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The Tax Institute

Taxation in Australia

Vanderstock and the future of federal–state tax powers
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Invitation to write

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

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Tax News – at a glance

by TaxCounsel Pty Ltd

November – what happened in tax?

The following points highlight important federal tax developments that occurred during November 2023. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 306 (at the item number indicated).

Superannuation fund mergers and defined benefit income streams

In a media release on 28 October 2023, the Assistant Treasurer stated that the government was progressing legislative amendments to the superannuation transfer balance cap for individuals with a capped defined benefit income stream to ensure that members are not adversely impacted in the event of a merger or successor fund transfer between superannuation funds. **See item 1.**

Promoter penalties

The Commissioner has lodged an application in the Federal Court seeking orders for the imposition of a civil penalty under the scheme promoter penalty regime (Div 290 of Sch I of the *Taxation Administration Act 1953* (Cth)). **See item 2.**

Decision impact statement: Bains case

The Commissioner has issued a decision impact statement that outlines the ATO's response to the decision of the AAT in *Bains and FCT* ([2023] AATA 2477) in which the AAT held that, based on the facts and circumstances of the case, a lump sum payment received by the taxpayer from the Victorian Taxi Reform Fairness Fund was not income according to ordinary concepts. **See item 3.**

Corporate collective investment vehicle regime

The Commissioner has released a draft law companion ruling in relation to the amendments made to the tax law to specify the tax treatment for corporate collective investment vehicles (LCR 2023/D1). **See item 4.**

FBT: draft legislative instruments

The Commissioner has released several draft legislative instruments dealing with the records that are to be accepted (from 1 April 2024) for FBT purposes as an alternative to an employee declaration in a number of circumstances, and also a draft legislative instrument that will provide an additional method for working out pay as you go instalments for monthly FBT payers. **See item 5.**

Default assessments: Federal Court

In dismissing appeals by two taxpayers from a decision of the AAT, the Federal Court (Charlesworth J) has considered whether the taxpayers had discharged their onus of proof where the assessments to which the objection decisions related were default assessments (*McPartland v FCT* [2023] FCA 1260). **See item 6.**

Default assessments: AAT

The AAT has rejected appeals by two taxpayers (QQRK and WHKY, who were brothers) from objection decisions in relation to assessments or amended assessments that the Commissioner had raised for the income years ended 30 June 2011 to 30 June 2016 and which were effectively default assessments (*QQRK and FCT* [2023] AATA 3493). **See item 7.**

Overpaid JobKeeper: non-repayment discretion

The AAT has considered the exercise of the discretion conferred by s 9(4) of the *Coronavirus Economic Response Package (Payments and Benefits) Act 2020* (Cth) that a JobKeeper payment recipient should not be required to repay an overpayment (*Jassar & Manesh Pty Ltd as trustee for the Jassar Manesh Consultants Unit Trust and FCT* [2023] AATA 3499). **See item 8.**

Tax agent: not fit and proper person

The AAT has affirmed a decision of the Tax Practitioners Board to terminate the registration of a tax agent and to prohibit her from re-applying for registration for a period of three years (*D'couto and Tax Practitioners Board* [2023] AATA 3485). **See item 9.**

Production of documents

The Federal Court (Colvin J) has dismissed a taxpayer's application for judicial review of a decision of the AAT to refuse to require production by the Commissioner of documents (which included external legal advice provided to the Commissioner) where the taxpayer alleged that the AAT held an erroneous view of the law relevant to its powers (*Sage v FCT* [2023] FCA 1247).

President's Report

by Marg Marshall, CTA

A year of investment and connection

President Marg Marshall reflects on her time as President and the future of our Institute.

As we close out on the 80th year of The Tax Institute and on my tenure as President, I am proud to have represented our membership and to have seen the Institute laying the foundations for a bright future.

I'd first like to welcome and congratulate our incoming President, Todd Want, CTA. Todd has been part of the tax profession for over 20 years and now holds a role as a Director in William Buck's Tax Services division. He works across a wide range of tax topics and provides consulting advice to accountants, lawyers, financial planners and other professionals in public practice, putting him in good stead to understand the diverse needs and experiences of our membership.

Over the past year, Todd has served as Vice President of the Institute, and I have seen first-hand his enthusiasm for our community and his valuable insight into the experience of membership.

Congratulations also go to Tim Sandow who has been named as incoming Vice President.

The past year and what's to come

Reflecting on my time as President, I can't say it was without challenges, as is the case with any period of significant growth. Our organisation has seen ups and downs throughout its long history, and this past year has been no different.

One of the ongoing challenges that our profession faces is the lack of action from government around a number of announced but unenacted measures. This lack of action creates uncertainty and frustration for practitioners – and rest assured that I and the team at the Institute share those feelings. We recognise the importance of gaining certainty in these areas and the Institute will continue to engage with consultation and advocacy activity to seek that clarity on your behalf.

Despite any challenges, we have reached many wonderful achievements this year. One of my goals as President was to represent our SME members and to ensure that those members' voices would continue to be heard. Two-thirds of our members belong to SMEs or microbusinesses. That represents a significant diversity of thought, experience and opinion, which is characteristic of the tax profession broadly. It also represents a wide range of needs and preferences when it comes to how and when we offer support.

I am proud that over 60% of our committee members are now from these same sectors. This goes a long way to ensuring that our members are represented by those who understand and care for their perspectives. It also shows how much dedication the Institute has to guaranteeing that its members are fairly represented. Reaching this point required some significant restructuring and some very honest assessment of where we were previously. I think it is a testament to our organisation that the team undertook this change and a testament to our community that there were so many SME practitioners willing to stand up as representatives.

A special mention also goes to our education arm, which has not only been acknowledged as an outstanding example of assessment standards, but has also successfully launched our microcredential offering, Tax Academy, to businesses.

Education is our main driving purpose as an Institute and this year has shown the dedication and skill that our team applies to that endeavour. We are thrilled to offer high-quality learning options that evolve alongside our members' and the tax profession's needs.

I have also immensely enjoyed getting among our members at our various CPD events, including a fantastic three days at The Tax Summit in Melbourne. Our members really do make the Institute what it is, and I have thoroughly enjoyed the opportunity to get to know you all a little better.

As I sign off for 2023, I look forward to seeing the investments we have made this year pay off in the months and years ahead. I am confident that our members will continue to take centre stage in the decisions that our Board and wider team make. And as a member myself, I know that I, and all of us, are in good hands for the future.

CEO's Report

by Scott Treatt, CTA

2023: challenges, triumphs and future opportunities

CEO Scott Treatt discusses the achievements of 2023 and the path forward for the Institute.

As 2023 comes to a close, in many ways I feel as if we are just getting started. Our team of volunteers, staff and our wider membership will hopefully all have some time off over the festive season for rest and recuperation. But tax never stands still, and neither do we.

I, personally, am working to steer our path towards a future where our members are engaged, fulfilled and empowered by their membership experience. It's a task that I'm eager to be taking on for the coming years.

Putting our members first

As I settle into my new role as CEO, I have laid out my plan for our future and have begun to build the foundations of that future. First and foremost in those plans is to focus on listening and responding to our members.

In Sydney last month, I was thrilled to meet with an active group of our members who were keen to share their ideas and insights. This was an opportunity organised by a member for other members and was immensely helpful in allowing me to connect more closely with these passionate individuals.

Hearing issues from the coalface helps us to understand what is most important to our community. That means we can offer better education for our members, and educate government on issues within the system and the practical consequences of decisions being made regarding policy and administration.

To be the voice of tax, you first need to be listening.

The highest standard of tax education

This year, we have taken great leaps and bounds in the development of our microcredential learning units, Tax Academy. Not only are these units now available for businesses to chart a plan of development for, and investment in, their staff, but they also provide an approved pathway for learners to complete the CTA program through Tax Academy.

This is a major achievement, which significantly furthers our mission to make high-quality tax education available in flexible ways that suit busy professionals.

We also took part in an external benchmarking submission on assessment and have been held up as a best-in-class example of assessment, specifically relating to our real-world learning, use of tax technical expertise, and rigour of assessment design. This is evidence that businesses can have great confidence in the fact that practitioners who learn with us really can apply their knowledge and add value to their clients.

Improving our resources

One of the things I know our team at The Tax Institute is proud of, and that our members highly value, is our outstanding tax technical resources.

In 2023, we have worked hard to improve the delivery of these resources over our digital platforms, including major upgrades to our Tax Knowledge Exchange database. This work was not without its challenges, but it has gone a long way to making our digital systems more adaptable, robust and resilient.

This work will continue into the new year, and beyond. There is always room for improvement and growth, especially in a profession that is as fast-paced as tax. As tax changes and new legislation, guidance and thinking emerge, we will continue to improve our resources in order to keep our members at the cutting edge.

Connecting with community

Our CPD events have long been a mainstay of the tax community. The program of events that we hold each year provides opportunities to not only immerse yourself in the latest tax technical thinking, but also to be surrounded by like-minded peers.

We delivered over 30 successful events this year, including the first Tax Summit to be held in Melbourne.

Building a network has certainly driven my career forward over the years and the Institute's role in allowing practitioners to do this is a vital part of our purpose. We are our community.

The past year has brought challenges for our Institute, but it has also seen many triumphs and many open doors for future opportunities. I am excited to embark on a new year with you all.

Senior Tax Counsel's Report

by Julie Abdalla, FTI

2023: a recap

We reflect on the significant tax measures over the past year and evaluate the key takeaways for 2024.

While 2023 witnessed a few historic moments, including King Charles III's coronation and the Matildas' leap into the FIFA Women's World Cup semi-final, it was not free from challenges. Ongoing economic uncertainty created by the global pandemic continued into 2023, and inflation remained stubbornly high. Repeated interest rate hikes have added to the cost-of-living pressures. For the tax profession, it was another significant year with some key tax changes, including landmark tax decisions.

Ethics and professional conduct

One of the most significant reforms proposed this year was the government's announcement on 6 August 2023 to increase penalties (up to $780m) against promoters of tax schemes and to strengthen regulatory powers. The reforms, which aim to restore public confidence and faith in the tax profession, cover three priority areas: (1) strengthening the integrity of the tax system; (2) increasing the powers of the regulators; and (3) strengthening regulatory arrangements to ensure that they are fit for purpose.

Recently passed legislation amends, and newly introduced legislation proposes to amend, the *Tax Agent Services Act 2009* (Cth) to increase the obligations imposed on registered tax and BAS agents, and increase the powers of the regulators.

Superannuation

Major superannuation reforms include:

- exposure draft legislation of the Treasury Laws Amendment (Better Targeted Superannuation Concessions Bill) 2023 – this proposes to introduce new Div 296 into the *Income Tax Assessment Act 1997* (Cth) to levy a 15% additional tax on earnings on total superannuation balances above $3m. The measure is proposed to start on 1 July 2025;
- payday super which will require employers from 1 July 2026 to pay their employees' superannuation guarantee contributions at the same time as their salary and wages. The measure is proposed to start on 1 July 2026; and
- amending the non-arm's length expense (NALE) provisions (Sch 7 to the Treasury Laws Amendment (Support for Small Business and Charities and Other Measures) Bill 2023) to limit the amount of non-arm's length income arising from a general NALE for self-managed superannuation funds and small APRA-regulated funds to twice the level of a general expense. The new measures are proposed to apply retrospectively from 1 July 2018.

Small and medium enterprises

In addition to the proposed temporary increase to the instant asset write-off and the proposed energy incentive boost, an important development in the SME sector is the AAT's decision in *Bendel and FCT* ([2023] AATA 3074). The Commissioner has appealed this decision to the Federal Court.

Large business and international tax

As part of its election commitments, the government announced a multinational tax integrity package containing various measures, including an overhaul of Australia's thin capitalisation regime and implementation of the OECD's two-pillar solution. Several of these measures are proposed to apply retrospectively from 1 July 2023, but as yet remain unenacted.

State taxes

Significant payroll tax changes affecting general medical practitioners have developed in several states. While the changes apply retrospectively, Queensland and South Australia have provided an amnesty to affected medical practices. Also, on 18 October 2023, the High Court handed down its decision in *Vanderstock v Victoria* ([2023] HCA 30) which is likely to have significant implications for states' ability to collect revenue.

Key recommendations for 2024

Reflecting on the measures introduced and consulted on during 2023, two themes emerge as priorities for 2024:

1. **improving short consultations:** consultation is crucial to improve policy outcomes and prevent unintended consequences. However, the challenges that come with tax reform are exacerbated by short consultation periods. The Tax Institute's view is that there are opportunities to improve the consultation process for the benefit of all stakeholders and the system as a whole; and
2. **retrospective application of proposed measures**: retrospective legislation is subject to a caveat that it should not be unreasonable and may be justified only when it is beneficial, curative or clarificatory in nature. Retrospective legislation in taxation matters creates uncertainty for taxpayers and involves substantial corrective compliance costs. The Tax Institute's view is that it should be limited to exceptional circumstances and, where appropriate, coupled with grandfathering or transitional provisions.

Tax News – the details

by TaxCounsel Pty Ltd

November – what happened in tax?

The following points highlight important federal tax developments that occurred during November 2023.

Government initiatives

1. Superannuation fund mergers and defined benefit income streams

In a media release on 28 October 2023, the Assistant Treasurer stated that the government was progressing legislative amendments to the superannuation transfer balance cap for individuals with a capped defined benefit income stream to ensure that members are not adversely impacted in the event of a merger or successor fund transfer between superannuation funds.

Under the current legislation, a member's cap may be unintentionally impacted due to the original income stream being treated as ceasing and a new one beginning. This means that a new valuation of the capped defined benefit income stream is required which can result in a higher valuation for the transfer balance cap and lead to adverse outcomes for some members.

The amendments will ensure that members receiving an income stream prior to a merger or successor fund transfer will continue to receive their income stream without unintentionally impacting the transfer balance cap.

The amendments are to apply retrospectively from 1 July 2017.

The Commissioner's perspective

2. Promoter penalties

The Commissioner has lodged an application in the Federal Court seeking orders for the imposition of a civil penalty under the scheme promoter penalty regime (Div 290 of Sch I of the *Taxation Administration Act 1953* (Cth)).

The Commissioner will allege that a former Ernst & Young tax partner promoted a tax exploitation scheme. The ATO has been working closely with the Tax Practitioners Board on this matter. As the matter is before the courts and no findings have been made, the ATO is limited in making any further comments.

The promoter penalty laws are in place to deter and disrupt the promotion and implementation of aggressive tax avoidance and evasion schemes. The promotion of tax exploitation schemes undermines the integrity of the tax and superannuation system and challenges community trust and confidence. These schemes create an uneven playing field for everyone, including businesses and advisers.

The ATO uses promoter penalty laws to take action against alleged promoters of tax exploitation schemes, regardless of their firm size or their occupation, position in the organisation or standing in the tax community.

3. Decision impact statement: Bains case

The Commissioner has issued a decision impact statement that outlines the ATO's response to the decision of the AAT in *Bains and FCT*[1] in which the AAT held that, based on the facts and circumstances of the case, a lump sum payment received by the taxpayer from the Victorian Taxi Reform Fairness Fund was not income according to ordinary concepts.

The Commissioner accepts the AAT's decision that payments from the Fairness Fund are not income according to ordinary concepts and will administer the law in accordance with the tribunal's decision.

The impact statement points out that the AAT did not consider payments from the Victorian Taxi Reform Hardship Fund or Victorian Transition Assistance payments. The AAT also did not consider other payments made as a result of the taxi industry reforms in other Australian states.

The Commissioner considers that the decision does not impact the ATO's position on the other types of financial assistance payments made to Victorian taxi licence holders.

The Commissioner acknowledged that there are entities which might be impacted by the AAT's decision and is currently identifying those taxpayers with a view to providing remediation pathways to these entities as a matter of importance.

In the Tax News column in which the AAT's decision in the *Bains* case was noted,[2] it was suggested that there may be an argument that, on the facts of the case, CGT event H2 might have some operation. The decision impact statement does not refer to the possibility that there may be CGT issues and it must be taken that the Commissioner would not seek to rely on the CGT provisions in the circumstances.

4. Corporate collective investment vehicle regime

The Commissioner has released a draft law companion ruling in relation to the amendments made to the tax law to specify the tax treatment for corporate collective investment vehicles (CCIVs) (LCR 2023/D1).

A CCIV is a new type of company limited by shares that is available for funds management. From a regulatory perspective, a CCIV is a registered company with all of its assets and liabilities segregated into "sub-funds", and which is operated by a single corporate director.

However, the tax framework treats each CCIV sub-fund as a separate tax entity that is a trust. The general intent is to align the tax outcomes of CCIVs and their investors with the existing treatment of investors in attribution managed investment trusts (AMITs). The general trust taxation rules apply to CCIVs, subject to some modifications, where they do not qualify for the AMIT regime.

LCR 2023/D1:

- outlines the operation of the CCIV regime;
- explains the deeming principle and its effect on the tax treatment of a CCIV, a CCIV sub-fund trust and investors; and
- provides views on specific tax interpretative issues.

5. FBT: draft legislative instruments

The Commissioner has released several draft legislative instruments dealing with the records that are to be accepted (from 1 April 2024) for FBT purposes as an alternative to an employee declaration in a number of circumstances, and also a draft legislative instrument that will provide an additional method for working out pay as you go (PAYG) instalments for monthly FBT payers.

The particular employee declarations that are affected are:

- an employee declaration in respect of expense payment fringe benefits, housing fringe benefits or residual fringe benefits, where the employer seeks to reduce the taxable value of a benefit in respect of providing temporary accommodation or the temporary hire of household goods to an employee and their family members and the temporary accommodation is required solely because the employee is required to change their usual place of residence in order to perform the duties of their employment (LI 2023/D18);
- an employee declaration in respect of expense payment fringe benefits, property fringe benefits or residual fringe benefits, where the employer seeks to reduce the taxable value of the fringe benefit by applying the otherwise deductible rule (LI 2023/D19);
- an employee declaration in respect of living-away-from-home allowance (LAFHA) fringe benefits, where the employee receives a LAFHA fringe benefit and the employer seeks to reduce the taxable value of the benefit under s 31(2) of the *Fringe Benefits Tax Assessment Act 1986* (Cth) (FBTAA86) (LI 2023/D20);
- an employee declaration in respect of living-away-from-home allowance (LAFHA) fringe benefits, where an employee who works on a fly-in fly-out or drive-in drive-out basis to which s 31E FBTAA86 applies receives a LAFHA fringe benefit and the employer seeks to reduce the taxable value of the benefit under s 31A FBTAA86 (LI 2023/D21);
- an employee declaration in respect of residual fringe benefits, where the benefit consists of the private use of a motor vehicle other than a car, the employer seeks to reduce the taxable value of the benefit under the otherwise deductible rule, and the employer chooses to ascertain the amount of the reduction by reference to the number of business use and/or private use kilometres travelled in the vehicle (LI 2023/D22).

As indicated, the Commissioner has also released a draft legislative instrument that outlines an additional method for working out PAYG instalments for monthly FBT payers, and the circumstances in which monthly payers can choose to use the additional method (LI 2023/D23).

Since the *Tax Laws Amendment (2013 Measures No. 2) Act 2013* commenced operation on 29 June 2013, certain large entities have been required to pay PAYG instalments monthly. Subsequent consultation identified concerns that impacted entities could incur significant costs in complying with the requirement to calculate and pay PAYG instalments each month.

