added)

Even though only some states operate under evidentiary law which is to be uniformly intercepted with federal evidence law, there is no reason in principle why the five general propositions at para 88 of *Cassaniti* should not be of general application in a variety of state tax matters arising under state tax laws. Further, s 1305 operates regardless of which state or territory the matter arises in. Accordingly, it should be possible to utilise the principles in *Cassaniti* to help establish that the onus of proof has been met by the taxpayer in state matters.

Concluding comments

The decision in *Cassaniti* represents much-needed clarification on the extent to which the Commissioner can successfully assert that the burden of proof has not been met. More practically, it provides a roadmap to steps that can be taken to narrow issues in dispute before and during litigation by reference to certain documentary and sworn evidence to reduce the cost, complexity and risk in resolving disputes with the Commissioner(s). For corporations, both large and small, both the five principles enunciated at para 88 of *Cassaniti* and the operation of s 1305 highlight ways in which it may be possible to contain the extent of a factual dispute both before and during litigation. Taxpayers would be well advised to consider the case and its implications in any active disputes, at the audit or later stages, with the Commissioner.

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2 *Cassaniti* at [88].

3 See also *Cassaniti* at [9] per Logan J.

4 S 9 of the *Corporations Act 2001* (Cth); see also ss 268 and 1305 of the *Corporations Act 2001*.

5 [2019] FCA 543.

6 Ss 14ZZK and 14ZZO of the *Taxation Administration Act 1953* (Cth).

7 *Cassaniti* at [5] per Logan J, citing s 80 of the *Judiciary Act 1903* (Cth) and *Chief Executive Officer of Customs v Labrador Liquor Wholesale Pty Ltd* (2003) 216 CLR 161 at [132]; *Dickinson v Minister of Pensions* [1953] 1 QB 228 at 232; *Currie v Dempsey* (1967) 69 SR (NSW) 116 at 125.

8 S 98 of the *Taxation Administration Act 1997* (Vic); s 88 of the *Taxation Administration Act 1996* (NSW); s 66 of the *Taxation Administration Act 2001* (Qld); s 85 of the *Taxation Administration Act 1996* (SA); s 37 of the *Taxation Administration Act 2003* (WA); s 81 of the *Taxation Administration Act 1997* (Tas).

9 *FCT v Thomas* [2018] HCA 31 at [84] and [85] per Gageler J.

10 *FCT v Thomas* (2018) 357 ALR 445; [2018] HCA 31 at [84] – [85] per Gageler J.

11 *Cassaniti* at [17] per Logan J; see also *FCT v Dalco* (1990) 168 CLR 614 at 624 per Brennan J.

12 *FCT v Dalco* (1990) 168 CLR 614 (*Dalco*).

13 S 167 ITAA36.

14 *Dalco* at 618 per Brennan J.

15 *George v FCT* (1952) 86 CLR 183.

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17 *FCT v Australia and New Zealand Savings Bank Ltd* (1994) 181 CLR 466 at 479.

18 *FCT v Ma* (1992) 37 FCR 225 (*Ma*).

19 *Ma* at 226.

20 *Ma* at 230.

21 *Haritos v FCT* [2015] FCAFC 92 (*Haritos*) at [234].

22 *Haritos* at [236]-[237].

23 [2016] FCAFC 38.

24 Ibid at [12].

25 *Rigoli and FCT* [2015] AATA 169 at [73].

26 [2015] FCA 1092.

27 *Chevron Australia Holdings Pty Ltd v FCT (No. 4)* [2015] FCA 1092 at [504]-[525].

28 *Cassaniti* at [29].

29 *Cassaniti* at [87].

30 *Cassaniti* at [30].

31 *Cassaniti* at [31].

32 *Cassaniti* at [32(4)].

33 *Cassaniti* at [34].

34 *Jones v Dunkel* [1959] HCA 8.

35 *Cassaniti* at [45].

36 *Cassaniti* at [43].

37 *Cassaniti* at [58].

38 Citing a series of propositions regarding this point provided by Justice Perram in *Australian Competition and Consumer Commission v Air New Zealand Limited (No. 1)* (2012) 207 FCR 448 at [92].

39 S 69 of the *Evidence Act 1995* (Cth) and *Guest v FCT* [2007] FCA 193 at [25].

40 S 9 of the *Corporations Act 2001*.

41 S 286 of the *Corporations Act 2001*.

42 *Cassaniti* at [71].

43 *Australian Securities and Investments Commission v Rich* [2005] NSWSC 417; *Caratti v The Queen* [2000] WASCA 279; and *Linfox Transport (Aust) Pty Ltd v Arthur Yates & Co Ltd* [2003] NSWSC 876 are referred to.

44 *Cassaniti* at [88].

45 *Allied Pastoral Holdings Pty Ltd v FCT* [1983] 1 NSWLR 1 at 8.

46 *Australian Securities and Investments Commission v Rich* [2005] NSWSC 417.

47 S 286 of the *Corporations Act 2001*.

48 S 69(3)(a) of the *Evidence Act 1995*.

49 *Price v FCT* [2019] FCA 543 (*Price*).

50 *Price* at [161].

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A Matter of Trusts

by Neil Brydges, CTA, Sladen Legal

Residency of a trust: don't get it wrong

This article looks at what determines the tax residence of a trust and what the consequences can be from a change of tax residence.

The Full Federal Court decision in *Harding v FCT*[1] (*Harding*) and the High Court decision in *Bywater Investments Ltd v FCT*[2] (*Bywater*) focused minds on the residency tests for individuals and companies. But what of the residency tests for trusts? And what does the jurisprudence on individual and corporate residency mean for the residency of a trust?