In recognition of this, a legislative instrument was registered in 2013 to provide those entities that pay PAYG instalments monthly with a simpler alternative method for working out the amount of their monthly instalment.

The present draft legislative instrument is an update of the 2013 instrument, which is due to sunset on 1 April 2024. The instrument will continue to provide monthly payers with a simpler alternative method for working out the amount of their monthly instalment. The instrument will reduce compliance costs for eligible taxpayers by allowing them to use reasonable estimates of their instalment income in the first two months of an instalment quarter, rather than their actual instalment income for those months, to work out the amount of their monthly instalment.

Recent case decisions

6. Default assessments: Federal Court

In dismissing appeals by two taxpayers from a decision of the AAT, the Federal Court (Charlesworth J) has considered whether the taxpayers had discharged their onus of proof where the assessments to which the objection decisions related were default assessments (*McPartland v FCT*[3]).

The case was an appeal from a decision of the Administrative Appeals Tribunal in relation to the tax affairs of a married couple, Darryl and Kathleen McPartland (the McPartlands) for the financial years ending 30 June 2015, 30 June 2016 and 30 June 2017.

In those financial years, the McPartlands were the recipients of a Disability Support Pension and a Carers Pension from Centrelink, totalling about $24,000. They did not file tax returns because they claimed to have received no taxable income.

At relevant times, the McPartlands were directors and shareholders of MacAttack Rentals Pty Ltd (MacAttack), a company that operated a business relating to (at least) the importation of motorcycles. Mr McPartland was also the director and shareholder of HD Downunder Pty Ltd (HD Downunder), which undertook very little trade following its incorporation in September 2014. The financial records relating to the conduct of the motorcycle business and the personal financial affairs of the McPartlands were intermixed and dishevelled. The McPartlands operated a multitude of bank accounts, mostly in their personal names, into which their pensions and business revenue were paid, and from which both business and personal expenses in significant amounts were withdrawn. No contemporaneous reconciliation of business and personal expenditure was undertaken.

While conducting audits of the tax affairs of MacAttack and HD Downunder, the Commissioner concluded that MacAttack had paid income to the McPartlands in the nature of director fees or allowances, equivalent to the amount of the personal expenditure drawn from the bank accounts. For the purposes of MacAttack's tax assessments, those payments were treated as deductible expenses of the company.

The Commissioner conducted audits of the personal tax liabilities of the McPartlands and issued default notices of assessments to the McPartlands based on the audit findings. The auditors referred to the same banking records informing the companies' assessments, showing that the McPartlands had incurred and paid personal expenses from the intermixed accounts. The Commissioner assessed the McPartlands' taxable income in amounts equalling the total personal expenditure, specifically, $328,533 in the 2015 financial year, $364,963 in the 2016 financial year, and $242,075 in the 2017 financial year, divided equally between them.

The McPartlands objected to the default assessments on grounds that alleged (among other things) that their personal expenditure was less than that calculated in the audits and that the expenditure was funded from non-taxable sources of income, including money in the nature of repayments of a loan owed to them by MacAttack.

The AAT held that the McPartlands had not discharged the burden of proving that the assessments were excessive or otherwise incorrect and what the assessments should have been.

Charlesworth J concluded that the McPartlands' appeals from the AAT's decision should be dismissed for four reasons. These were:

1. the AAT did not commit some of the errors that were alleged;
2. to the extent that some errors had been identified, the errors were not errors of law and so could not form a basis for the grant of relief on the appeal;
3. it had not been shown that the AAT misunderstood or misapplied the burden of proof imposed on the McPartlands; and
4. notwithstanding the errors of law that her Honour had identified, it had not been shown that the material before the AAT was capable of supporting a finding as to what the assessments ought to have been. Accordingly, a remittal of the application for review to the tribunal would be futile.

7. Default assessments: AAT

The AAT has rejected appeals by two taxpayers (QQRK and WHKY, who were brothers) from objection decisions in relation to assessments or amended assessments that the Commissioner had raised for the income years ended 30 June 2011 to 30 June 2016 and which were effectively default assessments (*QQRK and FCT*[4]).

QQRK and WHKY both claimed that the large amounts of cash passing through their hands in the relevant years were attributable to their (mostly successful) individual records as prolific gamblers or to loans given and received in connection with their gambling. While they conceded (or did not contest) that some amounts should have been reported as income, they contended that the Commissioner's assessments were wrong.

At a general level, the AAT, after pointing out that a taxpayer bears the onus of establishing that an assessment is excessive or otherwise incorrect and what the assessment should have been, said that it was not enough to prove that the Commissioner was wrong. The Commissioner is guessing, so it would be unsurprising if his estimate of a taxpayer's income was off. The taxpayer must go further and positively establish their taxable income to the satisfaction of the tribunal.

The AAT also said that, as a model litigant, the Commissioner is expected to make concessions where possible, and certainly where there is no real dispute over particular transactions or deductions. But even where the Commissioner makes concessions about individual transactions or deductions or classes of transactions or deductions, it will remain incumbent on the taxpayer to provide evidence which positively establishes each of the integers of taxable income. It does not inevitably follow that the tribunal is permitted to reduce the assessment by the amounts associated with a concession if there remains doubt over other components.

The AAT considered that QQRK was not a satisfactory witness and had, at best, an inconsistent recollection of detail and was often evasive when pressed in cross-examination. When confronted with evidence that was inconsistent with his statement, for example, the evidence about winnings that he had derived from trips to Crown casino, he sought to clarify that evidence in a way that was conveniently difficult to check.

Taken at its highest, QQRK's evidence suggested that he was a prolific gambler with a lengthy track record of gambling increasingly large amounts prior to the period under review. It followed that the AAT accepted that QQRK had provided an explanation in respect of amounts flowing into his accounts. But it was unclear whether it was a sufficiently complete and satisfactory explanation of his taxable income in circumstances where the extent of his winnings was unclear. The AAT also identified concerns over the explanations relating to the provenance of deposits into his accounts. The AAT was not prepared to accept QQRK's assertions about other deposits that he had attributed to individuals who had not provided statements. Those gaps meant that QQRK had not adequately explained his taxable income. In those circumstances, he had failed to discharge his onus.

In relation to WHKY, the AAT said that his evidence was central to the outcome of the review of his assessments. That was a problem because WHKY was an unsatisfactory witness who was given to exaggeration.

While the AAT could accept that WHKY had established that the Commissioner's objection decisions were wrong, at least to some extent, that was not enough for WHKY to succeed in the review. He was also obliged to identify the correct (or more nearly correct) amount of taxable income in the years under review. The AAT was not satisfied that he had done so.

8. Overpaid JobKeeper: non-repayment discretion

The AAT has considered the exercise of the discretion conferred by s 9(4) of the *Coronavirus Economic Response Package (Payments and Benefits) Act 2020* (Cth) (CERPA) that a JobKeeper payment recipient should not be required to repay an overpayment (*Jassar & Manesh Pty Ltd as trustee for the Jassar Manesh Consultants Unit Trust and FCT*[5]).

The Commissioner had disallowed JobKeeper payments claimed and received by the applicant in the total amount of $1,541,450. Following a review of information produced in the AAT proceedings, the Commissioner made the concession that the applicant was entitled to receive a total of $852,850. The applicant accepted that it was not entitled to the remaining amount ($688,600).

The sole issue to be decided was whether the tribunal should exercise the statutory discretion, provided in s 9(4) CERPA, to determine that the applicant was not liable to repay all or part of the overpaid amounts.

Section 7 CERPA provides for the making of rules governing schemes for payments to be made by the Australian Government in response to the Coronavirus pandemic. The JobKeeper scheme, which was established under rules made under the CERPA, provided for eligible employers to be paid a fortnightly subsidy for wages paid to eligible employees. Broadly speaking, the scheme provided for employers to be paid a fortnightly amount of $1,500 in respect of each eligible employee. It was a requirement that the employer had paid at least $1,500 to the employee by way of wages, including PAYG deductions, for the fortnight.

If JobKeeper payments were made in circumstances where the employer was not entitled to the payments, the employer is required to repay the overpaid amount (s 9(1) and (2) CERPA). However, under s 9(4) CERPA, the Commissioner has a discretion not to require repayment of an overpaid amount. Section 9(4) provides for the discretion in these terms:

> "The Commissioner may make a written determination that the entity is not liable to repay an amount under subsection (2), in which case the entity is not liable to repay the amount."

The AAT considered that s 9(4) requires a separate exercise of the discretion in respect of each payment, rather than a global exercise of the discretion in respect of the total of all overpayments or categories of overpayments. The AAT said that it would be surprising if it were otherwise, since considerations relevant to one overpayment may differ from those relating to another overpayment, even if in the same category.

The AAT said that examination of the subject-matter and scope of the JobKeeper scheme revealed that it is a subsidy for wages actually paid to employees. Having regard to that fundamental feature, and although each case must be decided taking into account all relevant circumstances, the AAT said that it would be a rare case in which it would be appropriate to not require repayment of a JobKeeper payment wrongly made to an entity that did not pay equivalent (or higher) wages to an employee.

The AAT accepted that the JobKeeper provisions were beneficial in nature and generally should not be construed in a narrow or unduly restrictive fashion. However, it was less clear that the discretion in s 9(4) CERPA should be given a broad construction. It was, after all, a provision that effectively allows the Commissioner to forgive what would otherwise be, in this case, a substantial debt to the Commonwealth. In any case, the authorities at the highest level are clear regarding the identification of factors relevant to the exercise of an otherwise unfettered discretion – they are to be derived from the subject-matter, scope and purpose of the legislation. The AAT said that it was unclear how taking a broader or narrower view of s 9(4) would result in a construction that required the decision-maker to approach their task other than by asking whether, in all of the circumstances, determining that an entity is not to be liable to repay an overpaid amount is appropriate.

In summary, the tribunal's view was that it must decide, having regard to all relevant circumstances, whether it was appropriate to exercise the discretion not to require repayment of the overpaid amounts. Relevant circumstances would include:

- the applicant's explanation for claiming amounts to which it was not entitled and the plausibility of the stated reason;
- whether the applicant retaining the overpaid amounts would be consistent with the fundamental nature of the JobKeeper scheme as a wage subsidy designed to encourage employers to retain existing employees; and
- where it is able to be so established, whether the applicant retained any personal benefit as a result of over-claiming JobKeeper payments.

In the circumstances, the AAT set aside the objection decision and remitted the matter to the Commissioner for reconsideration in accordance with a direction that the applicant's JobKeeper claims were to be allowed in accordance with Commissioner's concession in the proceedings.

This case was managed together, and heard sequentially, with another application for review of JobKeeper decisions by the same applicant company in its capacity as trustee of a different trust (*Jassar & Manesh Pty Ltd as trustee for the Jassar & Manesh Unit Trust and FCT*[6]). The AAT's reasons for decision in this other case reflect the reasons for decision explained above.

9. Tax agent: not fit and proper person

The AAT has affirmed a decision of the Tax Practitioners Board (the Board) to terminate the registration of a tax agent and to prohibit her from re-applying for registration for a period of three years (*D'couto and Tax Practitioners Board*[7]).

The Board's decision was made after an investigation that was conducted following two referrals from the ATO, one on 29 January 2021 concerning the tax agent's personal tax affairs, and the other on 9 February 2021 concerning the tax agent and audits of work-related expenses carried out on 19 of her clients.

The Board was satisfied that the tax agent had breached several principles of the Code of Professional Conduct provided for in s 30-10 of the *Tax Agent Services Act 2009* (Cth) (TASA) and, in particular, to act honestly and with integrity, to comply with tax laws in the conduct of her personal affairs, and to ensure that a tax agent service that she provided, or that was provided on her behalf, was provided competently.

The AAT said that the tax agent's underreported business income and overclaimed deductions in her 2017 and 2018 income tax returns, coupled with her incorrect reporting of GST supplies and input tax credits over the same period, illustrated dishonesty on the tax agent's part and/or a want of integrity. The AAT inferred that the tax agent deliberately understated her income (GST sales) and overstated her deductions (and input tax credits) or, at a minimum: (1) made false representations in her tax returns and business activity statements (BASs); (2) acted with such carelessness as to demonstrate that no genuine attempt had been made to carry out the duties and obligations imposed by law; and/or (3) displayed an inadequate sense of her obligations as a registered tax practitioner and/or an evident reluctance to ascertain and comply with those obligations.

The AAT concluded that the tax agent's impugned conduct was the consequence of a lack of competence, having more work than she was capable of doing (for various reasons, including lack of support staff and ill health), and consequently being overwhelmed and unable to cope. She lacked insight into her shortcomings. In any event, based on the ATO's audits of clients for the income years 2019 and 2021, and taking into account the conduct of the tax agent's own tax matters, the AAT was satisfied that the tax agent had failed to ensure that the tax agent services that she had provided and that had been provided on her behalf, were provided competently.

The findings made led to the conclusion that the tax agent was not a person of good repute with the ATO, or with her clients who were subjected to audit and consequently issued with amended assessments and penalties. The findings also led to the conclusion that the tax agent did not have a proper knowledge of tax laws and was not able to prepare income tax returns and BASs competently, particularly her own. The tax agent was not a person of such competence that others might entrust their tax affairs to her care.

The AAT said that the tax agent was not a person of such reputation and ability that ATO officers may proceed on the footing that the tax returns lodged by the agent had been prepared by her competently. In 2013, income tax returns that she or her staff had lodged on behalf of clients included incorrect and/or unsupported work-related expenses and other claims. The tax agent was provided with a comprehensive report that provided recommendations. The audits in respect of the 2019 and 2021 income years revealed the same inadequacy. Her lack of knowledge meant that she was not able to deal competently with any queries which may be raised by ATO officers.

Also, the tax agent had not demonstrated a genuine understanding of her shortcomings and therefore had not demonstrated that she was able to address them so that the AAT could be satisfied that she was now a fit and proper person to be eligible for registration as a tax agent.

The conclusion of the AAT was that the tax agent did not meet the "tax practitioner registration requirement" in s 20-5(1)(a) TASA that she be a "fit and proper person".

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References

1 [2023] AATA 2477.

2 Vol 58(4) at p 177.

3 [2023] FCA 1260.

4 [2023] AATA 3493.

5 [2023] AATA 3499.

6 [2023] AATA 3502.

7 [2023] AATA 3485.

Tax Tips

by TaxCounsel Pty Ltd

Isolated transaction: deductible loss

The circumstances in which a loss on the purchase and sale of a residential property may be an allowable deduction were considered by the AAT in a recent decision.

Background

The question of whether what may be called an "isolated transaction" involving the purchase and sale of property gives rise to assessable income has arisen with some frequency over the years. As a matter of history, before the advent of CGT, the question was frequently covered by provisions that depended for their operation on whether the taxpayer had acquired the particular property for the purpose of profit-making by sale.[1] With the repeal of those provisions and putting CGT to one side, the issue in these cases now is typically whether the transaction gives rise to income according to ordinary concepts (ordinary income).[2]

Again putting to one side CGT issues, where an isolated transaction results in a loss, not a profit, the question of whether the loss is an allowable deduction does not turn on ordinary concepts, but rather on whether the terms of the statutory general deduction provision are satisfied.[3]

In a recent decision, the AAT was called on to consider whether an isolated transaction of an individual taxpayer which involved the purchase and sale of a residential strata unit at a loss gave rise to a general deduction and, if so, in which income year. The decision is *Bowerman and FCT*[4] and is discussed in this article.

The issues in brief

The AAT described the factual matrix involved in the case as being somewhat unusual. The taxpayer (Mrs Bowerman) purchased a residential strata unit located at Dune Walk, Woolooware Bay in NSW (the Dune Walk unit), with the intention of selling it for a profit but she had also lived in it. This was in circumstances where Mrs Bowerman had earlier purchased another residential unit (the Foreshore Boulevard unit) in the same development, and it was in this other unit that she always intended to reside and currently resided in. However, due to the unfortunate timing relating to the onset of the COVID-19 lockdowns at the time that she needed to sell the Dune Walk unit, Mrs Bowerman made a loss on the sale of that unit.

The Commissioner argued that Mrs Bowerman was not entitled to claim the loss on the sale of the Dune Walk unit for a number of reasons. At the hearing, the Commissioner submitted that the loss made by Mrs Bowerman was not deductible because it was of a private or domestic nature,[5] and/or because the loss was not incurred in the 2020 income year in which she sought to claim the deduction.

As a further alternative position, the Commissioner argued that Mrs Bowerman had not discharged her onus of proving that she fell within the relevant principles that emerged from the decision of the High Court in *FCT v Myer Emporium Ltd*,[6] that is, she did not have the requisite intention to make a profit on the sale of the property at the time she acquired it, and the property transaction was not a commercial transaction or the sort of thing that a business person or person in trade would do.

The AAT held that Mrs Bowerman was entitled to an allowable deduction for the loss and that the deduction was allowable in the 2020 income year.

The facts

Mrs Bowerman was 86 years old and a self-funded retiree. In about June 2015, her husband passed away. Since then, Mrs Bowerman had managed her own investment portfolio made up of various shares, managed investment trust and rental property investments. Mrs Bowerman impressed the AAT as being savvy and entrepreneurial.

From 1961, Mr and Mrs Bowerman had been active in establishing and running successful businesses in the hairdressing industry but these were exited in the early 1990s. In about 1963, Mr and Mrs Bowerman also started investing in property and, in addition to deriving rental income, they derived capital gains from the long-term holding of properties.

In or about 2002, Mr and Mrs Bowerman had decided, as part of their retirement investment strategy, to cease making more rental property investments and instead invested in ASX-listed shares and managed fund investments, as well as some fixed income investments. They directed their attention to generating income returns from investments rather than seeking long-term capital growth, although they still continued to own property investments.

On 23 July 2015, a few weeks after Mr Bowerman's passing, Mrs Bowerman entered into an off-the-plan contract to purchase a strata unit in a complex at Woolooware Bay (the Foreshore Boulevard unit) for $1,505,000. This was the residential unit that Mrs Bowerman purchased to live in, and currently lived in. The completion of the contract was to be funded from the sale of the existing family home.

At the time Mrs Bowerman entered the contract to purchase the Foreshore Boulevard unit, completion was not expected to occur until approximately four years later. Further, under cl 61.1(a) of the contract, the vendor could extend the completion date by up to 12 months by giving Mrs Bowerman a copy of a certificate from the vendor's project manager stating that the construction of the building was delayed. This extension did occur, with the result that the completion date became 30 June 2020. Mrs Bowerman testified that she was nevertheless content to continue living in the existing family home until the Foreshore Boulevard unit was built.

In November 2017, Mrs Bowerman was advised by her real estate agent that she would be able to sell the existing family home for more than $2m.

On 29 November 2017, Mrs Bowerman executed a resale contract for an existing off-the-plan contract to purchase (for $1,200,000) another unit in the same development at Woolooware Bay. This unit was located at Dune Walk and was in a different stage of the same development as the Foreshore Boulevard unit. It was the purchase and sale of the Dune Walk unit that was the subject of the proceedings before the AAT.

In her affidavit, Mrs Bowerman relevantly stated as follows in relation to her Dune Walk unit purchase:

> "10. During the period from July 2015 through November 2017, I was kept updated on the progress of the Woolooware Bay development through my interaction with the property manager and onsite sales office. I became aware of the significant market interest in properties available for sale, including the development of a secondary market for the sale of existing 'off-the-plan' contracts on properties which were still to be constructed. I was impressed with the Woolooware Bay development and formed the view that it would be possible to make a profit on the acquisition and disposal of an apartment held for only a short period of time. Some of the key elements of the Woolooware Bay development which I believe supported this view was the location, the accelerated movement by downsizers such as myself from house to apartment living and the general economic demographics of the Sutherland Shire which would continue to support the growth in sales and prices for these apartments.
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> 11. Based on my expectation as to the continued popularity of the Woolooware Bay development which I considered would translate into higher future sales prices for the limited number of apartments available, I decided in November 2017 to purchase an existing 'off-the-plan' contract for a two-bedroom apartment. Accordingly, I contacted the Woolooware Bay sales office to ascertain if there were any existing purchase contracts available for re-sale …
>
> 12. … Settlement of the Dune Walk Unit purchase occurred on 7 May 2018 and I moved into the apartment approximately a week later."

Mrs Bowerman's evidence was that her motivation for entering into the Dune Walk unit contract on 29 November 2017 was to make a profit when she subsequently had to sell the Dune Walk unit to provide the funds necessary to settle the acquisition of the Foreshore Boulevard unit (which occurred on 14 July 2020). Although she intended to reside at the Dune Walk unit when the apartment became available to her, her decision to acquire the Dune Walk unit was not motivated by being able to reside in it. If she had not believed that she would be able to make a profit on the acquisition and sale of the Dune Walk unit, she would never have proceeded with the acquisition in the first place.

The Dune Walk unit was in stage two of the Woolooware Bay development, and it was expected to complete before the Foreshore Boulevard unit which was in stage three.

At the time of Mrs Bowerman exchanging the contract for the purchase of the Dune Walk unit (29 November 2017), settlement of the contract was to occur by 1 August 2019. However, this was subject to an extension for delays due to inclement weather, council issues etc. This meant that completion could be extended until as late as 1 August 2020.

Under cross-examination, Mrs Bowerman stated that she purchased the Dune Walk unit with the expectation of making a profit on the sale. She denied buying it purely or solely to move into it while the Foreshore Boulevard unit was being constructed. Mrs Bowerman acknowledged, however, that, at the time of executing the contract for the purchase of the Dune Walk unit, her intention was to live in the Dune Walk unit when it became available to her for a limited period during the construction of the Foreshore Boulevard unit. She stated that she did not wish to lease the Dune Walk unit as, in her experience, tenants would not look after it, but she would move into it and look after it herself.

Mrs Bowerman also stated under cross-examination that she did not research buying any other property as "this one looked really good", and she was aware that the Woolooware Bay development was selling very well and would be progressing to stages five and six. Mrs Bowerman further acknowledged that, at the time of buying the Dune Walk unit, she knew she would have to sell it to fund the completion of the Foreshore Boulevard unit in which she planned to ultimately reside. She would also have to sell the family home to fund the completion of the purchase of the Dune Walk unit. However, Mrs Bowerman did not need to sell the family home before exchanging on the purchase of the Dune Walk unit, in respect of which she paid a 5% deposit.

On 21 December 2017, Mrs Bowerman's real estate agent listed the family home for sale.

On 7 May 2018, four days after settlement of the sale of the family home, settlement of Mrs Bowerman's purchase of the Dune Walk unit occurred.

On or about 14 May 2018, Mrs Bowerman moved into the Dune Walk unit and she lived in it for approximately 26 months until early July 2020.

Mrs Bowerman accepted that moving into the Dune Walk unit made her life easier. She reiterated, however, that she would not have bought the Dune Walk unit if she had thought she would not make money on it.

In or around April 2020, Mrs Bowerman's real estate agent listed the Dune Walk unit for sale. Unfortunately for Mrs Bowerman, the timing coincided with the first lockdown restrictions in NSW in response to the COVID-19 pandemic, and this was a particularly difficult time to sell property. According to Mrs Bowerman, the selling agent found it difficult to show the property to interested purchasers due to COVID-19 restrictions. Also, due to the initial uncertainty caused by the COVID-19 pandemic, there was reduced demand in the market for property at the time. It was not in dispute between the parties that Sydney property prices fell by 2.9% between April and September 2020 and that property prices later rose in the subsequent quarter.

On 20 April 2020, contracts were exchanged for the sale by Mrs Bowerman of the Dune Walk unit for the sum of $1,015,000, which represented a loss to Mrs Bowerman of $265,935. Mrs Bowerman accepted that she was compelled to sell at that time because she needed the funds to settle her purchase of the Foreshore Boulevard unit and, but for that circumstance, she would not have agreed to sell the Dune Walk unit at a loss. Settlement of the contract for the sale of the Dune Walk unit occurred on 9 July 2020.

On 14 July 2020, settlement of Mrs Bowerman's purchase of the Foreshore Boulevard unit took place. Mrs Bowerman subsequently moved into the Foreshore Boulevard unit and had continued to live in it. The acquisition of the Foreshore Boulevard unit was funded from the proceeds from the sale of the family home and the proceeds from the sale of the Dune Walk unit.

The assessment and objection

On 18 September 2020, Mrs Bowerman lodged her tax return for the 2020 income year without taking into account any implications that the sale of the Dune Walk unit could give rise to, and the Commissioner issued an assessment on 25 September 2020. On 28 September 2020, Mrs Bowerman lodged an objection against the assessment on the basis that she was entitled to an allowable deduction under the general deduction provision for the loss made by her on the sale of the Dune Walk unit. The Commissioner rejected the objection and Mrs Bowerman applied for the AAT to review the Commissioner's objection decision. The AAT allowed Mrs Bowerman's objection.

The issues raised and the AAT's decision on each issue are set out below.

Issue 1: was the loss a general deduction?

The first and most fundamental issue that the tribunal considered was whether the loss on the sale of the Dune Walk unit was incurred in gaining or producing Mrs Bowerman's assessable income within the meaning of s 8-1(1)(a) ITAA97. This necessarily involved an analysis of whether Mrs Bowerman satisfied the first limb and the second limb of *Myer Emporium*.

The AAT said that, broadly, *Myer Emporium* stands for the proposition that a profit from an isolated transaction involving the sale of property will form part of a taxpayer's assessable income when two limbs are satisfied. First, where the taxpayer acquired the property for the purpose of profit-making (the first limb). Second, where the acquisition and sale of the property took place in the context of a business operation or commercial transaction (the second limb).

Specifically, the Commissioner argued that, having regard to a wide survey and an exact scrutiny of Mrs Bowerman's activities during the five-year period between 30 June 2015 (when Mr Bowerman passed away) and 9 July 2020 (when Mrs Bowerman settled on the sale of the Dune Walk unit), the tribunal could not be satisfied that Mrs Bowerman had the requisite intention to profit from the acquisition and re-sale of the Dune Walk unit.

The AAT rejected the Commissioner's contentions. In the AAT's view, the objective evidence pointed to Mrs Bowerman having the requisite profit-making intention at the time that she purchased the Dune Walk unit and her intention to live in it was a subsidiary purpose.

The AAT placed considerable weight on the incontrovertible fact that, even before purchasing the Dune Walk unit on 29 November 2017, Mrs Bowerman already intended to re-sell the Dune Walk unit for a profit instead of holding on to it for long-term investment. This was evident from her evidence that she needed to sell the Dune Walk unit to have the funds to settle on the purchase of the Foreshore Boulevard unit, which she had previously contracted to purchase and which she intended to be, and now was, her home. The re-sale of the Dune Walk unit was not a mere possibility. It was in fact specifically contemplated by Mrs Bowerman at the time of purchasing it.

The AAT agreed with Mrs Bowerman's submission that the profit-making intention under the first limb of *Myer Emporium* was not required to be the sole or dominant purpose of entering into the transaction. The requirement is satisfied if just one of the purposes included the requisite profit-making intention.

As to the second limb of *Myer Emporium*, the AAT said that it was persuaded that Mrs Bowerman's acquisition of the Dune Walk unit with the intention of re-sale at a profit, not with the intention to be held for some other long-term purpose, satisfied the second limb of *Myer Emporium* and could be considered, therefore, to be a "commercial transaction". This was because it was the sort of thing that a business person would do, and, as noted by Steward J in *Greig v FCT*,[7] the requirement that a transaction be a "business deal" or "commercial transaction" involves only a low threshold. So long as there is a flavour of commercial or business dealing, that is sufficient. In particular, Mrs Bowerman purchased the Dune Walk unit to make a profit from buying and re-selling it in the short-term.

Issue 2: was the loss of a private or domestic nature?

The second issue was whether, if the loss on the sale of the Dune Walk unit was otherwise deductible under s 8-1(1) ITAA97, the loss was prevented from being deductible due to it falling within the negative limb with respect to losses or outgoings of a private or domestic nature in s 8-1(2)(b) ITAA97.

The Commissioner submitted that the fact that Mrs Bowerman lived in the Dune Walk unit for the entire period of her ownership "stamps the loss as being of a private or domestic nature", even if Mrs Bowerman intended to make a profit when the Dune Walk unit was sold. Accordingly, the Commissioner submitted that the exception with respect to losses of a private or domestic nature in s 8-1(2)(b) ITAA97 prevented Mrs Bowerman from claiming the loss as a deduction.

The AAT rejected the Commissioner's submissions and concluded that the negative limb with respect to losses or outgoings of a private or domestic nature in s 8-1(2)(b) ITAA97 did not apply. The reasons for this were based on the finding that Mrs Bowerman intended, from the outset, to make a profit on the sale of the unit when she sold it and, despite her having resided in the unit, that characterisation did not change.

Issue 3: when was the loss incurred?

The third issue was whether any loss otherwise deductible under s 8-1 ITAA97 in respect of the sale of the Dune Walk unit was "incurred" in the income year ended 30 June 2020. This issue arose because the settlement of the contract for the sale of the Dune Walk unit did not occur until 9 July 2020 (in the 2021 income year), while the Commissioner's objection decision related to the income year ended 30 June 2020 (in which the contract for the sale was entered into).

The AAT held that the effect of the Commissioner's binding ruling TR 97/7 was that the deduction for the loss was able to be claimed by Mrs Bowerman in the 2020 income year. If it had not been for TR 97/7, the AAT would have decided that she had not "incurred" the loss on the sale of the Dune Walk unit until settlement.

Observations

It is as yet not known whether the Commissioner will appeal to the Federal Court from the decision of the AAT in the *Bowerman* case. It is thought that the decision raises issues that would warrant an appeal.

It would seem that, in some circumstances, the *Myer Emporium* decision may in fact impose a less rigorous test than the first limb of the former s 26(a) ITAA36 did. The first limb of the former s 26(a) applied where a taxpayer made a profit from the sale of property that was acquired for the purpose of profit-making by sale. The reference to "the purpose" was construed as a reference to the sole or dominant purpose actuating the acquisition.[8]

In the *Bowerman* case, the AAT, after quoting from the *Myer Emporium* decision, went on[9] to refer to the judgment of Middleton J in *Visy Packaging Holdings Pty Ltd v FCT*,[10] including the following passage:

> "185. The principle of law which is at the centre of this case is clear: if the intention or purpose of the relevant entity in entering into a transaction or upon acquiring an asset was to make a profit or gain, that profit or gain will be income, even if the transaction was extraordinary by reference to the ordinary course of that entity's business … Similarly, if the intention or purpose was to make a profit or gain but a loss was ultimately in fact sustained, then a deduction in the amount of that loss would be permitted.
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> 186. It is not necessary that the sole or dominant purpose of entering into the relevant transaction is to make a gain or profit. It is enough if a 'not insignificant purpose' of the relevant transaction was to obtain a profit or gain …"

It will be seen that the not insignificant purpose test imposes a standard that is lower than the sole or dominant purpose test. When the predecessor to the former s 26(a) was enacted, it was explained that it was effectively stating what would have been ordinary income. The then Treasurer stated that the provision "is merely a statutory declaration of what has for many years been accepted as settled law in Australia". However, it seems that the provision may have been effectively stating a higher standard than was imposed by the ordinary concept of income.

Where there could be any doubt as to the income year in which a deduction may properly be allowable under s 8-1 ITAA97, an objection should be lodged against the assessment for each income year in which it could be argued that a deduction was allowable. In the context of the *Bowerman* case, an objection could also have been taken against the assessment for the 2021 income year. That objection would have been necessary but for the decision of the AAT in relation to the effect of TR 97/7.

From a CGT perspective, any capital gain that Mrs Bowerman would otherwise have realised on the disposal of the Dune Walk unit would be disregarded under the main residence exemption.[11]

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References

1. Former ss 26(a) and 25A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36). See also s 15-15 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).
2. S 6-5 ITAA97.
3. S 8-1 ITAA97. It may be noted that there was a provision (former s 52 ITAA36) that allowed a deduction in circumstances in which the former profit-making by sale provision would have brought a profit into assessable income.
4. [2023] AATA 3547.
5. Within the terms of s 8-1(2)(b) ITAA97.
6. [1987] HCA 18.
7. [2020] FCAFC 25.
8. See, for example, *Pascoe v FCT* (1956) 11 ATD 108.
9. [2023] AATA 3547 at [64].
10. [2012] FCA 1195.
11. S 118-110 ITAA97.

Mid Market Focus

by Josh Chye, ATI, HLB Mann Judd

Unrealised tax liabilities in family law settlements

This month's column explores the significance of addressing unrealised tax liabilities in family law settlements in Australia, strategies for mitigation, and relevant case law.

Introduction

Family law settlements are a common and often complex part of legal proceedings in Australia. These settlements involve the division of assets and liabilities between separating parties.

While tax implications are not the primary focus in family law matters, they are crucial. Unrealised tax liabilities, such as CGT and other obligations, can significantly impact the outcome of settlements.

Summarised below are some of the key principles that can be drawn from relevant case law that deals with unrealised tax liabilities in family law settlements. Importantly, each case needs to be considered on it owns facts and circumstances, and evidence will be critical to support any contentions or positions made.

Whether CGT is likely or foreseeable

The key case that has considered how CGT should be factored into family law settlements is the 1998 Family Court decision, *Rosati v Rosati*.[1]

In this case, the court established the following broad principles:

1. whether CGT should be taken into account varies according to the circumstances of the case, including the likelihood or otherwise of that asset being realised in the foreseeable future;
2. if the court orders the sale of an asset, or is satisfied that a sale of it is inevitable or would probably occur in the near future, or if the asset is one which was acquired solely as an investment and with a view to its ultimate sale for profit, then, generally, allowance should be made for CGT; and
3. if the court is satisfied that there is a significant risk that the asset will have to be sold in the short to mid-term, the court may take that risk into account under s 75(2) of the *Family Law Act 1975* (Cth).

The relatively recent decision in *Taffner v Taffner*[2] is an example whereby CGT liability may be overlooked by the courts. This case was an appeal by the husband against property settlement orders by the primary judge, whereby the primary judge held that the properties were to be divided to effect an overall distribution of 60.63% to the wife and the balance of 39.37 % to the husband.

The concern raised by the husband was that it cast the burden of CGT solely on him for a property that was jointly owned because, if the property was not able to be refinanced, the court required the property to be sold. The husband contended that this tax burden had the effect that the actual division of property was 65.87% to the wife, rather than the 60.63% that had been assessed by the primary judge. The appeal was allowed to re-adjust the settlement allocations to factor in the CGT to be shared by both parties.

Selling costs

Kelly and Kelly (No. 2)[3] provided case law guidance that deductions for selling costs would be appropriate when determining the value of assets to be factored into family law property settlements.

Income tax arising to meet final orders/settlements

Pfenning & Snow[4] provided guidance as to whether the potential tax on dividends required to be paid by a private company owned by the husband in order to meet final orders/settlements should be factored into the value of divisible assets.

The court allowed for a contingency for the tax on dividends in order to meet the obligations arising from final orders/ settlements.

Tax losses considered as a "financial resource"

JEL and DDF[5] and *Cromwell & Cromwell*[6] provide guidance on the fact that, if it can be proved that the current existence of tax losses will likely be valuable in the future, these tax losses can be taken into account as a "financial resource" under s 75(2) of the *Family Law Act 1975*.

Key tax planning considerations

As the impost of tax can significantly reduce the value of divisible assets and/or create surprises that may arise after settlements have been agreed/concluded, if this is not considered specifically in a family settlement scenario, there is every risk that parties inheriting assets may have unequal tax profiles and inherit tax liabilities.

Set out below are some tax planning considerations and concessions that may be available to mitigate against unnecessary tax liabilities and potentially generate beneficial tax outcomes in the future.

CGT roll-overs

The transfer of CGT assets between spouses, or between a company or trustee and a spouse, pursuant to a family court order may be eligible for CGT roll-over under the provisions of Subdiv 126-A of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).

The key outcomes are that the transferee spouse obtains the tax cost base and acquisition date of the transferer spouse's ownership interest.

If the roll-over is to be undertaken, it is important that all of the steps and requirements of the court order are followed (for example, assets are not transferred to a related entity that was not identified in the court order and settlement agreements), as not doing so may cause the roll-over provisions to be ineffective.

Small business CGT concessions

Instead of triggering a CGT roll-over, consideration may be given as to whether the small business CGT concessions are available to eliminate any capital gain; if so, the concessions may provide an opportunity for the tax cost base of the CGT asset to be reset to market value.

The application of the small business CGT concessions is complex and this option would need to be carefully undertaken to ensure compliance with all necessary provisions (such as the active asset exemption, the retirement exemption, or the 15-year exemption).

CGT main residence exemption

The CGT main residence exemption is one of the few assets where CGT exemption status still remains. Therefore, consideration should be given as to how main residence asset tax-exempt status may be used to allocate value.

Potential Div 7A exposures

Division 7A ITAA36, which can trigger an assessable unfranked dividend outcome to the recipient, is a commonly encountered tax concern and often plays a significant role in family law settlements as these issues may remain hidden until the relationship between parties sours, prompting independent tax advice.

Division 7A may apply in the following situations:

- when the court instructs a private company to make a payment or transfer property to one of the parties;
- when the court orders the forgiveness of a debt owed to a private company by a party who is a shareholder or an associate of that company;
- when a Div 7A loan is transferred to another party or entity, raising questions about potential forgiveness; and
- when there is a lack of complying Div 7A loan agreements or a lack of compliance with the minimum interest and loan repayments.

If an honest mistake or an inadvertent omission is made, it is recommended that a voluntary disclosure to the Commissioner is undertaken and any rectifications made before any settlements are finalised.

Review potential duty relief provisions

Stamp and landholder duty is a significant transaction cost that may apply (eg in Victoria, 6.5% for real estate values over $2m). However, stamp duty relief may be available in the breakdown of a marriage or domestic relationship. For example, in Victoria, under s 44 of the *Duties Act 2000*, the exemption may apply where:

- the transferor is a party (or both parties) to the marriage or domestic relationship;
- the transferee is a party (or both parties) to the marriage or domestic relationship; and
- no other person takes or is entitled to take an interest in the property.

Therefore, it is important to factor in duty as a potential transaction cost, but review and apply for any relief that may be available.