Source and residency

Before exploring the residency tests for trusts, it should be noted that a fundamental principle of Australian tax law is that Australian tax residents are assessed in Australia on ordinary and statutory income from all sources, whether inside or outside of Australia, unless a statutory rule overrides this general rule.[3] A non-resident, however, is generally assessable only on income from Australian sources or on income on a basis other than having an Australian source.[4]

Australia's double tax treaties, for countries where Australia has such an agreement, can alter these general principles.

The "source rules" help Australia tax income derived by non-residents while the "residency rules" cause the taxation of Australian tax residents on their worldwide income.

For instance, if income derived by an Australian resident trust has an Australian source and the trust distributes that income to a foreign beneficiary, prima facie Australia has a right to tax that distribution. Conversely, foreign source income derived by an Australian trust may not be assessable in Australia if distributed to a foreign beneficiary but should be assessable if distributed to an Australian beneficiary.

Similarly, the residency of the trust will determine whether the trust's income from all sources is assessable in Australia (Australian trust) or only income with an Australian source or income on a basis other than having an Australian source (foreign trust). That is, while different concepts, source and residency are "two sides of the same coin" when it comes to determining any Australian tax liability on a distribution to a beneficiary.

Residency of trusts

A trust is a resident of Australia for an income year if the trust has *a* resident trustee *at any time* during the income year or the central management and control (CMC) of the trust was in Australia *at any time* during the income year.[5] A non-resident trust is a trust that is not a resident trust.[5]

If a trust has multiple trustees, only one need be a resident for the trust to be a resident. This is because s 95(2) of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) refers to "a trustee", which connotes that the requirement is satisfied if any trustee is a resident, even if that trustee is one of a number of trustees where the other trustees are not Australian residents for taxation purposes.

The tests are interactive. For example, a trust with a foreign company as trustee will be an Australian resident trust if the foreign company carries on business in Australia and the company's CMC is in Australia causing the trustee to be an Australian resident. Similarly, if there is a foreign resident trustee (individual or corporate), and the trustee exercises the CMC of a trust in Australia, the trust will be an Australian tax resident despite the trustee being a foreign resident.

This latter example also raises the possibility that the trust could be a resident of Australia and the foreign country (under the residency tests in that country). In this case, for countries where Australia has a double tax agreement, most agreements have a "tie breaker" rule in circumstances of dual residency.

The residency tests for companies and trusts both include the concept of CMC. While there is considerable jurisprudence, including *Bywater*, on CMC for companies, there is not an Australian court decision considering CMC for trusts. However, in the Canadian Supreme Court decision of *Fundy Settlement v Canada*,[6] the court said that "there are many similarities between a trust and a corporation" and CMC is where "[the trusts] real business is carried on".[7]

While the Australian corporate jurisprudence on CMC is useful in the context of trusts in determining what activities constitute CMC, it is likely the concept for trusts is somewhat different because s 95(2) includes the word "the" before "central management and control" which the s 6(1) ITAA36 residency test for companies does not. That is, a company may have multiple places of CMC,[8] while for trusts, there either must be only one CMC (in Australia) or, if there is more than one, the predominant one must be in Australia.

Harding concerned the "domicile test" under the s 6 definition of residency for an individual. The court's decision turned on the meaning of the term "permanent place of abode". The court found, regardless of the nature of Mr Harding's accommodation (being a "temporary" serviced apartment), that it was correct to conclude his place of abode was Bahrain rather than Australia for Bahrain was the "place" where he was living.[9]

For trusts with individual trustees, *Harding* "expanded" what could be a permanent place of abode such that for an individual Australian-resident trustee, it may be "easier" for that individual to stop being an Australian resident or "harder" for an individual foreign-resident trustee to become an Australian trustee (with the flow-on consequences for the trust of which the individual is trustee in both cases).

Is there a difference for capital gains tax?

Unlike for individuals and companies, for trusts there is a separate residency test for capital gains tax (CGT) purposes.

For trusts other than unit trusts, the test for CGT purposes is the same as the s 95 test.

For unit trusts, there is a different test for CGT purposes, with the s 95 test for other purposes. A unit trust is an Australian tax resident for CGT purposes for an income year if at any time:

1. any property (not just real property) of the trust is situated in Australia or the trust carries on a business in Australia; and
2. the CMC of the trust is in Australia or Australian residents held more than 50% of the beneficial interests in the income or property of the trust.

Therefore, it is possible for a unit trust to be a non-resident for most Australian tax purposes but a resident trust for CGT purposes (or vice versa). For example, a unit trust may have a foreign trustee and CMC (and so would not be an Australian tax resident for most purposes) but if the unit trust owned property situated in Australia and Australian residents held more than 50% of the units, the trust could be an Australian resident trust for CGT purposes.

Trusts ceasing to be a resident of Australia or becoming a resident of Australia

A trust ceases to be a resident of Australia

If a trust ceases being a "resident trust for CGT purposes", CGT event I2 in s 104-170 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) happens. The time of the event is when the trust stops being a "resident trust for CGT purposes".[10]

A trust ceases being a "resident trust for CGT purposes" at the time during an income year when the trust no longer meets the requirements of that definition.[11]

The trustee of the trust is required to work out if it has made a capital gain or a capital loss for each CGT asset that it owned (in the capacity as trustee of the trust) just before the time of the CGT event.[12] The trustee makes a capital gain (loss) if the market value of the asset (at the time of the event) is more than the asset's cost base (reduced cost base).[13] If the trust is a fixed trust, foreign resident beneficiaries may be able to disregard their share of the capital gain.[14]

The only exceptions relate to "taxable Australian property" that is:[12]

1. "taxable Australian real property";
2. an asset used in carrying on a business through a permanent establishment in Australia; or
3. an option or right to acquire the above.