Conclusion

In family law settlements, unrealised tax liabilities should not be underestimated. Failure to address these liabilities can have significant financial implications for both parties involved. With the right strategies, knowledge of the Australian tax system, and a collaborative approach, tax advisers and legal practitioners can ensure that their clients navigate these complexities successfully.

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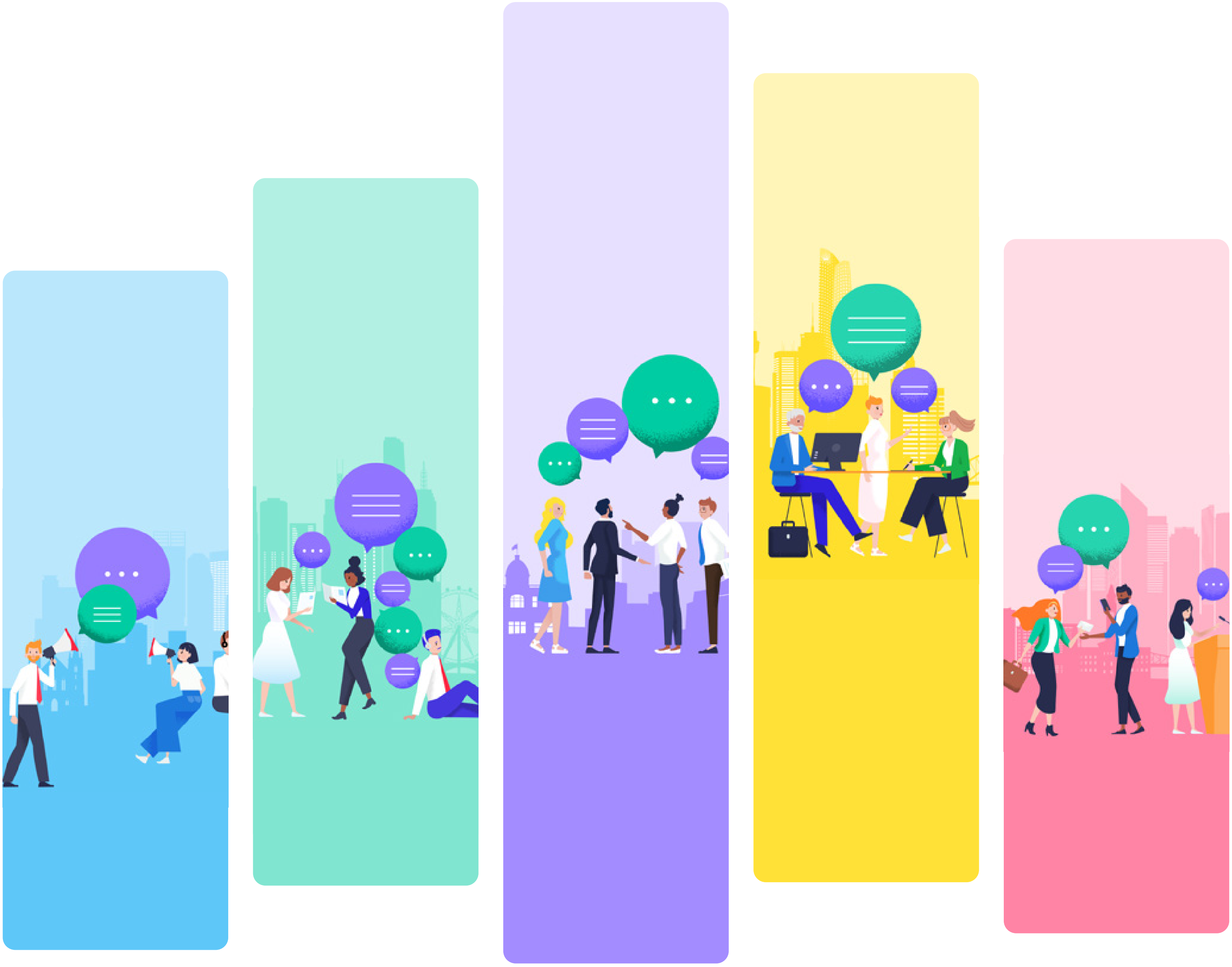
References

1 [1998] FLC ¶92-804.
2 [2021] FamCAFC 68.
3 [1981] FamCA 78.
4 [2016] FamCA 29.
5 [2000] FamCA 1353.
6 [2006] FamCA 1454.



Vanderstock and the future of federal–state tax powers

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In its recent decision of *Vanderstock v Victoria*, the High Court has ruled by a 4:3 majority that the Victorian electric vehicle road user charge is unconstitutional. The court held that s 7(1) of the *Zero and Low Emission Vehicle Distance-based Charge Act 2021* (Vic) is invalid as it imposed a duty of excise prohibited by s 90 of the Constitution. Section 90 of the Constitution makes exclusive the power of the Commonwealth Parliament to impose taxes that are duties of customs and excise. Any duty of customs or excise imposed by a state, or by a territory, is therefore invalid. The decision has expanded the range of taxes that can only be levied by the Commonwealth Parliament, to the exclusion of the states. This decision is likely to have broad repercussions for the tax base of the states and the federal–state distribution of taxation powers (ie it will increase the so-called "vertical fiscal imbalance").

Impact of the High Court's decision

The key takeaways from *Vanderstock v Victoria* (*Vanderstock*),[1] include:

- the High Court has ruled Victoria's electric vehicle road user charge (EV charge) invalid for being unconstitutional under s 90 of the Constitution;
- the decision suggests that any state tax, or territory tax,[2] which is properly characterised as a "tax on goods" under the relevant tests is unconstitutional and therefore invalid;
- the decision has significant implications for taxpayers who pay, and state governments that collect, state taxes imposed on the consumption or use of goods, including potentially stamp duty on the transfer of goods, motor vehicle registration and transfer duty, gaming machine taxes and other fees, and levies imposed at the point of consumption; and
- it remains to be seen if the Commonwealth Government will step in to implement federal taxes that mirror unconstitutional state taxes in order to protect the states' tax bases going forward, and to effectively deny refunds of tax already paid.

Victorian EV charge held to be invalid

The High Court has held that s 7(1) of the *Zero and Low Emission Vehicle Distance-based Charge Act 2021* (Vic) (the ZLEV Act) is invalid for imposing a duty of excise in breach of s 90 of the Constitution. The majority of the High Court justices were of the view that the Commonwealth Parliament has exclusive legislative power to impose taxes that are properly characterised as a "tax on goods".

In coming to this decision, the court reopened and overruled its earlier decision in *Dickenson's Arcade Pty Ltd v Tasmania*,[3] which held that a tax on the consumption of goods does not constitute a duty of excise.[4]

The EV charge was held to be a tax within the scope of this expanded definition of excise. Following the decision in *Vanderstock*, the definition of an excise is no longer limited to taxes imposed *before* a good reaches a consumer, but can now include taxes on the consumption, ownership, use, resale, reuse or destruction of a good in Australia.[5]

Excise redefined: a new test introduced

The expanded scope of the term "excise" for the purposes of s 90 was supported by a majority, including a single judgment of Kiefel CJ, Gageler and Gleeson JJ, and a concurring judgment by Jagot J.[6] The plurality diverged from existing authority significantly in holding that a tax is a "tax on goods", and thus a duty of excise, if:[7]

- it bears a close relation to the production or manufacture, sale, distribution *or consumption* of goods; and
- it is of such a nature as to affect the goods as subjects of manufacture or production or as articles of commerce. As was the case in *Vanderstock*, a tax will be of a nature that sufficiently affects goods as articles of commerce if the tendency of the tax is to depress demand for those goods,[8] although the majority did not limit the scope of their decision to only such cases.

In evaluating whether a tax satisfies these two "elements", the plurality emphasised that one should look to both the legal form and substance (or practical operation) of the law. A court will consider economic analysis informed by observed market behaviour, including elasticities and cross-elasticities of supply and demand, to identify the precise incidence of a given tax.[9]

The plurality suggested that:[10]

> "What is in each case required is the formation of a practical judgment. That is the stuff of constitutional adjudication."

It is worth noting that the High Court unanimously refused Victoria leave to re-open the High Court's decisions in *Capital Duplicators Pty Ltd v Australian Capital Territory*[11] and *Ha v New South Wales*,[12] on the basis that these authorities are critical to federal–state financial relations and the GST. Therefore, "they are not to be judicially disturbed".[13] This emphasis on federal–state financial relations reflects the High Court's recent reasoning upholding the validity of notional GST in *Hornsby Shire Council v Commonwealth*.[14]

Application to the ZLEV Act

Section 7(1) ZLEV Act required the registered operator of a zero or low emissions vehicle (ZLEV) to pay a charge for "use of the ZLEV on specified roads". The tax applied where a ZLEV was used on public roads and was levied on the basis of kilometres travelled by the ZLEV.

Despite the legal form of the tax, which was levied on the use of a ZLEV rather than on the ZLEV itself, the plurality held that the EV charge was a tax on goods:[15]

- due to the close relation between the tax and the use of ZLEVs; and
- because the tax affects ZLEVs as articles of commerce, including because of its tendency to affect demand for ZLEVs.

The majority rejected the characterisation of the EV charge as being nothing more than a tax on the activity of driving a ZLEV on a "specified road"; that distinction was unsustainable having regard to the breadth of the definition of "specified road", which extended to anywhere in Australia in which members of the public have a right of way.[16]

The majority concluded that the EV charge was, therefore, a duty of excise.

Beyond EV charges: are other state taxes affected?

It is very likely that other state taxes will be impacted by the decision in *Vanderstock*. First, it is likely that EV charges imposed by other states are invalid. Second, other state taxes that bear a close relation with goods and depress demand for such goods could also be invalid. The dissenting judgments point to the following taxes that could all come within the expanded scope of s 90 based on the reasoning of the *Vanderstock* majority:[17]

- duties paid on the transfer of goods where transferred with land or businesses (eg plant and equipment, or trading stock in the case of Queensland);
- motor vehicle duties and vehicle registration charges;
- commercial passenger vehicle levies;
- gaming machine levies and "point of consumption" betting taxes;
- waste disposal levies; and
- tobacco licensing fees.

Edelman J, in dissent, also argued that, extending the majority's reasoning to its logical conclusion, it is no longer obvious that the following taxes do not breach s 90:[18]

- payroll tax;
- industrial land tax;
- licence fees to carry on a business where the business concerns the production or manufacture of goods;
- a tax concerning the carriage of goods; and
- taxes on a gift of goods or an inheritance of goods.

It seems unlikely that state land taxes in general breach s 90, given that s 114 of the Constitution expressly contemplates that the states can impose taxes on property (which must be property other than goods, a category that clearly includes land). Even when applying the reasoning of the majority in *Vanderstock*, state land taxes would appear not to satisfy the first requirement of bearing a close relation to the production, manufacture, sale, distribution or consumption of goods, given they are generally imposed on unimproved land values.

> "Vanderstock may mark a decisive change in the fiscal balance between the states and the Commonwealth."

Licence fees paid to carry on a business might also be a fee for a statutory right to exploit a limited resource, which is not a tax in the first place and thus not a duty of excise.[19] Nothing in the reasoning of the majority in *Vanderstock* appeared to doubt the requirement that a duty of excise must first be a tax.[20] So, for example, state mineral royalties are unlikely to be invalid duties of excise because they are not taxes, but rather fees to obtain property in a resource (ie if a person already owns the resource, they are not subject to royalties on it).[21]

At first blush, state payroll taxes would not appear to be taxes on goods, as opposed to taxes on remuneration paid to employees and some independent contractors, but at least one taxpayer is currently seeking to argue as such in the Supreme Court of New South Wales.[22]

Impact on federal–state taxation powers

Vanderstock may mark a decisive change in the fiscal balance between the states and the Commonwealth. Indeed, the minority of Gordon, Edelman and Steward JJ heavily criticised the majority for undermining federalism and the financial interests of the states.[23] As Edelman J put it, if s 90 were to extend to any tax where a real and substantial economic effect in a market for the sale of goods was anticipated, it would go further than even contemplated by the plurality, potentially undermining federalism itself.[24] The dissenting judgments included lengthy criticisms of the economic analysis used by the majority,[25] highlighting the complexity and uncertainty inherent in predicting the economic effect of a consumption tax.[26]

Gordon J's dissent indicates that future litigation in relation to s 90 is likely as parties seek greater certainty regarding the distinctions between taxes that are and are not an excise:

> "... the legal and practical operation of any subsequent state law imposing a tax that may have a potential effect on the demand or market for goods is likely to be the subject of years of litigation as the courts seek to determine how the new rule is to operate and, no less importantly, the manner of determining the legal and practical operation of a 'tax on goods' ... We just do not know whether there are limits and how any such limits are to be applied — uncertainty is the default and it is likely to remain the default for many years."

Implications for Australia's transition to clean energy

The decision is also likely to affect states' abilities to play a role in facilitating Australia's energy transition, given that the imposition of taxes can be a powerful tool for adjusting market behaviour, and a number of states were considering equivalents to the Victorian EV charge before *Vanderstock*. Gordon J's dissent highlighted and criticised the impact of the majority's decision on the implementation of climate-related regulation:[27]

> "The unstated assumption is that it is the Commonwealth, not the States, which has the responsibility to address climate change and to regulate ZLEVs. That unstated assumption is wrong. It is equally the responsibility of the States."

That said, the decision in *Vanderstock* forms part of a broader trend in tax-related cases favouring taxpayers who invest in assets that facilitate Australia's energy transition. For example, in *Chief Commissioner of State Revenue v Shell Energy Operations No. 2 Pty Ltd*,[28] the New South Wales Court of Appeal held that hydroelectric power stations severed from the land by statute were goods for both general law and landholder duty purposes (with underlying goods taxed more concessionally than land). Similarly, in *Valuer-General Victoria v AWF Prop Co 2 Pty Ltd*,[29] the Victorian Court of Appeal held that wind farm assets were chattels for general law purposes and thus not subject to a fire services levy. Interestingly, the reasoning in these cases, when combined with that of *Vanderstock*, may suggest that the imposition of state transfer duty and, potentially, land tax, in respect of hydroelectric power stations and wind farms in similar circumstances may no longer be valid.

How the High Court's decision could affect you

As a consequence of *Vanderstock*:

- the EV charge is invalid, with the effect that any annual charges levied on EV users under the ZLEV Act are invalid (and, subject to the enactment of any saving legislation, should be refunded);
- equivalent EV road-user charges in other states (eg New South Wales) could also be invalid; and
- other state-imposed taxes relating to the use or consumption of goods may be invalid.

There remains a possibility the Commonwealth Parliament will impose "saving" legislation to ensure that tax collected under impugned state legislation does not need to be refunded or "mirror" legislation imposing the state tax on a prospective basis. Saving legislation was imposed, for example, after the successful challenge to the tobacco franchise levy in *Ha*,[30] while saving and mirror legislation was imposed after the successful challenge to the imposition of state taxes at Melbourne Airport in *Allders International Pty Ltd v Commissioner of State Revenue (Vic)*.[31]

Following *Ha*, the Commonwealth Parliament introduced the *Franchise Fees Windfall Tax (Collection) Act 1997* (Cth) and the *Franchise Fees Windfall Tax (Imposition) Act 1997* (Cth) as savings measures which applied from the date of the High Court's judgment in *Ha*. However, following *Allders*, the savings measures applied from the date on which the Treasurer announced the Commonwealth Parliament's intention to legislate the savings measure. In each instance, the legislation imposed a windfall tax equal to the amount which a state is liable to repay a taxpayer due to the constitutional invalidity of the state law in question, and empowered the states to withhold the windfall tax amount from that refund.

However, outstanding unconstitutional state excise duty liabilities that are not paid in the interim might not be captured by a relevant "saving" provision and, potentially, relevant "mirror" legislation. This possibility could arise where, as happened following *Ha* and *Allders*, the savings legislation applied only to where a taxpayer had "paid" an amount of tax under the invalid state law prior to commencement of the savings legislation, but the mirror tax only applied for amounts which become due for payment after the commencement date for the mirror tax. This possibility appears to be acknowledged expressly by the explanatory memorandum to the *Allders* mirror tax Bill.[32]

It would also be necessary to consider state legislation that seeks to limit refunds. For example, the *Recovery of Imposts Act 1963* (NSW) limits a taxpayer's ability to bring proceedings against the state for the recovery of tax on the grounds of the invalidity of tax legislation. Any such proceedings must be brought within 12 months of payment of the tax sought to be refunded, unless a longer time period is contained in the provisions of another Act (eg under the general provisions of objection, review and appeal against state tax assessments).[33]

As noted above, it is possible that the Commonwealth Parliament may impose federal taxes designed to "mirror" state taxes found to be invalid under s 90, with a view to preserving the states' revenue base going forward (eg by having each state collect and keep the "mirror" tax or by paying any tax collected by the Commonwealth to the states). The authors would speculate that this is most likely for motor vehicle transfer and registration duties but, in any case, it would require cooperation between the Commonwealth and the states, at least at a practical level.

Any such mirror taxes would need to comply with the limitations on the taxing powers of the Commonwealth Parliament, including that such taxes cannot discriminate between states or give preference to any state.[34] While the High Court has previously held that the mirror taxes imposed by the Commonwealth Parliament in Commonwealth places, like Melbourne Airport, after the *Allders* decision, did not infringe these limitations,[35] that was on the basis that any differential treatment by the federal mirror taxes of Commonwealth places in different states was appropriate and adapted to attaining the proper objective of assimilating the tax laws of those Commonwealth places to those of the surrounding state.

Since then, the relevance of such proportionality analysis to the prohibitions on federal taxes that discriminate between, or give preference to, states has been doubted by the High Court.[36] Moreover, and in any event, the federal mirror tax legislation enacted after *Allders* would be fundamentally different to any federal mirror tax legislation enacted following *Vanderstock*. In *Allders*, the state taxes were only invalid to the extent of Commonwealth places located within the state; they remained valid in the remainder of the state. In contrast, following *Vanderstock*, state duties of excise will be completely invalid. In that context, it is not so clear that the enactment by the Commonwealth Parliament of a "mirror" tax imposing, for example, transfer duty on goods at different rates in different states, reflecting the erstwhile state transfer duty regimes, would be appropriate and adapted to any proper objective. Uniform national duties of excise may be required instead.

Any predictions regarding the future application of *Vanderstock* are also complicated by the recent changes to the High Court bench. As Kiefel CJ has recently retired and Beech-Jones J has been appointed, there is a chance that either the reconstitution of the High Court bench or the persuasive, strongly worded dissents inspire a watering-down or even a reversal of the High Court's reasoning in *Vanderstock*.

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References

1 [2023] HCA 30.

2 The High Court has held, by a 4:3 majority, that s 90 extends to duties of excise imposed by the territories: see *Capital Duplicators Pty Ltd v Australian Capital Territory* (1992) 177 CLR 248 at 279 and 290. For convenience, the remainder of this article will refer only to "states".

3 [1974] HCA 9.

4 *Vanderstock* at [133] per Kiefel CJ, Gageler and Gleeson JJ, [940] per Jagot J.

5 *Vanderstock* at [197] per Kiefel CJ, Gageler and Gleeson JJ.