A trust that stops being a "resident trust for CGT purposes" during an income year does not make any capital gain or capital loss in that income year from any CGT event that happens from the time at which it stops being a resident trust in the income year until the end of that income year, unless the asset is "taxable Australian property" and Div 855 ITAA97 applies.[11]

A trust becomes a resident of Australia

If a trust becomes a "resident trust for CGT purposes", the trustee is taken to acquire the CGT assets it owns at their market value at the time the trust became a "resident trust for CGT purposes" except for an asset that:[15]

1. is "taxable Australian property"; or
2. the trustee acquired before 20 September 1985.

The above does not apply if the trust, just before it became a "resident trust for CGT purposes", was a transferor trust.[16]

A trust becomes a "resident trust for CGT purposes" at the time during an income year when the requirements of that definition (see above) are satisfied.

A trust that becomes a "resident trust for CGT purposes" during an income year does not make any capital gain or capital loss in that income year from any CGT event that happens from the beginning of the income year until the time at which it becomes a resident trust in the income year, unless the asset is "taxable Australian property" and Div 855 applies.[11]

What does it mean?

The residency rules are complex. The Board of Taxation has recommended the modernisation of the individual residency rules,[17] while the corporate residency tests are complicated post-*Bywater* by the Australian Taxation Office views in TR 2018/5 considering that case.

The difficulties in the individual and corporate residency tests (including the related concept of CMC) can play out in the residency tests for trusts, for which specific guidance — judicial or otherwise — is minimal.

As a change of residency of a trust can result in significant tax costs for a trust (or its beneficiaries), in a world where individual mobility is common, individuals who are trustees or directors of a corporate trustee should consider whether changes in their circumstances also affect the residency of the trust. Getting it wrong can have consequences beyond their personal affairs.

Neil Brydges, CTA
Principal Lawyer
Sladen Legal

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Superannuation

by Kimberley Noah and Daniel Butler, CTA, DBA Lawyers

Is the SG system in need of an urgent overhaul?

Employers are required to make the minimum superannuation guarantee (SG) contribution for each employee to avoid a shortfall under the *Superannuation Guarantee (Administration) Act 1992* (Cth) (SGAA). This appears to be a simplistic rule.

If an employer does not provide the minimum SG contribution, significant penalties apply. The real issue from an employer's perspective is that the SG is far from simple. It involves a complex mix of superannuation, tax and employment law.

The downside for getting it wrong is potentially disastrous for an employer. The penalties and costs, not to mention the potential adverse stigma of "wages/SG theft", can readily ruin a business. Directors can also be personally liable.

This article provides a brief overview of a number of key SG issues and concludes that the SG regime should undergo a systematic review to make it simpler and fairer.

Who is an employee?

For the SG obligations to apply, the relevant worker must fall within the definition of an "employee" under s 12 SGAA. The SGAA adopts the common law meaning of employee. Section 12(3) then expands this definition to include individuals who are employed under a contract that is wholly or principally for their labour.

Broadly, the ATO in SGR 2005/1 provides that the following factors must be considered when determining whether a contract for labour exists:

- Is the contractor remunerated (either wholly or principally) for their personal labour and skills?
- Is the contractor required to perform the work personally, such that there is no right of delegation?
- Is the contractor paid to achieve a result?

It should be noted that a contractor can readily fall within the scope of the SGAA's expanded definition of "employee" unless they qualify as an independent contractor. There is a raft of cases that have considered these aspects and each case generally turns on the particular facts.

One seminal case on point is *On Call Interpreters and Translators Agency Pty Ltd v FCT (No. 3)*[1] where Bromberg J held:[2]

> "Whether a person is an employee or alternatively an independent contractor is to be answered by reference to an objective assessment of the nature of the relationship that person has with the entity that takes the benefit of that person's work. Either the relationship is between an employee and an employer or the relationship is between an independent contractor and its client. Whether a person falls on one side or the other of that binary divide is often a question which may not be easy to answer. It is important that in attempting to arrive at the right answer, the correct interpretative tools are utilised."

Indeed, Bromberg J held[3] that the modern approach to defining an employment relationship is "multi-factorial" and it is the "totality of the relationship which is to be considered". Accordingly, careful consideration of a multitude of different factors must be taken into account when determining whether an employer or a principal under a contractor arrangement have SG obligations.

Due to the complexity of the law and the downside of getting this wrong, many employers/principals will generally only engage a contractor who operates via a company. Employers/principals are generally too fearful of engaging an individual who claims to be an independent contractor, as applying the multi-factorial legally complex test of who is an employee/independent contractor is likened to being exposed to "being cut by a thousand swords".

What is OTE?

Broadly, SG is payable by an employer on an employee's ordinary time earnings (OTE) which typically includes remuneration paid to an employee in relation to ordinary hours of work.

Pursuant to s 6(1) SGAA, OTE includes earnings in respect of ordinary hours of work and over-award payments, shift-loading and commissions. Generally, SG does not apply to overtime payments.

The relationship between OTE and "salary or wages" involves some complexity. The ATO confirms in SGR 2009/2 that an amount only forms part of an employee's OTE if it is "salary or wages". However, salary or wages may also include amounts that are not OTE. The ATO classifies some 34 different employer payments into salary or wages or OTE in SGR 2009/2.[4] This analysis shows some of the complexity that relates to the SG regime as each different type of payment has to be analysed to determine whether it is, or is not, covered by the SG regime. For example, a lump sum payment in relation to unused sick or annual leave paid on the termination of employment are excluded from OTE.