6 *Vanderstock* at [197] per Kiefel CJ, Gageler and Gleeson JJ, [949] per Jagot J.

7 *Vanderstock* at [147]–[148] per Kiefel CJ, Gageler and Gleeson JJ.

8 *Vanderstock* at [150] per Kiefel CJ, Gageler and Gleeson JJ.

9 *Vanderstock* at [151] per Kiefel CJ, Gageler and Gleeson JJ.

10 *Vanderstock* at [154] per Kiefel CJ, Gageler and Gleeson JJ.

11 (1992) 177 CLR 248.

12 [1997] HCA 34.

13 *Vanderstock* at [8] per Kiefel CJ, Gageler and Gleeson JJ; see also at [427] per Gordon J, [610] per Edelman J, [811] per Steward J, [856] per Jagot J.

14 [2023] HCA 19.

15 *Vanderstock* at [185] per Kiefel CJ, Gageler and Gleeson JJ.

16 *Vanderstock* at [188] per Kiefel CJ, Gageler and Gleeson JJ.

17 *Vanderstock* at [785] per Steward J, [416] per Gordon J.

18 *Vanderstock* at [677]; see more generally at [672]–[678] per Edelman J.

19 See, for example, *Harper v Minister for Sea Fisheries* (1989) 168 CLR 314 at 325, 335–337.

20 See, for example, *Vanderstock* at [146]–[148] per Kiefel CJ, Gageler and Gleeson JJ, [909] per Jagot J. See also *Hornsby Shire Council v Commonwealth* [2023] HCA 19 at [28].

21 See, for example, *Glencore Coal Queensland Pty Ltd v State of Queensland* (2022) 12 QR 295 at 315, 319, 324.

22 *Aymsheen Pty Ltd v Chief Commissioner of State Revenue* [2023] NSWSC 1237.

23 *Vanderstock* at [401] per Gordon J, [702]–[703] per Edelman J, [801] per Steward J.

24 *Vanderstock* [457] per Edelman J, [203] per Gordon J.

25 *Vanderstock* at [477]–[478] per Edelman J.

26 *Vanderstock* at [270]–[272] and [415] per Gordon J, [643]–[647] per Edelman J.

27 *Vanderstock* at [419] per Gordon J.

28 [2023] NSWCA 113 at [113]–[114].

29 (2021) 65 VR 327 at 345, 366.

30 See *Franchise Fees Windfall Tax (Collection) Act 1997* (Cth) and *Franchise Fees Windfall Tax (Imposition) Act 1997* (Cth).

31 [1996] HCA 58. See the *Commonwealth Places Windfall Tax (Collection) Act 1998* (Cth) and the *Commonwealth Places Windfall Tax (Imposition) Act 1998* (Cth).

32 Explanatory memorandum to the Commonwealth Places (Mirror Taxes) Bill 1998, 10-1 [1.31]–[1.33].

33 S 2(1) and (2) of the *Recovery of Imposts Act 1963* (NSW).

34 Ss 51(ii) and 99 of the Constitution.

35 *Permanent Trustee Australia Ltd v Commissioner of State Revenue (Vic)* (2004) 220 CLR 388 at 423–425.

36 *Fortescue Metals Group Ltd v Commonwealth* (2013) 250 CLR 548 at 585 per French CJ, 594 and 604 per Hayne, Bell and Keane JJ.

Deferred consideration

by Ellen Thomas, Partner, Allens

This article discusses some of the tax issues that can arise when deferred consideration is payable by a buyer to a seller under a share purchase agreement. In this article, "deferred consideration" refers to an amount payable by the buyer to the seller for their shares on a deferred basis. The deferred consideration is not contingent on any event occurring, but is paid at a date after completion. Despite being a simple sale structure, deferred consideration can give rise to a range of tax issues relating to the character of the consideration being paid on a deferred basis, including whether the consideration should be characterised as an earnout or as employment income. For taxpayers subject to tax under TOFA, the position can be complex with market value adjustments being required. Finally, this article discusses the tax consequences if deferred consideration is not in fact paid to the seller.

When is deferred consideration used?

A buyer may wish to use non-contingent deferred consideration to hold back some of the cash payable to a seller. By way of example, the buyer agrees to pay $100 to a seller as consideration for the sale of shares in a target company, but some or all of this consideration is paid after completion.

From a commercial perspective, deferred consideration might be used in a sale structure:

- because the buyer does not have sufficient cash to pay all of the consideration at completion;
- to provide a mechanism for the buyer to recover from the seller under the warranty and indemnity regime in the sale and purchase agreement (SPA) (with the amount payable to the seller in the future being set off against claims that the buyer might have against the seller);[1] or
- because there is some uncertainty about whether the target company will itself recover certain amounts, and payment of the deferred consideration is limited in recourse to recovery of those amounts.

What is the difference between "deferred consideration" and an "earnout"?

Deferred consideration is similar to an earnout in that some of the payment to the seller will be provided following completion. However, unlike an earnout, the buyer's obligation to pay deferred consideration is generally not subject to a contingency.

It is important to distinguish between non-contingent deferred consideration and earnouts because those transactions are taxed differently. In particular, the full amount of deferred consideration is taxed upfront for the seller (and included in the cost base of the buyer) (see below). By contrast, amounts received in respect of an earnout are generally taxed when actually received.[2]

It can be particularly difficult to tell the difference between deferred consideration and a reverse earnout as both sale structures involve receiving a specific amount for the shares. In this regard:

- there will be a reverse earnout if the seller accepts a specific sum by way of consideration but undertakes to pay an amount or amounts (post-sale payments) to the buyer calculated by reference to the earnings generated by the shares during a specified period after completion of the sale (see TR 2007/D10 (withdrawn)). Importantly, the undertaking from the seller to pay the buyer if certain conditions arise is treated (for tax purposes) as a separate right provided by the seller for which consideration is received; and
- this can be contrasted to a deferred consideration sale structure, where the consideration payable to the seller might be reduced through the normal operation of the warranties and indemnities[3] but no separate right to receive those payments is recognised for tax purposes.

When is an earnout deferred consideration?

PBR 1052020371737 and PBR 1052020105622

The label given to a sale structure does not always reflect its legal and tax characterisation, which can be seen from the share sale transactions which were the subject of PBR 1052020371737 and PBR 1052020105622. In those transactions, the consideration payable to the sellers was described as an "earnout", but the ATO treated the earnout as deferred consideration which was taxable upfront.

By way of background, the founders of the business and other investors had entered into an SPA with the buyer. The buyer was happy to pay the investors (but not the founders) 100% of their consideration upfront. The buyer wanted the two founders to remain in the business for a number of years post-acquisition. Apparently, the buyer had previously had a bad experience in M&A transactions with founders whom they wished to retain in the business; if the seller has the cash consideration, they may not be motivated to work following completion. Accordingly, the buyer proposed an arrangement that was intended to motivate the founders to remain in the business for a number of years (and to punish them if they left).

Under the share sale transaction, the buyer agreed to pay at completion:

- 100% of the purchase price to the non-founder shareholders; and
- 65% of the purchase price to the founder shareholders.

There were two ways for the founders to receive the earnout payments in the future:

- the founder could remain employed (or be a "good leaver"); or
- the target company met certain business hurdles within a five-year period.

The earnout arrangement only applied to the founders, not to other shareholders, who each received 100% of their consideration upfront.

At first blush, this arrangement might be characterised as an earnout (either as defined in s 118-565 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) or in the sense set out in TR 2007/D10 (ie non-complying earnouts)), not least because it was described as an earnout in the SPA.

The ATO concluded in the private binding rulings that the earnout payments were not to be characterised for tax purposes as an earnout, whether qualifying for concessional tax treatment under Subdiv 118-I ITAA97 or not. Rather, the earnout was to be treated as deferred consideration. The ATO's rationale was:

- none of the amounts payable in relation to the earnout could be described as "indeterminate". The founders were basically guaranteed to get the money; all they had to do was keep their job;
- the earnout payments were fixed amounts calculated with reference to the agreed purchase price. The earnout payments were only withheld from the sellers to incentivise them to remain employed with the target company for a specific period; and
- this is contrasted with earnout payments which occur when there is insufficient agreement on the value of an asset or business and therefore future payments to the seller are based around, and calculated with reference to, the economic performance of the assets or business. By contrast, under the relevant transaction, the payments were merely made in respect of the acquisition of the shares in the target company.

In relation to the question as to whether the earnout could satisfy the conditions of s 118-565 (ie it would be a qualifying earnout), the stumbling blocks were:

- s 118-565(1)(a): whether the right to future financial benefits was reasonably ascertainable at the time the right was created;
- s 118-565(1)(f): whether the financial benefits were contingent on the economic performance of the CGT asset or business; and
- s 118-565(1)(g): whether the value of the financial benefits reasonably related to that economic performance.

These aspects are discussed in further detail below.

Financial benefits reasonably ascertainable

The main issue with s 118-565(1)(a) was whether the amount of the earnout was known or "reasonably ascertainable at the time the right is created".

On the one hand, the total maximum amount that could be payable under the earnout was capped and known. However, whether the shareholders actually received part or any of the payment depended on future events.

The ATO pointed to the fact that the quantum of the financial benefits was known at the commencement of the arrangement. The financial benefits were therefore considered to be "reasonably ascertainable" and thus the arrangement was disqualified from being a qualifying earnout.

However, having a capped earnout is not an unusual feature of an earnout arrangement provided there is a contingency as to what amount might be payable. It is likely that the ATO considered in PBR 1052020371737 and PBR 1052020105622 that the fact that one of the contingencies – remaining employed – could easily be met, meaning that the circumstances fell within those outlined in para 1.63 of the explanatory memorandum to the Tax and Superannuation Laws Amendment (2015 Measures No. 6) Bill 2015 (the earnout EM), which states:

> "1.63 In most cases, the fact that financial benefits are contingent will mean that they are also reasonably unascertainable. However, in some cases a benefit may be contingent on future events where *there is little or no doubt that these events will transpire* and the quantum of the payment is fixed or can reasonably be determined given what is known. In this case, the benefit can reasonably be ascertained and the right cannot be a look-through earnout right." (emphasis added)

Financial benefits not contingent on economic performance of CGT asset or business

For a right to be a look-through earnout right, future financial benefits provided under the right must be linked to the future economic performance of the asset. Generally, measures that may be appropriate include both:

- financial measures, such as the profit, sales or turnover of the business (or the business in which the asset is used); and
- non-financial measures, such as the number of clients retained or attracted.[4]

While the earnout included achieving certain business goals, the financial benefit to be provided to the sellers was not considered to be wholly contingent on this metric. It was possible to satisfy the earnout requirements by the founders staying employed.

Arguably, the founders remaining employed was connected to the economic performance of the target company and was itself a business contingency. The retention of the founders as employees was critical to the ongoing success of the business.

However, the ATO's view was that the continued employment of the founders was not a guarantee of future economic performance and therefore could not be considered a metric of economic performance. Simply by remaining employed for a period from completion, the founder becomes entitled to the earnout regardless of the economic performance of the target company over that period. It was therefore concluded that it was not the case that the earnout amount was contingent on the economic performance of the target company for the purposes of s 118-565(1)(f). This approach can be contrasted to the ATO's approach in PBR 1051659115719 (discussed below), where certain people remaining employed was said to be relevant to the economic performance of the target company.

Value of financial benefits not reasonably related to economic performance

For a right to be a look-through earnout right, in addition to the financial benefits being contingent on the future economic performance of the asset or the business in which it is used, the value of the benefits must also reasonably relate to this performance (see para 1.58 of the earnout EM). Although this requirement does not entail a precise or mathematical link between performance and payment, a nexus must nonetheless exist.

In PBR 1052020371737 and PBR 1052020105622, the ATO concluded that there was no link or nexus between the satisfaction of requirements to achieve the earnout and the quantum of the earnout. Rather, the satisfaction of the relevant conditions merely brought the founders into the same position in terms of capital receipts as the other sellers who participated in the sale. Therefore, had the financial benefits been contingent on economic performance, they would nonetheless not have been reasonably related to that economic performance. The requirement in s 118-565(1)(g) was not satisfied.

CGT consequences

Seller's position

Whether a payment is received on income or capital account is to be determined by its character in the hands of the recipient.[5] The High Court in *GP International Pipecoaters Pty Ltd v FCT* said:

> "14. … To determine whether a receipt is of an income or of a capital nature, various factors may be relevant. Sometimes, the character of receipts will be revealed most clearly by their periodicity, regularity or recurrence; sometimes, by the character of a right or thing disposed of in exchange for the receipt; sometimes, by the scope of the transaction, venture or business in or by reason of which money is received and by the recipient's purpose in engaging in the transaction, venture or business. The factors relevant to the ascertainment of the character of a receipt of money are not necessarily the same as the factors relevant to the ascertainment of the character of its payment."

Proceeds received as the result of a mere realisation of a capital asset (eg shares) will be of a capital nature.[6]

Section 116-20(1) ITAA97 includes in capital proceeds:

- the money that the seller has received or is entitled to receive in respect of the event happening; and
- the market value of any other property that the seller has received, or is entitled to receive, in respect of the event happening (worked out at the time of the event).

Generally (and subject to the taxation of financial arrangements (TOFA) discussion below),[7] the seller would include in their capital proceeds the full amount of the consideration payable to them, including consideration to be received at a later time. Deferred consideration is an amount that the seller is "entitled to receive" and therefore should fall within s 116-20(1)(a).[8]

This position is confirmed in s 103-10(2) ITAA97, which provides that the CGT rules apply as if the seller is entitled to receive money or other property if the seller will not receive it until a later time or the money is paid in instalments.

Generally, the seller would be entitled to the CGT discount in relation to the full amount of consideration that is to be received.

Buyer's position

The buyer would similarly include (subject to s 230-505 ITAA97) the total consideration payable in its first element cost base and reduced cost base (see ss 110-25(2) and 110-55(2) ITAA97).

Deferred consideration: ordinary income for seller or deductible for buyer?

Ordinary income: annuity

Outside the TOFA rules (discussed below), it is necessary to consider whether any part of the deferred consideration for the sale of shares would be treated as ordinary income.[9]

Generally, where shares are sold for a fixed gross amount, with part of the payment deferred following completion, this would be regarded as a payment for the shares by instalments. However, in some "extreme circumstances",[10] an obligation to pay deferred consideration may be treated as an annuity stream which is included in the assessable income of the seller.[11]

Some examples of old cases where deferred consideration in respect of an asset was treated as an annuity are discussed below.[12]

Chadwick v Pearl Life Insurance Co

In *Chadwick v Pearl Life Insurance Co*,[13] the buyer provided a covenant to pay sums of money by quarterly payments for the acquisition of a leasehold interest. The buyer had agreed to pay a fixed amount, then make an annual payment in quarterly instalments until the expiration of the term of the lease. The payment by instalments was calculated as the net rent which the assignors, as at the date of assignment, were receiving under certain sub-leases which they had made of the leasehold premises.

Walton J held that what the sellers had "bargained for" was that they should continue to receive, until the end of the term, the same amount of income that they were receiving from the property. The quarterly payments were held to be an annuity rather than the payment of instalments of principal and interest. Walton J said (p 514):

> "It is obvious that there will be cases in which it will be very difficult to distinguish between an agreement to pay a debt by instalments, and an agreement for good consideration to make certain annual payments for a fixed number of years. In the one case there is an agreement for good consideration to pay a fixed gross amount and to pay it by instalments; in the other there is an agreement for good consideration not to any fixed gross amount, but to make a certain, or it may be an uncertain, number of annual payments. *The distinction is a fine one, and seems to depend on whether the agreement between the parties involves an obligation to pay a fixed gross sum.*" (emphasis added)

Egerton-Warburton v DCT

In *Egerton-Warburton v DCT*,[14] a father agreed to sell land to his two sons, together with all stock, chattels and effects.

The consideration for the transaction was stated to be: (1) an annuity to the father during his life of £1,200 by quarterly payments; (2) after his death, an annuity to his widow of £1,000 by quarterly payments; and (3) after the death of both the father and his widow, the sum of £10,000 to his three daughters and the children of a deceased daughter.[15] The father reserved under the agreement the right to use and occupy a dwelling house on the land.

Rich, Dixon and McTiernan JJ concluded that the payments would be included in assessable income (p 569):

> "The present case may be regarded notionally, perhaps, as if the father had stipulated for a capital payment from the sons sufficient to purchase an annuity for his life of £1200, and had then reinvested it with them as the purchase price of an annuity which they undertook to pay him. If the price were ascertained the transaction so regarded might come within the provision which would authorise the exclusion of so much of the annual payment as represented principal expressed in the price. *The difficulty is that no definite or ascertainable capital sum is agreed upon between the parties.* The purchase price of an annuity depends upon the annuitant's expectation of life, which is not solely a question of age, and upon the adoption of a rate of interest which is not rigidly determined by law or custom. With no fixed price expressed by the parties, with no expectation of life fixed when the annuity was stipulated for, and no rate of interest adopted by the parties for its calculation, it is, we think, impossible to find in the transaction a purchase price for the annuity. The statutory provision gives an advantage in cases which conform to conditions established positivi juris. One of the conditions is that there must be an ascertained or ascertainable price. In our opinion the conditions cannot be satisfied in the present case." (emphasis added)

Just v FCT

Just v FCT[16] concerned a transfer of land. The Just brothers were the owners of a block of land on which a building stood adjoining the buyer's land. The buyer wanted to acquire the land of the Just brothers and to erect on the land already owned a number of shops and offices which the buyer proposed to let to certain tenants.

The buyer agreed to pay to the sellers 90% of the rents received from that property for 50 years. The payments were held to be assessable income. Importantly, it was only when rents were "received" on the property that any claim for payment could arise. While a headline sale price for the transfer had been noted for stamp duty purposes, the amount that might be received over time might have been more or less than that amount.

Note that the fact that the payments were assessable in the hands of the Just brothers did not mean that the payments were deductible to the buyer. See *Colonial Mutual Life Assurance Society Ltd v FCT*[17] discussed below. Webb J was a common judge for both decisions.

Jones v Commissioners of Inland Revenue

The sale of a business for a share of the profits may be included in assessable income. In *Jones v Commissioners of Inland Revenue*,[18] Rowlatt J stated:

> "On the other hand, a man may sell his property nakedly for a share in the profits of the business. In that case the share of the profits of the business would be the price, but it would bear the character of income in the vendor's hands. *Chadwick v Pearl Life Insurance Company*, (1905) 2 KB 507, 514, was a case of that kind."

The cases discussed above pre-date the CGT regime. If such a transaction were to take place today, it is likely that the seller would make a capital gain equal to the value of the contractual right to be paid an annuity (see TR 2007/D10). The seller might then make a capital loss when the annuity ended. Depending on the drafting of the relevant sale arrangement and annuity, it is possible that the "profits emerging" basis (eg ATO ID 2009/63) might be used to recognise income from the annuity (or TOFA might apply). The seller would take the risk that the amount actually received in cash is less than the market value of the annuity.