The Federal Court undertook an examination of OTE in *Australian Workers' Union v BlueScope Steel (AIS) Pty Ltd*.[5] Broadly, this case involved a consideration of whether additional hours included in annualised salary and public holiday payments were OTE. It was initially held by Flick J of the Federal Court that the employer BlueScope Steel should have made contributions in respect of additional hours and public holiday components as these constituted OTE. However, this decision was recently set aside on appeal by

the Full Federal Court holding the payments were not OTE. As you would appreciate, not many employers would have the resources to contest these finer points of law.

What if things go wrong?

Employers are required to make SG contributions on at least a quarterly basis; within 28 days after the end of each quarter. Being one day late can expose an employer to substantial penalties, including a 200% penalty of the usual SG shortfall payable. Moreover, employees may nominate the superannuation fund into which they would like the SG contributions paid. An employer who fails to provide an employee with a choice of fund is exposed to further significant penalties.

Where an employer fails to make the minimum level of SG contributions for a particular quarter, they are liable for the superannuation guarantee charge (SGC). The SGC is calculated as follows:

- a shortfall amount determined by multiplying the employee's total salary or wages (not just their OTE, which may be a significantly lower amount) against the relevant charge percentage, which is currently set at 9.5%;
- a $20 administration fee, per quarter, per employee; and
- interest of 10% on the above shortfall amount (as a proxy for lost earnings the employee would have missed out on).

Interestingly, when the 10% rate was set, this reflected prevailing rates of expected returns from investments. Given the current much lower prevailing rates of return, many employees may want their employers to fail to satisfy the SG rules, so they get a guaranteed 10% pa return.

Employer penalties

In addition to the SGC, failure to contribute the minimum 9.5% of an employee's OTE can also result in the following liabilities:

- penalties for failing to provide information or a statement by each quarterly deadline as required under the law, which can be up to 200% of the amount of the SGC, pursuant to Pt 7 SGAA (Pt 7 penalties);
- a penalty of up to 100% under the *Taxation Administration Act 1953* (Cth) (TAA);
- general interest charge imposed where the SG charge or Pt 7 penalties are not paid by the due date; and
- an amount equal to the SGC personally if the Commissioner of Taxation issues a director penalty notice.

Moreover, a choice of fund penalty of up to $500 per quarter, per employee, may also apply where an employer fails to offer eligible employees a choice of fund or fails to make the SG payments to each employee's chosen fund.

Indeed, these penalties and liabilities should not be taken lightly as they apply regardless of whether the failure to make the SG contributions was an innocent mistake, a misunderstanding in applying the complex legislative provisions, or deliberate avoidance. Notably, the Commissioner does not have discretion to remit the SGC. As discussed above, the cumulative effect of these penalties can be crushing on a business.

The calculated SGC can be particularly burdensome, given that it is calculated using the employee's salary and wages compared to their OTE. The calculated amount can be considerably greater if the relevant employee is paid for overtime and other amounts that do not constitute OTE.[4]

Navigating the SG regime

As evidenced above, navigating the SG regime is complex and determining whether SG obligations apply can be particularly onerous on employers. As the SG provisions are difficult to understand and complex to administer, inadvertent errors are likely to arise.

There are further difficulties when considering that multiple awards may apply to the same employee and under these multiple awards, multiple categories of pay and entitlements may also apply to the same employee. To avoid an SG shortfall, employers generally contribute on the higher base to minimise any shortfall risk.

Recent changes

In April 2019, a number of integrity measures were introduced to hold employers accountable and ensure that they meet their SG obligations. These integrity measures are set out below.

Single touch payroll

The single touch payroll (STP) framework was introduced to increase transparency in relation to employer SG obligations. Under this framework, small employers (19 or fewer employees) and large employers (20 or more employees) are now required to provide the ATO with real-time information on employer PAYG and superannuation obligations.

Education direction

Pursuant to s 384-10(1) of Sch 1 TAA, where an employer has failed to comply with its SG obligations, the Commissioner can issue a direction to the employer to undertake an approved education course. Following completion, the employer must provide proof and failure to comply with an education direction can result in administrative or criminal penalties.[6]

Direction to pay SGC

As previously mentioned, where an employer has failed to pay an SGC, the Commissioner may issue a direction to pay the charge within a specific period, pursuant to s 265–90(1) of Sch 1 TAA. If this direction is not complied with within the specified time period, a penalty of $10,500 and/or 12 months' imprisonment may be imposed by the ATO.

Conclusion

Australia is well known for having, in addition to one of the most complex tax systems in the world, one of the most complex and rigid employment law systems in the world. The inherent complexities of the SG regime are certainly no exception to this proposition.

The SG penalty regime is strict, unforgiving and severe penalties can be imposed for even innocent mistakes.

The SG regime should undergo a systematic review to make it easier for employers to understand and comply with their obligations. In conjunction with making it simpler, the

SG regime should be made more flexible and with more sympathetic penalties levied.

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6 The ATO has developed an online education course to provide further information around superannuation obligations to employees, available at www.ato.gov.au/Business/Super-for-employers/In-detail/SG-employer-obligations-course.

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Tax Cases

by Michael Norbury, CTA, Norbury Lawyers

Who owned the residence?

Did the taxpayer or a trust own the residence, and did the CGT main residence exemption apply?

Mingos v FCT[1] concerns the main residence exemption. It turned on the evidence, in particular who was entitled to the residence, the taxpayer or a trust?

Facts

In 1992, Unique Planning Pty Ltd purchased a residence in Mt Waverley, Victoria on trust for the taxpayer absolutely. The taxpayer and his wife, Maria, and their two children immediately took up occupation as the family's main residence.[2]

In November 2016, Unique Planning Pty Ltd transferred all of its interest in the residence to the taxpayer for a consideration of "entitlement in equity". The taxpayer immediately transferred his entire interest in the residence to Maria for a consideration of "natural love and affection".[3]

Shortly after the transfer to Maria, the marriage between the taxpayer and Maria broke down, and the taxpayer moved to alternative accommodation.