Deductions for deferred consideration

In both *Colonial Mutual Life Assurance Society Ltd v FCT* and *Egerton-Warburton v DCT* (discussed above), the court had to consider (in addition to determining whether the consideration was assessable to the seller) whether the payments were deductible to the buyer. In each case, a different conclusion was reached:

- the court in *Egerton-Warburton v DCT* did not treat the annuity as a payment on capital account but rather an ongoing cost which the sons had to incur in order to obtain the asset. The payments were therefore deductible; and
- the High Court held in *Colonial Mutual Life Assurance Society Ltd v FCT* that the buyer of the land from the Just brothers was not entitled to a deduction for the ongoing payments because those payments constituted the price payable on a purchase of land. In this case, Williams ACJ distinguished *Egerton-Warburton* on the basis that *Egerton-Warburton* "bore all the marks of a family settlement" and that "their Honours evidently considered that the annuities, being charged on the land and payable during the lives of the father and mother, were in the *nature of rents* which the sons had to pay during this period in order to occupy the land and carry on their business" (p 430).

The cases above pre-date the CGT regime. Nowadays, the deferred consideration would be included in the buyer's cost base and the payments should not generally be deductible unless there are unusual circumstances. Refer to the ATO's discussion paper on earnouts:[19]

> "27. Where a buyer is obliged to satisfy an earnout right by way of periodic payments and the payments represent working expenses that are incurred as part of an income-producing activity (such as mining), the payments *may* be deductible to the buyer under ordinary deduction principles. However, if the payments represent expenditure necessary for the acquisition of property or of rights of a permanent character the possession of which is a condition of carrying on an income-producing activity (for example, the payments are part of the purchase price), they will generally not be deductible to the buyer."

Employment income

General proposition

Generally, deferred consideration should not be regarded as employment income where the SPA makes it clear that the deferred consideration is consideration for the sale of the shares in the company. However, a question may arise as to whether the sellers receive their deferred consideration as employment income if:

- the sellers (or their associates) are also employees of the target company following the sale; and
- the receipt of deferred consideration is paid in substitution for salary and wages.

It is relevant to consider "whether the amount received in a lump sum was part of the consideration for the services rendered in the office or employment".[20] Payments received as a reward for services have an income character.[21] If the buyer is treated as paying salary or wages to the seller employee, there would be other tax consequences for the buyer, such as PAYG withholding etc. However, the fact that the consideration for the sale of shares is calculated by reference to lost employment income or a bonus does not necessarily give the consideration the character of employment income.

ATO private binding rulings

PBR 1051485266678

In PBR 1051485266678, the transaction was treated as being on capital account where part of the consideration for a share sale was linked to the continuing employment of individuals. The taxpayer could receive either additional shares in B Pty Ltd or cash a number of years after the completion date. A condition to this occurring was that the directors of A Pty Ltd remained continuously employed by C Ltd or A Pty Ltd or one of its subsidiaries (or, in the event that they cease to be so employed, for the reasons stipulated in the contract):

> "8. Pursuant to the terms of the contract, consideration for the purchase will be provided in two stages:
>
> a) At the completion date as specified in the contract, the original interest holders will be given ordinary fully paid shares in B Ltd to the value of $X in proportion to their respective shareholdings in A Pty Ltd.
>
> b) X years after the completion date, subject to each of the directors of A Pty Ltd remaining continuously employed by C Ltd or A Pty Ltd or one of its subsidiaries (or, in the event that they cease to be so employed, for the reasons stipulated in the contract), C Ltd will either:
>
> i. cause to be delivered to the original interest holders ordinary fully paid B Ltd shares to the value of $X, or, if this is not possible;
>
> ii. pay the original interest holders cash consideration of $X,
>
> in proportion to their respective shareholdings in A Pty Ltd."

PBR 1051485266678 provided that scrip-for-scrip roll-over relief was available to the extent that the taxpayer received shares in B Pty Ltd. It appears that the question was not asked as to whether the deferred consideration or earnout was characterised as ordinary income.

PBR 1051659115719

In PBR 1051659115719, the earnout was linked to the continued employment of general employees (earnout payments 1 and 2) and specific employees (earnout payment 3):

> "You further advised that the first and second period earnout amounts are calculated by reference to the attrition rate of general employees. The third period amount of $XXXX is attributable to relevant employees of the seller either being employed by the buyer throughout the earnout period or having a managed termination service."

The earnout payment satisfied s 118-565(1)(f) of the look-through earnout rules because there was a link between the ongoing employment of certain people and the success of the business:

> "The business sold provides XXXX services and is entirely dependent upon skilled employees who can provide those services. Therefore, the retention of the specialised employees will have a direct impact on the productivity, serviceability and survival of the business. The entitlement to the financial benefits is contingent to the employee retention. Therefore, under s118-565(1)(f) of the ITAA97, the financial benefits are contingent on the economic performance and satisfy the conditions for the business with CGT assets being active assets."

By implication, the continued services of the employees were therefore a valid way of calculating capital proceeds, and it was appropriate that the payments were on capital account.

It is not clear whether the sellers were all founders (or their associates) or whether only some of the sellers were founders (or their associates). Again, the question was not asked as to whether the deferred consideration or earnout was characterised as ordinary income.

Deferred consideration private binding rulings

In PBR 1051485266678 and PBR 1051659115719 (discussed above), the ATO did confirm that the deferred consideration was not employment income. This was because:

- it was clear that the deferred payments represented capital proceeds that formed part of the acquisition price of the shares disposed of by the founders; and
- although the payments were in part contingent on the founders remaining employed by the target company for a period, they were not in respect of services rendered. The founders each had an employment contract and received appropriate remuneration separate to the SPA, in respect of services rendered.

ATO class ruling

CR 2022/63 involved the sale of shares in the employee-owned wealth advice and portfolio management services advisory business, Crestone Holdings Ltd (Crestone).

Crestone was an unlisted public company, whose shareholders largely comprised current and former employees.

Under the scheme, shares in Crestone were sold by the shareholders in return for an upfront cash amount, along with a potential future earnout payment, calculated on the financial performance of the business in future financial years.[22] Shareholders would not be entitled to receive the earn-out consideration if they engaged in certain competitive conduct during the earnout period.

The earnout payment was not employment income.

The technical explanation in CR 2022/63 focused on the fact that the share sale transaction gave rise to the entitlement to the earnout and did not treat any part of the capital proceeds as ordinary income:

> "126. Whether or not a particular receipt is ordinary income depends on its character in the hands of the recipient. In *GP International Pipecoaters Pty Ltd v Commissioner of Taxation* (Cth) [1990] HCA 25, the High Court stated:
>
> > To determine whether a receipt is of an income or of a capital nature, various factors may be relevant. *Sometimes, the character of receipts will be revealed most clearly by their periodicity, regularity or recurrence; sometimes, by the character of a right or thing disposed of in exchange for the receipt; sometimes, by the scope of the transaction, venture or business in or by reason of which money is received and by the recipient's purpose in engaging in the transaction, venture or business.*
>
> 127. Based on the circumstances of this case, neither the receipt of the Earnout Right nor the Earnout Scheme Consideration (if payable) are considered to result in an amount being assessable as ordinary income under section 6-5." (emphasis added)

Founders retention amount: case law

A "founders retention amount" payable under an SPA was found to be employment income in *NQZG and FCT*.[23] Relevantly:

- the founders retention amount was payable to the founders (in their capacity as founders, and not shareholders of the target company), one of whom was not the holder of shares in the company. As noted by the tribunal, this supported the conclusion that, merely because a payment was made by the purchaser to a person named as a "seller", it did not necessarily follow that the payment was received by those named sellers as consideration for the sale and transfer of the purchased shares (para 61);
- under the share sale agreement, the founders retention amount was consideration for specific covenants given by the founders in circumstances where the conditions to the receipt of the founders retention amount were the continued employment of the founders;
- as the tribunal noted, the share sale agreement did not contain a clause providing that the "purchased shares" were sold for the "purchase price" (para 59); and
- to qualify for the founders retention amount, it was necessary for the taxpayer to agree to provide services to his employer for the retention period, or if he was to cease to provide services that could not be for "cause".

Senior Member (now Justice) Hespe concluded that the founders retention amount was income and said:

> "77. … A substantial reason for the payment was the continuance of an employment relationship of the Applicant with the Company (or other employing entity). There was an evident connection between the continuance of that employment relationship (or if was to be terminated, the termination had to be without

Cause). *The continuation of the employment relationship was more than a cause for the payment of the FRA but went to the character of the FRA when received by the Applicant as a Founder, with the result that in substance and reality the FRA received by the Applicant was the product of his income-earning activity.* The FRA was made to the Applicant as an individual who, together with JH, had been a Founder of UPL, in relation to the continuation of his employment and for the non-compete and confidentiality obligations related to that capacity, rather than a payment received by the Applicant because he was a transferor of shares in UPL." (emphasis added)

Note that, in *NQZG and FTC* (in contrast to the position in CR 2022/63), the additional amount was only paid to the founders (not all shareholders).

Statutory income under s 15-2 ITAA97

Section 15-2 ITAA97 brings to account as assessable income the value of all allowances, gratuities, compensation, benefits, bonuses and premiums provided to a taxpayer in respect of, or for or in relation directly or indirectly to, any employment of or services rendered by the taxpayer. There is significant cross-over between the matters considered above and the matters raised by s 15-2 ITAA97.

TOFA: s 230-505 ITAA97

Application of s 230-505 to deferred consideration

Section 230-505 ITAA97 applies where you start to have a Div 230 ITAA97 financial arrangement as consideration for the provision or acquisition of a "thing". Section 230-505 may potentially apply to a deferred consideration structure because the seller and buyer would each start to have a Div 230 financial arrangement (being the right to receive an amount of money in the future) in return for the provision (or acquisition) of shares.

Section 230-505 may apply even though only part of the consideration for the shares would be the deferred consideration (s 230-505(7)). Section 230-505 appears to apply even if only $1 of consideration is deferred as part of the transaction.

"(7) To avoid doubt, this section applies even if your starting or ceasing to have the financial arrangement mentioned in subsection (1) is only part of the consideration for the provision or acquisition of the thing."

If s 230-505 applies, it is necessary to work out the market value of the thing at the time at which you in fact provide or acquire it. This is relevant not just for the purposes for Div 230, but also for other provisions in the ITAA97 and the *Income Tax Assessment Act 1936* (Cth) (ITAA36) (s 230-505(2)).[24] Note 1 provides:

"Note 1: The amount may be relevant, for example, for the purposes of applying the provisions of this Act dealing with capital gains, capital allowances or trading stock to the thing."

The amount determined under s 230-505 is relevant for the purposes of applying the provisions of the ITAA97 dealing with capital gains (for the seller) and cost base (for the buyer). Further, s 230-505 is relevant for working out the amount of any gain or loss that should be brought to account under TOFA for the financial arrangement.[25]

CGT consequences: seller's perspective

The consequence of s 230-505 applying to the seller should be that, for CGT purposes, the seller's capital proceeds would be taken to be the market value of the shares at the completion time (which is the time that the seller would cease to have the shares and begin to have the financial arrangement), rather than the date of contract. Similarly, the proceeds of the financial arrangement are taken to be the market value of the thing acquired. The difference between the market value of the shares at completion and the deferred consideration received would be a gain (or, potentially, a loss) that is brought to account under Div 230 (with no CGT discount available in respect of that gain).

Example 3.6 of the explanatory memorandum to the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008 (the TOFA EM) provides an example of how s 230-505 might apply to a seller in respect of a deferred settlement:

"**Example 3.6 : Deferred settlement**

Bill Co had an agreement to sell land to Jim Co for $100,000 and agreed to allow Jim Co 18 months from the settlement date to pay.

In the hands of Bill Co, the land (a CGT asset), is held on capital account with CGT tax treatment.

At the settlement date, the market value of the land is $87,000.

Bill Co will start to have a financial arrangement on the settlement date consisting of its cash settlable right to receive $100,000 from Jim Co (section 230-45). The financial benefit provided under the financial arrangement is the land, whose value is $87,000 (subsection 230-60(1)).

For the purpose of calculating a capital gain or loss on disposal of the land, Bill Co is taken to have received capital proceeds from disposal of the land equal to the market value of the land, being $87,000 (subsection 230-505(2)).

Assuming the cost base of the land is $50,000, Bill Co will make a $37,000 capital gain. Given that the cost of the financial arrangement (being the market value of the land) is $87,000 and the proceeds of the financial arrangement are $100,000, Bill Co will make a $13,000 gain on the financial arrangement.

In the absence of the rule in section 230-505, assuming the whole of the deferred settlement amount is included as capital proceeds, the capital gain would have been $50,000 ($100,000 capital proceeds less $50,000 cost base) in addition to the $13,000 gain made on the financial arrangement. As a result, section 230-505 will ensure there is no duplication of gains or losses in respect of the transaction for all tax purposes."

Section 230-505 overrides the normal CGT rules regarding the calculation of a capital gain or loss in relation to a CGT event happening. That is:

- CGT event A1 generally happens when the contract for the disposal of shares is entered into, and the capital gain or loss is determined at that time (based on the amounts payable under the sale contract);
- however, s 230-505 would deem the capital proceeds to be market value as at completion, when the seller provides the entitlement to receive deferred consideration. Completion is at a later date to the date on which the share sale agreement is entered into;
- s 230-505 does not change the time at which a CGT event happens under the CGT provisions, only the consideration deemed to be received in respect of the CGT event; and
- as a result, it is possible that this could give rise to unexpected tax outcomes if there are differences between the value of the shares on the date on which the SPA is signed and completion.[26]

CGT consequences: buyer's perspective

Similar to the position of the seller outlined above, the buyer's cost base and reduced cost base in their shares under s 230-505 would be the market value of the shares at completion.

When the buyer prepares an allocable cost amount calculation, the buyer would generally recognise the market value of the shares plus its liability to the seller in step 1 and step 2 of s 705-60 ITAA97, respectively.[27] However, to the extent that the liability to pay the seller the deferred consideration amount would give rise to a deduction to the head company of the new consolidated group, an amount is not to be added (to the extent of that deduction) (s 705-70(1AA) and (1AB) ITAA97.

Observations on market value

Broadly, s 230-505 presupposes that the seller would only agree to receiving the financial arrangement (ie the deferred consideration) if the market value of the asset being sold is less than the total amount that would be received following completion. That is, the parties must have implicitly agreed that some part of the deferred compensation amount is referrable to the time value of money (ie the deferral), and the market value of shares at completion must necessarily be different to the total consideration expressed to be payable.

A valuer may seek to ascertain the market value of the shares at completion by working backwards and applying an implied interest rate to the amount that would be outstanding as at completion. It may be more challenging if the valuer is instead asked to ascertain the market value of the shares as at the completion date and then work out the implied financing. It is possible that the market value of the shares may fluctuate in the relevant period.

For example, if completion of the transaction is materially delayed due to regulatory approvals from the Foreign Investment Review Board or the Australian Competition and Consumer Commission, or if there are material public announcements regarding the shares being sold in that period.

Interaction with CGT market value substitution rule

The TOFA EM notes (at para 11.45) that s 230-505 does not generally affect the modification rules, special rules and specific rules in the capital gains regime (eg the market value substitution rule).

In relation to a share sale, the market value substitution rule applies if the capital proceeds are more or less than the market value of the share, and the buyer and seller are not dealing at arm's length[28] in connection with the event.

If the parties *are* dealing at arm's length, it would appear that s 230-505 would apply to set the capital proceeds for the shares (being the market value of the shares *on completion*). However, if the parties *are not* dealing at arm's length and s 116-30 ITAA97 applies, the market value (determined as at the *contract date*) would appear to be the appropriate amount to be capital proceeds. The impact on the resulting financial arrangement of not dealing at arm's length is discussed below.

Non-arm's length dealing: balancing adjustment

The market value of the "thing" (here, shares) is an integer in calculating any balancing adjustment under s 230-445 ITAA97 in respect of the financial arrangement that results from the share sale transaction (s 230-60 ITAA97).

If the parties are not dealing at arm's length in relation to the share sale transaction, s 230-510 ITAA97 can apply to ensure that arm's length values are used to calculate the balancing adjustment. In particular, s 230-510 applies where:[29]

- a balancing adjustment is made under s 230-435 ITAA97 in respect of the financial arrangement;
- the parties to the financial arrangement did not deal at arm's length in relation to the cessation, or complete or partial transfer, of the financial arrangement, or in relation to an earlier time (including when starting to have the financial arrangement); and
- the amount of the financial benefit received or provided under the financial arrangement at any time from (and including) starting to hold the financial arrangement until (and including) a complete or partial transfer or cessation is more or less than the financial benefit that might be reasonably expected to have been received or provided if the parties were dealing at arm's length.

Note that s 230-510 would not adjust the capital proceeds — only the amount brought to account under the relevant balancing adjustment. As a practical matter, the operation of s 116-30 (discussed above) and any adjustments made under s 230-510 should be the same or similar. However, there is no specific interaction between the two provisions.

Exclusions from s 230-505

Section 230-505 only applies where Div 230 applies

Section 230-505 only applies where gains and losses from the relevant financial arrangement which is consideration for the "thing" are subject to Div 230 (see s 230-505(1), and the reference in that section to a "Division 230 financial arrangement"). Section 230-505 would not apply where a taxpayer provides an asset to another party as consideration for a right to receive a payment of money from that party in the future (a cash settleable financial arrangement), in circumstances where gains and losses from that right are not subject to Div 230. For example, Div 230 may not apply because of the taxpayer's traits (s 230-455 ITAA97), or because the period for which the right to receive deferred consideration would be outstanding is less than 12 months (s 230-450 ITAA97).[30]

The parties to a share sale transaction may be required to recognise a different value for tax purposes in relation to the sale of their shares if one party is subject to TOFA and the other is not.

Carve-out in certain circumstances

There is a carve-out in s 230-505(3) if the shares are themselves a Div 230 financial arrangement (ie if gains and losses in relation to the shares are brought to account under Div 230[31]) and the starting or ceasing arrangement is not itself a financial arrangement. Example of 3.9 of the TOFA EM provides as follows:

> "**Example 3.9 : Exchange of shares**
>
> On 1 July 2010 Finance Co enters into an arrangement with Business Co to exchange its Share A with Business Co's Share B on 30 June 2012. Finance Co fair values both Share A and Share B, but not the agreement (the overarching financial arrangement).
>
> Both Share A and Share B are financial arrangements to which Division 230 applies pursuant to subsection 230-50(1). However, the exchange contract is not a Division 230 financial arrangement because it is not fair valued nor subject to the financial reports election (and the shares are not cash settlable). In other words, the overarching financial arrangement is not subject to Division 230.
>
> *Here there is no overarching financial arrangement to which section 230-505 needs to apply to ensure appropriate interaction between the arrangements.* Therefore, subsection 230-505(3) operates to prevent the application of subsection 230-505(2) to Share A and Share B. Instead the ordinary cost and proceeds rules in the income tax law will apply so that, absent unusual features of the arrangement, the value of Share B will constitute the proceeds for the disposal of Share A, and vice versa." (emphasis added)

Proceeds held in escrow

Section 230-505 would not usually apply to a payment made by the buyer to the seller that is held in escrow (for the seller's benefit). This is because the seller would have received all of their cash and the escrow arrangement is for security purposes only.

Non-receipt

Seller's perspective

CGT: non-receipt rule

If the capital proceeds are not received in full, the seller will want to amend their return to reduce the capital proceeds on the basis that the non-receipt rule in s 116-45 ITAA97 applies. There is no time limit for amending capital proceeds if the non-receipt rule applies (item 80 of the table in s 170(10AA) ITAA36).

The non-receipt rule applies where:

- the taxpayer is not likely to receive some of the capital proceeds;
- this is not because of anything that the taxpayer (or their associate) has done or omitted to do; and
- the taxpayer took all reasonable steps to get the unpaid amount.

The non-receipt rule effectively operates where the payor is unable to pay and all sensible steps have been taken to recover payment.

The non-receipt rule would not apply where instalment payments are ultimately not received as a result of the seller agreeing at any time after completion of the sale agreement to a reduction in the amount owing (see ATO ID 2003/635 and ATO ID 2003/636). However, if a shareholder tries to recover unpaid consideration but the buyer is not able to pay, the non-receipt rule would apply to reduce the capital proceeds (see PBR 1051652180989 and PBR 1051583203973), provided there is no settlement deed where the seller expressly accepts that position.

The non-receipt rule may not apply if some of the deferred consideration is no longer payable because of something that the seller has done. For example, the seller may warrant that they (or their associate) will remain employed by the target company for a period following completion. If that does not occur, the proceeds are to be reduced and the deferred consideration is not payable. In this situation, the non-receipt of the capital proceeds may be because of something that "you (or your associate)" did or omitted to do (s 116-45(1)(b)). That is, the seller (being "you" or an associate of the shareholder entity) did not stay employed and therefore did something, or failed to do something, that caused the non-receipt. Therefore, there would be no reduction in the purchase price that had previously been brought to account. It is difficult to reconcile this outcome with the normal "adjustment to purchase price" clause which applies if the seller is not required to pay the full amount. However, it appears to be the ATO's position based on the private binding rulings discussed above.

CGT event C2

If the deferred consideration has not been received and the seller has forgiven or waived the debt, the seller may make a capital loss in relation to the outstanding amount owed by the buyer. The outstanding deferred consideration amount would be a "debt" (being an enforceable obligation on the buyer to pay money to the seller).[32]

The market value substitution rule applies to CGT event C2 (s 116-30), so the amount of any capital loss would be limited to the difference between the cost base in the deferred consideration (ie the debt owed to the seller) and the market value of the debt.[33]

Any loss arising from CGT event C2 may not be valuable to the seller unless the loss is made in the same year in which the seller sells its shares to the buyer (and thus can be used to reduce any capital gain from the share sale).[34]

Bad debt deduction

A bad debt deduction would not generally be available for the non-receipt of proceeds relating to the sale of a capital asset. This is because:

- the debt (ie the outstanding deferred consideration) would not itself have been included in assessable income (s 25-35(1)(a) ITAA97). The deferred consideration would have been relevant for determining the amount of a capital gain or loss which would form part of any net gain or loss included in assessable income. However, the deferred consideration would likely be regarded as an integer in an amount included in assessable income rather than itself being included in assessable income:
  - a similar conclusion regarding a capital gain being an integer when calculating a net capital gain that is included in assessable income was made by the Full Federal Court in *Burton v FCT*.[35] The ATO decision impact statement for that case states:

    "Per the whole Court – the reference in subsection 770-10(1) to foreign tax paid 'in respect of … an amount included in your assessable income' was a reference only to the proportion of the foreign tax paid on the net capital gain that was included in assessable income, as determined by subsection 102-5(1)";
  - TD 2016/19 (in relation to trust distributions that are not recoverable) also reached the conclusion that s 25-35(1)(a) does not apply. This is because the amount owing was not itself included in assessable income. TD 2016/19 states:

    "12. The equitable obligation on a trustee to pay the amount of a UPE to a beneficiary is not generally a debt at law … However, regardless of whether or not the reference to a 'debt' in section 25-35 of the ITAA 1997 is intended, in context, to extend beyond common law debts to include relevant obligations due merely in equity … a deduction is nonetheless not available under that section for a UPE that has been 'written off'. This is because paragraph 25-35(1)(a) of the ITAA 1997 requires the relevant debt to be included in the taxpayer's income in that year or in an earlier income year …

    13. Where a beneficiary is presently entitled to a share of the income of a trust estate, that income of the trust estate is not included in their assessable income under subsection 97(1) of the ITAA 1936. Rather, under that subsection the beneficiary's assessable income includes that same share or proportion of the trust's net income (subject to special rules concerning the streaming of capital gains … and franked distributions … that apply for the 2011 and later income years)"; and
- the debt normally would not have arisen in respect of money that was lent in the ordinary course of business (s 25-35(1)(b)).[36]

TOFA

Balancing adjustment. If the seller is subject to Div 230 and s 230-505 has applied to the transaction, the seller needs to consider whether to recognise a loss in respect of the deferred consideration financial arrangement.

A balancing adjustment would arise under s 230-435(1)(b) if the seller's rights under the financial arrangement cease.[37] A cessation of all rights and/or obligations under a financial arrangement would generally extend to their discharge, satisfaction, expiry, closing out, forfeiture or maturing.

> "Any loss arising from CGT event C2 may not be valuable to the seller …"

The seller would compare the total financial benefits that they provided under the financial arrangement (the market value of the shares) with the financial benefits received (ie any cash actually received) and amounts previously included in assessable income.

If the seller received no cash up front, the seller should be treated as making a loss under s 230-445 equal to the market value of the shares plus any assessable amounts accrued on the deferred consideration financial arrangement. If the seller received some cash up front, this would reduce the TOFA loss.

However, any deductible loss would be limited by s 230-465 ITAA97 (the equivalent of s 70B ITAA36), such that the loss would be reduced to the extent that the loss is a loss of capital or a loss of a capital nature if there is an apprehension or belief that the buyer was likely to be unable or unwilling to discharge their liabilities to pay the deferred consideration. That part of the loss would be on capital account and recognised under CGT event C2 (discussed above), and any deductible loss recognised under the balancing adjustment provisions would likely be limited to the amount previously recognised in assessable income under the financial arrangement.

The capital loss may not occur in the same year in which the income had been recognised by the seller, which may limit the value of the loss.

Interaction with bad debt rules. Division 230 generally permits a financial benefit to be recognised only under Div 230 (and not under another provision of either the ITAA97 or the ITAA36). However, s 230-25(3) ITAA97 preserves the availability of a bad debt deduction (if available) under s 25-35 if the relevant financial benefit had previously been included in assessable income. This would not improve the availability of a bad deduction in relation to the non-receipt of deferred consideration.

Buyer's perspective

CGT: recoupment

If the buyer does not pay the outstanding deferred consideration, the buyer may need to reduce their cost base in the asset acquired as a "recoupment" (s 110-45(3) ITAA97). A "recoupment" includes any kind of recoupment, reimbursement, refund, insurance, indemnity or recovery, however described (see s 20-25 ITAA97). For example, if the seller forgives some of the outstanding consideration, s 110-45(3) would apply.[38] Similarly, a release of an obligation to pay deferred consideration where the seller's employment warranty has been breached should cause s 110-45(3) to apply.[39]

Debt forgiveness

Any debt forgiveness may result in tax consequences under Div 245 ITAA97 for the buyer if interest could have been deducted on the outstanding amount (s 245-10 ITAA97). As the deferred consideration relates to the acquisition of shares which may produce dividends, interest on such a borrowing would normally be expected to be deductible. However, Div 245 does not apply to the extent that the cost base of the buyer's asset would be reduced under s 110-45(3) (s 245-85 ITAA97).

TOFA

If the deferred consideration is no longer payable, the buyer would make a gain under the balancing adjustment in s 230-435(1)(b) because the deferred consideration arrangement ceases. The gain would be the difference between:

- the financial benefits received (ie the market value of the shares at completion) and deductions recognised under Div 230; and
- any consideration provided by the buyer to the seller.

Since the gain would be taken into account under the TOFA provisions, arguably no reduction in the cost base of the shares should occur under s 110-45(3) (see s 230-25, which gives priority to Div 230). However, that position is not clear because the TOFA gain is not strictly included in assessable income or allowable as a deduction in respect of the shares outside of Div 230.

Conclusion

The tax treatment of deferred consideration in respect of a share sale is more complex than first appears. There are complexities on what amount to recognise upfront, how to treat the embedded financial arrangement, and what happens if funds are not received. Recent ATO rulings have also shown that arrangements which might ordinarily be considered as earnouts can be taxed as deferred consideration.

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Partner
Allens

References

1 A similar commercial outcome to deferred consideration can be achieved if the consideration is not payable by instalments but the buyer pays some of the cash consideration into an escrow account (held for the benefit of the seller) that is held for a period, pending the resolution of claims.

2 This is the tax treatment if Subdiv 118-I ITAA97 applies. Alternatively, if Subdiv 118-I does not apply, the market value of the right to receive the earnout is included in the capital proceeds (for the seller) and the cost base (for the buyer) for tax purposes.

3 Including forward-looking warranties and indemnities, unless (it appears) they specifically relate to the earnings generated by the shares, in which case, the earnout would fall within the description of a reverse earnout.

4 Para 1.53 of the earnout EM.

5 *Scott v FCT* (1966) 117 CLR 514 at 526; *GP International Pipecoaters Pty Ltd v FCT* [1990] HCA 25.

6 *NQZG and FCT* [2020] AATA 379 (discussed below).

7 Note 2 to s 116-10 provides that s 230-505 ITAA97 modifies capital proceeds.

8 Arguably, deferred consideration is also "property", being a contractual promise by the buyer to pay an amount in the future.

9 Similar issues have been considered in relation to the sale of trading stock. See *J Rowe & Son Pty Ltd v FCT* [1971] HCA 80.

10 Para 10 of TR 2007/D10 (withdrawn).

11 *Chadwick v Pearl Life Insurance Co* [1905] 2 KB 507; *Just v FCT* (1949) 23 ALJ 47.

12 *Moneymen Pty Ltd v FCT* [1990] FCA 486 at [24] per Hill J: "A taxpayer may sell a capital asset for a stream of income, in which case the consideration he or she receives will be income in ordinary concepts."

13 [1905] 2 KB 507.

14 [1934] HCA 40.

15 In such shares and on such terms as he might by deed or will appoint, and, in default of appointment, in shares of one-quarter to each of the three daughters and one-quarter to the children of the deceased daughter.

16 [1949] ALR 438.

17 (1953) 89 CLR 428.

18 (1920) 1 KB 711 at 714–15.

19 Australian Taxation Office, *Issues concerning earnout arrangements (excluding arrangements that create look-through earnout rights)*, 3 December 2018.

20 *Reseck v FCT* (1975) 133 CLR 45 at 56.

21 *Reuter v FCT* (1993) 111 ALR 716.

22 The earnout did not comply with the requirements of Subdiv 118-I ITAA97.

23 [2020] AATA 379.

24 Section 230-505 ITAA97 provides an interaction between the provisions of Div 230 and the other provisions of the ITAA36 and the ITAA97, where a financial arrangement (or part of a financial arrangement) whose gains and losses are subject to Div 230 is provided or received as consideration for a thing.

25 In particular, in relation to a balancing adjustment in relation to the financial arrangement (see note 2(a) in s 230-505(2)).

26 For completeness, where CGT event A1 occurs at completion (eg in the context of a scheme), there should be limited differences.

27 Note that s 705-65(5B) ITAA97 has no work to do because there is no contingency relating to the deferred consideration.

28 As noted by Peter Fraser in his June 2021 Gunn Club presentation, the question of whether parties are dealing at arm's length is complex.

29 Para 20.79 of the TOFA EM.

30 Generally speaking, the exclusion in s 230-460(13) ITAA97 should not apply in this context on the basis that the right to receive (and the obligation to provide) the deferred consideration in connection with the share sale would not be "contingent on aspects of the economic performance" of the business after the sale. As discussed above, unlike an earnout, the obligation to pay the deferred consideration is generally not contingent on events happening.

31 For example, under the fair value method in Subdiv 230-C ITAA97.

32 A debt does not cease to be an enforceable obligation simply because repayment is postponed or deferred (*FCT v Tasman Group Services Pty Ltd* [2009] FCAFC 148).

33 Note that the market value of the debt should be worked out as if the event had not occurred and was never proposed to occur (s 116-30(3A)).

34 Note that the loss carry back rules in Subdiv 160-B ITAA97 do not apply to capital losses and in any case ceased to apply following the income year ending 30 June 2023.

35 [2019] FCAFC 141.

36 Perhaps, except for a bank that is selling a capital asset, depending on the arrangements.

37 This assumes that: (1) the right to receive the deferred consideration is not an equity interest and neither the fair value method nor the elective financial reports method applies to it (s 230-440(1) ITAA97); and (2) the various other exceptions to the balancing adjustment rules do not apply.

38 Minutes of the Taxation Liaison Group Capital Gains Tax Subcommittee meeting, April 1990.

39 By analogy, if a limited recourse loan is used to acquire an asset and does not need to be repaid in full, there is a recoupment in respect of the CGT asset (see ATO ID 2013/64).

Tax and estate planning in 2024: what's "hot" right now?

by Matthew Burgess, CTA,
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In light of ongoing changes to the taxation regime and the expanding wealth of Australia's ageing population, there has for many years been a growing need for estate planning to utilise appropriate tax structuring. Holistic estate planning related areas have largely been outliers from radical simultaneous rule overhauls. Since 2018, this historical position appears to have changed with a range of announcements, possibly permanently. Subsequent years have seen evolution in a number of areas, including trust vesting, trust splitting, testamentary trusts, excepted trust income and family trusts. Near the start of a new calendar year, it is timely to explore a number of the most critical developments in the tax and estate planning arena over the last 12 months – or, in the vernacular of the movie *Zoolander*, what's so hot right now?

Introduction

In light of ongoing changes to the taxation regime and the expanding wealth of Australia's ageing population, there has for many years been a growing need for holistic estate planning to utilise appropriate tax structuring.

Around this time last year, an article in this journal[1] explored a number of key tax and estate planning related changes, including:

- trust distributions and trustee duties;
- regulating the assets of related entities;
- asset protection and the "gift and loan back" strategy,[2] particularly in light of the decision in *Re Permewan No. 2*;[3] and
- superannuation.

Twelve months on, this article examines the following key tax structuring and estate planning related developments in 2023, namely:

- lost trust deeds;
- loans, gifts and books of account;
- trusts and asset protection in family law situations; and
- a further key development in relation to superannuation and estate planning.

Lost trust deeds

As explored in previous articles in this journal,[4] lost trust deeds are a critical issue for all tax advisers and their clients.

The issues in relation to lost trust deeds appear to have intensified in recent years, at least in part driven by financiers complying with the "know your customer" regime.[5]

In the equivalent article last year in this journal, the decision of *Mantovani v Vanta Pty Ltd (No. 2)*[6] was explored in relation to the fiduciary duties owed by trustees, including in relation to securely retaining custody of the original, wet-signed, trust instrument and all variations.[7]

Fiduciary trustee duties are generally seen as the most onerous of all legal duties and, where they apply, they require a person to act solely in another party's interests.[8]

The decision in *Jowill Nominees Pty Ltd v Cooper*[9] underlines the importance of two of the key fiduciary trustee duties of any form of trust. That is, the duty of a trustee to know the terms of the trust deed, and to keep the original and, at least before November 2021, wet- (not electronically) signed trust instrument safe and secure.

Broadly, the factual matrix involved a trust that was established in 1976 and had, for many years, had as its substantive asset shares in Coopers Brewery Ltd. The original trust deed was unable to be located and there was also no copy of the document.

There was, however, an advice letter from a lawyer in 2007, based on a review of the original trust deed, that explained a number of key provisions, including the range of beneficiaries. Other aspects were also able to be reverse-engineered, such as the probable perpetuity period and the fact that the deed likely permitted capital distributions.

The capital distribution power was assumed to exist by the court on the basis of the lawyer's evidence that, if it did not, this would have been flagged in the advice letter, particularly because the lawyer confirmed that no trust deed read in 45 years of practice failed to contain such a provision.

The court confirmed that, under the relevant state-based Trustee Act, it could vary the trust deed (effectively adopting a new deed here), so long as the following tests were met (all of which were met, primarily due to the evidence of the lawyer that provided the 2007 advice letter):

- there is good reason to make the proposed exercise of powers;
- the proposed exercise of powers is in the interests of beneficiaries;

- the proposed exercise of powers will not result in one class of beneficiaries being unfairly advantaged to the prejudice of another class (here, it was critical that all beneficiaries were represented before the court);
- the proposed exercise of powers accords as far as reasonably practicable with the spirit of the trust;
- the proposed exercise of powers will not disturb the trust beyond what is necessary to give effect to the reasons for the revocation or variation; and
- the application is not substantially motivated by a desire to avoid or reduce the incidence of tax.

The deed approved by the court was based on a precedent as at 1978 of the firm that had likely drafted the trust deed, adjusted to align with the advice from 2007.

While the court did consider a request to simply revoke the trust, it ultimately confirmed its preference to approve the varied, adopted trust deed as it was the least disruptive approach. The court confirmed that the trustee could choose to exercise its discretion to make a capital distribution of the assets of the trust and subsequently vest the trust, relying on the terms of the court-approved deed.

The original decision in the case of *Mantovani v Vanta Pty Ltd (No. 2)*[10] and the appeal decision in *Vanta Pty Ltd v Mantovani*[11] starkly demonstrate that serious consequences flow where a trustee fails to maintain, and be familiar with the terms, of the full original trust deed.

In a factual matrix that centred around a trust where, despite extensive searches, only the schedule of key details could be located, the court considered the following six key issues (with the conclusion also noted briefly, before being explored in more detail below):

- Question 1: Was the trust deed lost? Answer: Yes.
- Question 2: Could secondary evidence be relied on to prove the existence and contents of the lost trust deed? Answer: No, although this conclusion was reversed on appeal.
- Question 3: Could the presumption of regularity be relied on to save the trust from failing? Answer: No.
- Question 4: Did the trust fail for uncertainty? Answer: Yes, although again this conclusion was reversed on appeal.
- Question 5: Should a declaration be made that the trustee held the trust property on a resulting trust for the settlor (or their estate)? Answer: Yes, although this conclusion was essentially made irrelevant due to the appeal decision determining that the trust had not failed for uncertainty.
- Question 6: Should an order for the taking of accounts and payment of moneys by the trustee owed to the settlor be made? Answer: Yes again, however, this was a conclusion which was reversed on appeal, given the trust was held to have not in fact failed.

On the basis of evidence showing that reasonable searches and inquiries had been made with all relevant persons, legal and accountancy firms, and third-party authorities that could have been expected to hold a copy of the trust deed, without success, the court concluded that the deed was lost.

Although a number of cases were discussed in relation to the secondary evidence requirements, arguably, the leading case for where a trust deed has been lost is *Maks v Maks*.[12] In this case, the court concluded that, where secondary evidence is being relied on to prove the existence of a trust, there must be clear and convincing evidence not only of the existence of the trust, but also of the terms of the trust.

In particular, as confirmed in *Chase v Chase*,[13] there needs to be evidence to satisfy the "three certainties of a trust", that is:

- the identity of the beneficiaries;
- the property the subject of the trust; and
- the nature of the trust (ie whether fixed or discretionary).