In November 2010, the taxpayer and Maria entered into a property settlement which resulted in final court orders being made on 23 December 2010.[4] One of the orders required Maria to transfer the residence to the taxpayer or at his direction on payment of $1,300,000.

The taxpayer did not have the funds to pay out Maria.

He was, however, a director of Lemnian Investments Pty Ltd (Lemnian), which acted as trustee of the Lemnian Investment Trust. (the Lemnian Trust). The Lemnian Trust owned properties in Mt Waverley and Cheltenham, both of which were unencumbered. It also owned units in a unit trust, which owned property in Carnegie. The Carnegie property was mortgaged to BankWest for $1,500,000.[5]

In May 2011, Lemnian borrowed $4,000,000 on the security of the residence as well as the other properties owned by the Lemnian Trust. These borrowings were used to:

- discharge the mortgage of $750,000 on the residence in accordance with court orders;
- pay Maria $1,300,000;
- prepay interest; and
- refinance the Carnegie property.[6]

The residence was sold in May 2014 for $5,100,000. Settlement occurred in August 2014.

The balance sheet for the Lemnian Trust showed the $5,100,000 as a receivable of the trust and a distribution to the taxpayer of $1,100,000 representing "100% profit on sale of the residence".[7]

Minutes of a directors' meeting for the 2014 year resolved "that the total net income of the Trust for the year ended 30 June 2014 be appropriated set aside and applied" as to the capital gain on the sale of the residence 100% to the taxpayer.

The Lemnian Trust tax return for the 2014 income year disclosed the distribution of the capital gain to the taxpayer. The taxpayer did not include this amount in his assessable income.[8] It was this capital gain which was the subject of the dispute.

Taxpayer's position

The taxpayer's case was that, although the residence was recorded as a trust asset, the residence was not in fact a trust asset, but rather it was the property of the taxpayer beneficially. The dispute was one of fact.

On affidavit, the taxpayer deposed to the difficulties he had in arranging a loan to comply with the court orders. He stated that he had only transferred the residence to the Lemnian Trust because the bank required it that way to proceed with the loan.[9]

Before the court was an email dated 1 June 2011 from Mr Munro, the taxpayer's accountant, to the bank which stated:

> "It would be preferable if … both the property title and mortgage documents were in the name of Lemnian Investment Trust."

The court found the email contrary to the taxpayer's evidence and evidenced that the bank was prepared to advance the funds on the basis of residence remaining in the taxpayer's name.[10] The taxpayer gave contradictory answers in cross-examination.

The court rejected the taxpayer's evidence that the residence was put in the name of Lemnian at the bank's request.[11]

The residence was shown in the trust accounts for the years 2011, 2012 and 2013. The taxpayer signed the directors' declaration in relation to the 2011 year. When the 2011 accounts were put to him in cross-examination, the taxpayer stated that he "'can't accept that' stating 'as far a [he] was concerned, [the residence] was [his] property'".[12]

The taxpayer's brother, Con, was a co-director of Lemnian. He gave evidence of discussing the ownership of the residence with Mr Munro. He stated:[13]

> "I always understood the [residence] to belong to [the taxpayer] to be used by him as his home. [The taxpayer] was responsible for the borrowings by [Lemnian] to pay out his wife and discharge the mortgage on the [property]. The accountant made sure that [the taxpayer] was responsible for all costs associated with the [property] like rates and land tax … I do not understand the way the proceeds of sale of the [residence] were dealt with by the accountant. I thought that the proceeds were [the taxpayer's] money."

Mr Munro gave evidence that he assisted the taxpayer in 2010 in reaching the matrimonial settlement with Maria. Mr Munro

deposed that the taxpayer did not have the financial resources to borrow the funds needed to pay out Maria, but the trust had at the time surplus rental income to meet the refinance debt servicing requirements, as well as significant equity in properties. He deposed that at the time, he was able to secure for the taxpayer a refinance deal with the bank for $4m, and this was settled in May of 2011. He further deposed that from the loan refinance moneys, the cash amount of $1.3m was paid to Maria and the residence was "then transferred into the name of [Lemnian] to be held on trust for [the taxpayer's] sole benefit as his residential home".[14]

The court found the brother's evidence far from satisfactory. It found his evidence vague, lacking in specifics and highly generalised. The brother's subjective view about what he said he understood was contradicted by the objective circumstances that, as a director of Lemnian, he signed the transfer of land placing title to the residence in the name of the company. He also signed, as fairly presenting the trust's financial position, the trust accounts for each of the 2011 and 2012 income years in which the residence was recorded as an asset of the trust, and the trust accounts for the 2014 income year in which the sale proceeds were recorded as a receivable of the trust. While only an unsigned copy of the trust accounts for the 2013 income year was in evidence, the residence was similarly recorded as an asset of the trust for that year and there was nothing in the evidence to suggest that Mr Mingos had not approved those accounts. The court also found significance in that that there was no suggestion in the brother's affidavit or oral evidence that he, at any stage, questioned the correctness of recording the property as an asset of the trust.[15]

The court rejected as untruthful that part of Mr Munro's evidence that what he said in the email to the bank was in error. Against that evidence was the clear email instructing the bank that the title to the residence was to be in the name of the trust, which the court accepted on its face was accurate and showed Mr Munro's evidence to be demonstrably wrong in this respect. Later in his cross-examination, Mr Munro gave evidence that he "never recorded anything as showing that [the] property belonged to the [trust]" as an asset of the trust in the financial statements. The court rejected that evidence also as untruthful as the property plainly was accounted for in the financial statements as an asset of the trust.[16]

Court's reasoning and decision

The court considered whether the taxpayer had discharged the onus of proving that he had an ownership interest in the residence. The court held that he had not.[17]

First, pursuant to the orders, it was open to the taxpayer to nominate another entity as the transferee.[18]

Second, the court found on the evidence that the taxpayer nominated Lemnian in its capacity as trustee of the trust. The court inferred that the residence was compiled by Mr Munro as an asset of the trust in the 2011 accounts consistently with his instruction to the bank that the property and mortgage were to be in the name of the trust.[19]

Third, under the terms of the trust deed, the trust was able to acquire property.[20]

Fourth, the taxpayer and his brother, as the directors of Lemnian, signed the 2011 accounts as fairly representing the financial position of the trust and the court inferred that the treatment in the later accounts was also accepted by the taxpayer as correct, although he did not sign the directors' declaration for those later years. Furthermore, the validity and effectiveness of the 2014 resolution was not the subject of any challenge.[21]

Fifth, there was no suggestion in the evidence that at any time, the treatment of the residence as an asset of the trust was questioned by either the taxpayer or his brother.[22]

Sixth, consistently, on the sale of the residence, the proceeds were accounted for as an asset of the trust.[23]

Seventh, the taxpayer was a member of the class of potential beneficiaries under the trust deed.[24]

Eighth, consistently with the terms of the trust deed, the directors of Lemnian in its capacity as the trustee of the trust had the power to allocate the net capital gain to a beneficiary.[25]

Ninth, consistently with treating the property as an asset of the trust in the accounts, the net income of the trust referrable to the capital gain on the sale of the property was distributed to the taxpayer.[26]

Tenth, consistently with the recorded resolution for the 2014 income year, the tax return of the trust disclosed the distribution of the net capital gain to the taxpayer.[27]

Eleventh, the brother's evidence was that the resolutions were explained to him satisfactorily before he signed them. It may be inferred that he accepted at the time the correctness of both the accounting and tax treatment in relation to the proceeds of sale.[28]

Twelfth, the accountant who prepared the 2013 and 2014 financial statements and the 2014 tax return was not called to give evidence and a *Jones v Dunkel*[29] inference is available.[30]

Thirteenth, the entries in the loan schedule neither prove the asserted "sub-trust" nor gainsay that the residence was an asset of the trust. Rather, such entries were equally consistent with what, in fact, actually happened, that is, the benefit flowed through to the taxpayer through the trust structure and distributions.[31]

The court found that the taxpayer had not discharged the onus on him to prove that he held a beneficial ownership in the residence pursuant to a separate trust of which Lemnian was trustee.[32]

The taxpayer then contended that the court orders vested an equitable interest in the residence to him. It was submitted that the estate or interest conveyed by Maria to Lemnian was no more than a bare legal estate.

This was rejected by the court. First, the submission ignored cl 6.2 of the court orders that pending "the payment, discharge of the mortgage, and/or sale of [the residence]" that "both parties hold their interest in [the residence] upon trust pursuant to this Order". In other words, the orders did not have an immediate dispositive effect of vesting an absolute equitable interest in the residence to the taxpayer. Second, the submission ignored the conditional nature of the taxpayer's entitlement to conveyance of the residence

under the court orders, as the taxpayer's entitlement was conditional on the discharge of the mortgage and the payment of $1.3m to Maria, failing which the residence was to be sold. Third, the submission ignored the fact that the taxpayer exercised his right to direct that Maria transfer all her right, title and interest in the residence to his nominated entity which, in this case, was Lemnian.[33]

Next, it was argued by the taxpayer that the transfer by Maria to Lemnian constituted a mortgage of Torrens title land by absolute transfer, vesting the legal title in Lemnian as mortgagee and leaving the taxpayer (mortgagor) with an unregistered equitable interest in the land. This was rejected by the court. The evidence did not support a finding that the true nature of the transfer of the property to Lemnian was as security for Lemnian's borrowings from the bank. First, the funds borrowed by Lemnian were not just for the purpose of enabling access to the amounts which the taxpayer was required to pay Maria to obtain title to the property, but were also used to refinance the Carnegie property, which was a trust asset.

Second, if the transaction effected by the transfer to Lemnian was a general law mortgage, Lemnian was obliged to account to the taxpayer for the balance of proceeds after discharge of the taxpayer's liabilities to Lemnian. There was no evidence that it did so. To the contrary, the proceeds were recorded as a receivable of the trust and a distribution of the capital gain made to the taxpayer. The treatment of the proceeds was not consistent with the characterisation of the transfer as a security transaction.[34]

Next, it was contended that, on transfer of the property to Lemnian by Maria, Lemnian held the residence on a resulting trust or constructive trust for the taxpayer. The court dismissed this submission. First, the facts established that the taxpayer intended a conveyance of the estate in fee simple in the residence to Lemnian to be held on the terms of the trust. Second, the financial statements brought to account as a beneficiary entitlement payable to the taxpayer the difference between the attributed market value of the residence at $4m and the amounts which the trust had paid out of the borrowing it took from the bank to enable the taxpayer to comply with the court orders. The court found that the trust provided valuable consideration for the transfer of the residence to it in the form of the recognition of a non-current liability to the taxpayer.[35]

Finally, it was argued that the evidence showed that the taxpayer occupied the property as his place of residence, otherwise than as a tenant, which supported an inference that he held either a licence or a right to occupy the residence. Such licence or right to occupy was said to constitute an ownership interest for the purposes of the main residence exemption. The court noted that the relevant capital gain which had been assessed to the taxpayer related to the CGT event constituted by the contract for the sale of the residence to a third party in May 2014, that is the disposition by Lemnian. Whether the taxpayer, rather than Lemnian, made the capital gain on disposal depended on whether the taxpayer had an absolute entitlement to the residence as against Lemnian.[36]

Court's application of the law

The court observed that s 118-110(1) of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) applied to a capital gain that "you make". It found no issue that the residence was a dwelling or that a capital gain happened in relation to the residence when Lemnian disposed of it. The issue was who made the capital gain.[37]

The court found that, when CGT event A1 happens, the capital gain was made by the person who disposed of the asset (s 104-10 ITAA97). Here, that person was Lemnian. That result was subject only to a statutory exception found in Div 106 ITAA97 (see s 106-1 ITAA97). The relevant exception was found in s 106-50 ITAA97, which provided:

> "**Absolutely entitled beneficiaries**
>
> (1) For the purposes of this Part and Part 3-3 (about capital gains and losses) and Subdivision 328-C (What is a small business entity), from just after the time you become absolutely entitled to a CGT asset as against the trustee of a trust (disregarding any legal disability), the asset is treated as being your asset (instead of being an asset of the trust).
>
> (2) This Part, Part 3-3 and Subdivision 328-C apply, from just after the time you become absolutely entitled to a CGT asset as against the trustee of a trust (disregarding any legal disability), to an act done in relation to the asset by the trustee as if the act had been done by you (instead of by the trustee) …"

The court held that s 106-50 deemed an act done in relation to an asset to which a taxpayer is absolutely entitled as against the trustee of a trust to be done by the taxpayer. A beneficiary will be absolutely entitled to an asset as against the trustee of a trust if the beneficiary has a vested, indefeasible and absolute entitlement in the trust asset, and is entitled to require the trustee to deal with the trust asset as the beneficiary directed.[38]

The court held that the taxpayer did not establish that he had an absolute entitlement to the residence as against Lemnian.[39]

Comment and conclusion

The court made some very harsh findings about the taxpayer's evidence and that of his witnesses. Not only did the taxpayer lose his appeal, he may have lost his reputation!

Mingos is of interest as much for the court's forensic approach in dealing with the contradictory evidence laid before it as it is for its application of the law.

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Principal
Norbury Lawyers

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Events Calendar

August 2019

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National		
National Transfer Pricing Conference	14/8/2019	7
2019 National Superannuation Conference	29/8/2019	12
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International Tax for SMEs	2/8/2019	7
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Darwin Seminar	2/8/2019	4
SA Private Business Day	2/8/2019	6
SA Essential Business Session 3	14/8/2019	1
Victoria		
International Tax Day	8/8/2019	6
Disputes and Litigation Masterclass	15/8/2019	3.75
Western Australia		
Corporate Tax Series 3	14/8/2019	1
Women in Tax Breakfast	22/8/2019	1
52nd WA State Convention	23/8/2019	11

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Alternative Assets Insights

by Christina Sahyoun, Wei-Ee Cheah
and John Scotland, PwC

ATO guidance on non-concessional MIT income

On 26 June 2019, the Australian Taxation Office issued guidance in the form of a draft law companion ruling LCR 2019/D2 (the draft LCR) on the concept of "non-concessional MIT income" (NCMI) on which a withholding tax rate of 30% applies to fund payments made by a managed investment trust (MIT) from 1 July 2019, unless transitional rules apply.

The draft LCR addresses various aspects of the new stapled structure law as they relate to NCMI, including:

- MIT cross-staple arrangements, including the meaning of "arrangement" and "facility";
- MIT cross-staple arrangement income and the transitional rules;
- the integrity rules, particularly in relation to concessional cross-staple rent;
- MIT trading trust income;
- MIT residential housing income; and
- MIT agricultural income.

Notwithstanding that the draft LCR is intended to clarify the application of the new stapled structure law, uncertainties remain and a number of new questions arise as many of the positions taken by the ATO were not expected and/or inconsistent with previous guidance. Further clarification will be required in the finalised version of the LCR.

Comments on the draft LCR were due by 9 August 2019.

Background

Stapled arrangements have been used for separating the risks arising from the operational aspects of a business from the valuable assets held to undertake the business, with a consequence being a split of the business income into active income and passive income with differential tax treatment of each. In particular, stapled arrangements could involve an operating entity (ie a company taxed at the corporate tax rate) making deductible rental payments to the other entity (ie an MIT), with the income received by the MIT being distributed to foreign members (and potentially taxed at the concessional MIT withholding tax rate).

With the increase in use of stapled structures and noting that some arrangements appeared to apply in an inappropriate manner, the ATO has sought to neutralise the tax benefits resulting from stapled arrangements. This was the key rationale which prompted the release of TA 2017/1 which highlighted and pre-empted the increased scrutiny that the ATO intended to apply to stapled arrangements. On 20 September 2018, the Australian Government introduced the Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018. The Bill received royal assent on 5 April 2019 as the *Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Act 2019* (Stapled Structure Act).

From 1 July 2019, the Stapled Structure Act applies to impose a 30% rate of withholding tax (rather than 15%) on fund payments made by an MIT to the extent that they are attributable to NCMI, unless the transitional rules apply.

The draft LCR considers the ATO's preliminary views on various aspects concerning the new concept of NCMI. The new NCMI rules apply to any fund payment made on or after 1 July 2019 in respect of the 2019-20 or later income years. An overview of the key issues covered by the draft LCR is provided below.

Definition of "facility"

The draft LCR examines the concept of "facility", and "ultimate facility" which was not previously addressed in the explanatory memorandum (EM) accompanying the Act. In particular, the draft LCR suggests in one of the examples that, notwithstanding that assets are part of an integrated system or network, they may be discrete facilities for the purposes of the new rules. Examples in the draft LCR include a storage facility adjacent to a transport facility, a road or discrete sections of road, bridges and tunnels which are part of an integrated system network and a depot from which services are dispatched in support of another facility (such as a toll road). This distinction indicates that the Commissioner may take a narrow interpretation of what constitutes a "facility".

The Commissioner's interpretation seems to indicate that where multiple "facilities" make up an "ultimate facility", each of the facilities may be considered separately in assessing whether a facility is eligible to be an "economic infrastructure facility". The implication of this could be far-reaching and may come as an unwelcome surprise to certain taxpayers who may have anticipated the entirety of their operations to be a single facility which meets the "economic infrastructure facility" definition. This may lead to two transitional periods for the "ultimate facility" (ie 15 years for the economic infrastructure facility component and seven years for other parts of the facility). This may result in an additional tax cost for certain investors and a heavy compliance burden on taxpayers to "reasonably apportion" cross-staple income.

In addition, in respect of a number of the examples in the draft LCR on what constitutes a "facility", the Commissioner has not provided detailed facts or reasoning, which makes it difficult to draw hard and fast rules from the examples. The listing of various examples where there are separate facilities without providing much in the way of supporting detail would seem to suggest the Commissioner is seeking to reserve the

right to challenge the scope of a "facility" on a case-by-case basis.

Change to existing cross-staple arrangements

The draft LCR provides guidance on when changes made to a cross-staple arrangement may result in a new arrangement. The draft LCR confirms the position adopted in the EM that the mere renewal of a lease agreement, covering the same facility and between the same parties would not, subject to the facts and circumstances, be expected to create a new cross-staple arrangement. However, surprisingly, one of the examples in the draft LCR indicates that a change in the external entities holding the stapled entities could result in a new cross-staple arrangement. This seems to suggest that a sell-down of interests in stapled structures by upstream investors could potentially result in a new cross-staple arrangement (ie the transitional provisions would cease to apply to the cross-staple arrangements entered into before 27 March 2018 and where a choice is made to apply the transitional rules). This is inconsistent with previous guidance and is a matter that requires urgent clarification.

Eligible investment business and the meaning of "rent"

Interestingly, notwithstanding that the new stapled structure law changes did not introduce a definition for "rent" or "investing in land primarily for the purpose of deriving rent", which have long been cornerstone principles of the taxation of trusts in the context of the meaning of an "eligible investment business", the draft LCR devotes significant attention to these matters in providing guidance on the definition of "rent from land investment", a new concept which refers directly back to these established concepts.

Law companion rulings are intended to "provide an insight into the practical implications or detail of recently enacted law"[1] and therefore the use of this draft LCR to express the ATO's views of concepts which are not amended or introduced in the amending law is novel. Given the importance of these concepts, additional ATO guidance is not unwelcome, although some of the conclusions reached in the draft LCR are not necessarily consistent with industry practice.

First put to use

For facilities that qualify for transitional relief that are either currently being constructed, or have yet to be constructed, it will be necessary to determine when the seven- or 15-year transitional concession begins. The draft LCR indicates that the clock will start to run from the time of first use of some "self-contained component or collection of assets" that of themselves satisfy the definition of "facility". This may occur prior to the ultimate facility being completed, which means for certain projects that are phased (or where one component of a project is brought on line ahead of others), the value of the transitional concession may be diminished.

Concessional cross-staple rent cap

The draft LCR does not provide any additional guidance on what will constitute an "objective method" for determining the annual rent under the lease, and instead reproduces comments from the EM. The lack of additional guidance suggests that the ATO's preference is to ensure taxpayers seek ATO guidance on their specific rent clauses, which will allow the ATO to administer the rent cap rules on a case-by-case basis.

Concessional MIT rate unavailable for amounts not classed as "rent" or attributable to moveable property

Receipts on cross-staple arrangements may only be eligible to limit designation as "MIT cross-staple arrangement income" (eg under the transitional rules) if they meet the definition of "rent from land investment", which, in the Commissioner's view, should exclude returns on arrangements which do not provide exclusive possession.

Additionally, in order to limit designation as "MIT cross-staple arrangement income" under the transitional rules or as an economic infrastructure facility, rent must be "attributable to" a facility. Importantly, the Commissioner considers that a facility does not include ancillary and peripheral assets, such as moveable property, and therefore rent attributable to such assets may not fall within the transitional rules.

Taxpayers who otherwise have an eligible investment business for Div 6C of the *Income Tax Assessment Act 1936* (Cth) purposes may still receive income which is not "rent" or which is attributable to moveable property which is not a facility, which in either case would give rise to MIT cross-staple arrangement income. Where this income exceeds the de minimis threshold of 5% of net income in the prior year, this may lead to a compliance burden on taxpayers to "reasonably apportion" income from cross-staple arrangements according to whether the returns are "rent" and whether the returns are attributable to a facility.

The draft LCR does not address the other measures that have been enacted by the same package of measures, including the changes to the thin capitalisation rules, the foreign pension fund withholding tax exemption and sovereign immunity rules. The ATO has indicated that guidance in respect of the foreign pension fund withholding tax exemption and sovereign immunity will be subject to a separate LCR, which is yet to be released.

The takeaway

The draft LCR provides some interesting insights into the ATO's proposed administration of the new stapled structures law. However, on taxpayer-specific issues, such as the nature of a facility and concessional cross-staple rent cap where the ATO appears reluctant to provide further public guidance, it may be useful to engage in discussion with the ATO and/or seek a private binding ruling directly from the ATO.

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Reference

1 See LCR 2015/1.

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