Generally, to satisfy these tests, the successful cases are those where the text of the missing document has been able to be reproduced in full.[14] Furthermore, the court must be "vigilant, being fully cognisant of the dangers of error and fraud, and the gravity of the consequences flowing from any finding made".[15]

In *Mantovani v Vanta Pty Ltd (No. 2)*,[16] the court in the initial trial confirmed that, while the schedule provided some basic information about the trust, it fell well short of providing clear and convincing proof of the contents of the trust deed. Therefore, the trust necessarily failed for uncertainty.

On appeal, however, the court concluded that the adoption of the "clear and convincing" proof test can produce two anomalies, namely:

1. it imposes too high a burden on the party endeavouring to prove the existence of the relevant facts, rather than respecting the reality that there can be a range of secondary evidence (oral and written) which assists in establishing the contents of a missing document, provided the facts and inferences to be drawn are established on the balance of probabilities; and
2. in a number of cases (including the initial trial judgment in this case), the emphasis on the strictness of this test conveys that, in the case of a missing document, only a facsimile or duplicate of the original document in its entirety will suffice in establishing sufficient proof of the terms of the document, which is incorrect given it essentially implies that almost all (if not all) of the terms of the deed need to be proven to avoid a finding that a trust has failed for uncertainty.

Instead, the key question is whether there is sufficient proof of the essential terms of the deed such that the missing deed does not cause the trust to fail for uncertainty. In the absence of a full copy of the deed, proof of the relevant facts and inferences (to be drawn from those facts) can be established on the available secondary evidence.

In what is arguably a timely reminder for all trust advisers, the trial judge confirmed that the obligation to act in strict conformance with the terms of a trust deed is "perhaps the most important duty" of a trustee.[17]

Where, as here, the deed has been lost, there is a material risk that a trustee will be held to be unable to discharge this overriding obligation and will be held to be acting in breach of trust.

At the initial trial, it was concluded that the trust must be held to have failed due to the lack of certainty of its terms. Indeed, the court confirmed that any decision by it that permitted the trustee to continue to deal with trust assets and administer the trust would effectively have amounted to sanctioning further breaches of trust.

On appeal, however, in direct contrast to the trial judge, the court confirmed that:

- there was sufficient evidence available as to the essential provisions of the trust to hold that it subsisted and remained valid;
- the court has the power to make orders or give directions as to the further administration of a trust, including adducing further evidence, determining the likely duration of the trust, and making orders as to the scope of the trustee's management powers;
- the court can also make any other orders to ensure that the trust is administered as intended; and
- a conclusion that a trust remains validly in existence is a far more preferable approach if it is consistent with the accepted evidence of the key parties (eg the settlor and the trustee), and the court should generally be reluctant to declare a trust as failing for uncertainty.

However, the fact that the lost trust deed caused both the initial trial and the appeal case (with each reaching radically different conclusions on the key issue) should be a stark warning to all trustees and their advisers. Indeed, what would, in all likelihood, have been material costs of the court cases further reinforces the adverse consequences that can flow from lost trust deeds.

As is the case in every lost trust deed situation, all of the issues that arose in this case would have been avoided had the trustee discharged its duty of ensuring not only that the original trust deed was kept securely, but that it was also read and complied with.

In other words, in addition to securely storing constituent trust documents, the trustee (and its advisers) should have embraced both of the "read the deed" and "heed the deed" mantras.

The appeal decision in this case does seem to provide some comfort for those involved with lost trust deeds, particularly given cases such as:

- *Re Cleeve Group Pty Ltd*,[18] where it was confirmed that, if there is a full copy of the deed (even if unexecuted), there is either no need to prove the terms through "clear and convincing" evidence, or if there is a need, the terms of the draft documents provide that "clear and convincing" evidence. Subsequent cases have also reached the same conclusion;[19] and
- *DR McKendry Nominees Pty Ltd*,[20] where a lost trust deed was accepted as being in the form of a solicitor's usual pro forma deed from the relevant era.

Loans, books of account and gifts

In estate planning arrangements, there are a range of relevant issues where two parties potentially owe mutual liabilities or obligations, including documenting the arrangements through books of account.

The case of *Horn v GA & RG Horn Pty Ltd*[21] provides a useful summary of the key principles to be considered in relation to loans, book entries and gifts.

In relation to loans and book entries, the court specifically confirmed the principles summarised below.

A loan is ordinarily understood to be an advance of money, coupled with a contract for its repayment.[22]

The intention of the parties to a loan, usually, is that ownership in the funds passes to the borrower and the lender is left with an in personam right, secured or unsecured, of repayment.[23]

Statutory provisions may extend the concept of a loan beyond that understood under the general law. For example, the provisions of Div 7A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) define a "loan" as including: not only an advance of money, but also a provision of credit or any other form of financial accommodation; a payment of an amount for, on account of, on behalf of or at the request of, an entity, if there is an express or implied obligation to repay the amount; and a transaction (whatever its terms or form) which in substance effects a loan of money (s 109D(3) ITAA36).

The party asserting that a loan exists bears the onus of proving that the payment of moneys should be characterised as a loan or in some way other than as a gift.[24]

The aforementioned onus is not discharged by mere proof of the payment itself.[25]

A payment of money may be made by making a journal entry in books of account where there is agreement by the relevant parties that payment be made by that means.[26]

Often a journal entry is simply shorthand for money or a cheque being handed across the table and money or a cheque being handed back.[27]

Conversely, a payment of money (purportedly) made by making a journal entry in books of account without reference to, or without the agreement of, the persons said to be the recipients of the money is ineffective in establishing a debt or any payment of money in discharge of such debt.[28]

Sometimes an agreement may be inferred between related companies to make payment by book entries, for example, where the companies were or are part of a wholly-owned group, share common directors, the group business is operated through a single bank account, the companies' accounts are all the subject of declarations by directors under the *Corporations Act 2001* (Cth) stating that they give a true and fair view of the financial position of the entity in question, and like (or similar) directions are made by independent auditors.[29]

That said, the existence or otherwise of an enforceable agreement depends ultimately on the manifest intention of the parties, objectively ascertained. Where mutual promises are sought to be inferred, the conduct relied on must, on an objective assessment, evince a tacit agreement with sufficiently clear terms. It is not enough that the conduct is consistent with what are alleged to be the terms of a binding agreement. That is, the evidence must positively indicate that both parties considered themselves bound by that agreement.[30]

A loan may arise where it is within the scope of the authority of an accountant to characterise a payment as a loan. Thus, as an example, in *Di Lorenzo Ceramics Pty Ltd v FCT*,[31] a loan was found to exist where:

- none of the directors or members of the relevant companies had given close attention to the legal character that the payments made by company A on account of the liabilities of a trustee company (being a trustee of a unit trust) was to bear;
- there was no evidence of an express agreement that the amounts were to represent either a loan or a subscription for additional units (and there was no suggestion that they were intended to be a gift);
- there was no agreement that the amounts were to be repaid by a particular date;
- there was no agreement that any particular number of additional units was to be issued; and
- the directors were content to leave the proper characterisation of the payments to the accountant as he saw fit and to prepare the company's and the unit trust's financial statements and tax returns accordingly. The evidence of an express instruction in the form of reference to a loan to the trustee company written against entries in company A's bank statements that were provided by a director to the accountant were able to be regarded as her acquiescence in the course that the accountant was already taking.

In relation to gifts, the court also confirmed:

- there is a presumption that a parent who provides money to a child (including adult children) has advanced the money as a gift;[32]
- in family or domestic transactions, there is always a preliminary issue for the party seeking to challenge a payment as to whether it is accompanied by any intention to create or affect legal relations;[33]
- it is no longer presumed that, in domestic transactions, the parties do not intend to create legal relations. The modern principle is that the issue is one of onus of proof for the plaintiff, who must prove that there was an intention to create legal relations;[34]
- a payee cannot, by subsequently describing an advance in language consistent with a loan, alter the status of the advance if it was in fact a gift, although the payee can gift (or forgive) moneys that were originally the subject of a loan;[35] and
- generally, once moneys are gifted, they cannot be recalled.[36] That is:

  "Gifts cannot be revoked, nor can deeds of gift be set aside, simply because the donors wish they had not made them and would like to have back the property given. [Therefore], where there is no fraud, no undue influence, no fiduciary relation between donor and donee, no mistake induced by those who derive any benefit by it, a gift, whether by mere delivery or by deed, is binding on the donor."

Ultimately, particularly in tax and estate planning situations, the factual matrix and evidence will be critical. For example, in *Russell and Dunphy v Dunphy*,[37] various alleged loans by a will-maker to an adult child were all held to be unsubstantiated. This conclusion was at least partly due to the fact that, essentially, the only evidence of their existence were handwritten Post-it notes pinned to a cork board on the floor next to the will-maker's desk.

The court confirmed that the Post-it notes made no reference to a loan, and the relevant child denied both having been shown the Post-it notes and borrowing the amounts mentioned. Therefore, the Post-it notes did not establish a loan.

> "… serious consequences flow where a trustee fails to maintain … the full original trust deed."

At most (assuming that the Post-it notes purported to record a loan), they were evidence of an uncommunicated, subjective intention harboured by the will-maker and therefore could play no part in the objective assessment of whether there was a contract of loan.

A further element in relation to a number of the alleged loans was that any potential cause of action was statute-barred long before the proceedings began, despite the parties alleging the loans arguing that the cause of action of a loan on demand arose when demand was given.

However, the court confirmed that it is well established that a loan of money on request creates an immediate debt (ie repayable on demand) – and the debt which constitutes the cause of action arises instantly on the creation of the loan, not on any subsequent demand for repayment.[38]

Trusts and asset protection in family law situations

Previous articles in this journal have explored numerous aspects of the ability for the Family Court to "look through" trust structures and attack the underlying assets.[39]

The decision in *Balken & Vyner*[40] provides an important reference point as an example of the approach that the Family Court takes in relation to family trusts, and one that we have seen adopted in subsequent situations that have been settled prior to trial.

Broadly, the factual matrix in this case was as follows:

- a couple, both previously married, had a period of perhaps a few years as de factos prior to their marriage (there was a debate as to when a de facto relationship may have started);
- the couple were married for six years;
- the majority of the asset pool was owned via trusts; and
- the majority of the trusts were created by, and the assets held via them contributed by, the husband's father (who died shortly before the couple married).

There was significant disagreement between the spouses on almost every substantive issue before the court, including the overall value of all assets, with the wife's estimate ($63m), more than double the husband's ($31m).

Specifically in relation to the level of control of the trusts that the husband had (and therefore, in turn, the ability for the court to apportion assets held via the trusts to benefit the wife), the key comments outlined below were made.

The husband was not the sole appointor of key trusts, nor the sole director or shareholder of the trustee companies.

The husband's father had left a letter of wishes[41] addressed to the directors and shareholders of the trustee company setting out his instructions.

There were independent directors of the trustee companies, and these persons were also appointors. The directors held regular meetings and exercised their discretion in relation to the income and capital of the trusts in accordance with the letter of wishes and there was no evidence which suggested that they would not continue to do so.

The accepted evidence was that the directors of the trustee had always acted, and would likely continue to act, in accordance with the wishes.

This meant that the husband had a present entitlement to 40% of the income and 40% of the capital, but only on the trusts vesting, as opposed to the 100% immediate entitlement to all income and capital of the trusts suggested by the wife.

The court confirmed that the evidence clearly demonstrated that the husband did not control the trusts, nor could he use the assets of the trusts for his own purposes.

In particular, there were regular meetings of the directors of the trustee companies. The husband reported to those meetings and was required to account to the other trustees and justify his actions.

To the extent that the husband was responsible for the day-to-day management, an independent director (a consultant to the group) reviewed the accounts and queried the husband about particular transactions. The husband was required to justify his actions to the other directors (which included a partner at a law firm) and ultimately to the beneficiaries.

The evidence also demonstrated that, if the husband received more than he was entitled to, according to the terms of the letter of wishes, any amount over and above was debited against his loan account and he was either required to repay those amounts or pay interest on any loan account balance.

Ultimately, the asset pool was decided to be in the region of $35m, which effectively excluded a number of assets held in the trusts due to the practical limitation on the husband's potential entitlements imposed by the letter of wishes.

The husband suggested a 85%–15% split in his favour. The wife suggested 65%–35% in the husband's favour.

In a detailed balancing of the contributions, the court made a primary allocation of 77.5%–22.5% in favour of the husband, with a further adjustment to benefit the wife, making the final allocation 75%–25% in favour of the husband.

Despite the above points highlighted by the court, advisers must be mindful of the fact that the significant emphasis placed on the letter of wishes and the fact that the Family Court held that the trustee directors essentially considered themselves bound by it need to be considered in light of wider trust principles. For example, the potential tax and stamp duty consequences of the letter of wishes, perhaps causing the various trusts to be amended, were not explored.

Furthermore, neither the rules against trustees fettering their discretion,[42] nor whether the trustee directors were otherwise discharging the three key obligations on a trustee exercising a discretion, were explored, namely:

- to do so in good faith;
- on a real and genuine consideration (a requirement that is so obvious that it is often not mentioned); and
- in accordance with the purpose for which the discretion was conferred.

A key development regarding superannuation and estate planning

Perhaps the most controversial intersection of tax, estate planning and superannuation laws is "fast death tax".

So-called "fast death tax" arises where funds that could otherwise be withdrawn tax-free by the member of a superannuation fund during their lifetime, remain in the fund at the date of death of the member and are then subject to tax on the distribution from the fund.

There are generally three potential pathways to manage this form of death tax:

1. ensure that the funds are withdrawn prior to death, while the member has capacity;

2. implement a complementary enduring power of attorney, allowing an attorney to withdraw funds if a member loses capacity and ensuring that the withdrawal is completed before the member's death; and
3. the member could sign a direction as to future withdrawal, with the effective date defined as being (say) one day prior to their death. In relation to this approach, if a complementary enduring power of attorney is in place, the attorney could sign such a direction.

The first two approaches appear to be accepted by the ATO. The third approach had historically been approved in a number of private binding rulings[43] issued by the ATO, but not publicly.

This approach relies primarily on s 307-15 of the *Income Tax Assessment Act 1997* (Cth) which provides:

"(1) This section applies for the purposes of:

(a) determining whether a payment is a ***superannuation benefit***; and

(b) determining whether a superannuation benefit is made to you, or received by you.

(2) A payment is treated as being made to you, or received by you, if it is made:

(a) for your benefit; or

(b) to another person or to an entity at your direction or request."

While, generally, a death benefit is defined as being a payment made to someone due to the death of another person, a payment under s 307-15 would seem to create a pathway that allows a payment to be held to have been made to a member, despite the fact that they have died.

A key aspect to supporting an argument along the lines outlined above, based on the private binding rulings issued by the ATO, is that the direction signed by the member must be drafted to specifically confirm reliance on s 307-15.

Furthermore, it should be noted that the private binding rulings issued by the ATO do not consider whether the anti-avoidance provisions under Pt IVA ITAA36 may be applicable to a direction as to future withdrawal designed to effectively sidestep the potential triggering of fast death tax.

The robustness of the above summarised approach is also subject to the ATO publication *Paying superannuation death benefits*,[44] which is outlined below.

If a member requests an amount to be paid from their fund before they die, but dies before they receive it, it may be a member benefit in some "limited" cases. The outcome in this regard is said to be "determined by the facts and circumstances surrounding the payment".

The relevant facts and circumstances listed by the ATO are set out as including:

- the terms of the request from the member;
- the terms of the trust deed and any other governing rules;
- the knowledge of the trustee at the time the payment is made (including whether the trustee is aware that the member has died);
- the entity that the payment is being paid to (eg the member's personal account or an account in the name of the member's legal personal representative);
- the circumstances and timing of the payment; and
- whether the payment is made because of, and in line with, the request made by the member.

Critically, the examples provided[43] by the ATO draw particular distinctions on the following items, apparently making them key factors in determining whether a payment after death is a member benefit or a death benefit:

- whether the trustee was aware that the member was deceased at the time of the payment (with the trustee being unaware supporting a conclusion that the payment is a member benefit); and
- whether the payment was made to an account in the name of the member or in the name of the member's legal personal representative (with payment to the member's account supporting a conclusion that the payment is a member benefit).

As flagged in the examples, this seems to indicate that the ATO believes that SMSFs will be unlikely to substantiate payment of a member benefit (as opposed to a death benefit) post-death (since the trustee is almost certain to be aware that the member has died) as compared to an APRA or retail fund where the trustee may be unaware of the member's death at the date of payment.

Furthermore, unless the purported member benefit payment is supported by the trust deed and implementation documentation and is made to the bank account of a member, any payment following a member's death is likely to be treated by the ATO as a death benefit.

These conclusions are arguably confirmed by subsequent ATO private binding rulings. For example, in two separate rulings where requests for withdrawal to retail funds were submitted on the day of, but before, the relevant member's death, the ATO reached following conclusions:

- with the first situation, the payment was treated as a member benefit, primarily on the basis that the trustee of the superannuation fund was not aware of the member's death before it paid the lump sum benefit;[45] and
- in the second factual matrix, the payment was treated as a death benefit, as the original request was held to be invalid on the basis that it was an electronic (as opposed to a wet-signed) request (wet-signed requests being a requirement for valid instructions under the rules for the fund), and the subsequent wet-signed request was sent after the date of death at a time when the trustee was aware that the member had died.[46]

The ATO approach appears to reinforce its view that SMSFs will never be able to rely on a withdrawal request made, but not completed, before death. That said, based on the reasoning in the above private binding rulings, it may in fact be the case that a payment after the death of a member by an SMSF could be a member benefit where the SMSF is administered by an external adviser (eg an accountant or an SMSF administrator).

A subsequent ruling[47] also provides context as to the approach that the ATO is taking in this area.

While it is unclear, under the later ruling, whether the fund was an SMSF, the key elements of the factual matrix were as follows:

- the relevant member lacked legal capacity and, as there was no enduring attorney document, the member's niece and niece's husband were appointed by a state tribunal as administrators;
- the administrators completed a withdrawal and account closure form for the member's account-based pension, and submitted it to the fund before the member's death; and
- payment of the benefit into the member's personal bank account was made one day after their death.

Applying reasoning similar to that summarised above, the ATO concluded that the payment was a member benefit, based specifically on the following:

- an assumption that the benefits were paid in accordance with the trust deed and other governing rules;
- the lump sum was paid into the member's personal bank account, the trustee was unaware of the member's death and payment of the lump sum was paid one day after death, and therefore the trustee made the payment with the expectation that the member would be alive to receive it; and
- the timeframe between the trustee becoming aware of the member's death shortly after it occurred and the payment being made one day after the member's death indicated that the payment was made because of, and consistent with, the member's request (via their administrator) as a member benefit payment.

Conclusion

In modern estate planning, significant complexities from the interaction between the legislation relating to tax, trusts, bankruptcy, family law and superannuation have been omnipresent.

To coin a related estate planning phrase, "in this world nothing can be said to be certain, except death and taxes"[48] – and, arguably in Australia, changes to the superannuation regime.[49]

As has been the case in each of the last few years, there are fundamental reasons why specialist tax and structuring advice will remain critical components of any holistic estate planning exercise.

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Acknowledgment

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18 [2022] VSC 342.

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20 [2015] VSC 560.

21 [2022] NSWSC 1519.

22 See *Papas v Co* [2018] NSWSC 1404.

23 See *Ying v Song* [2010] NSWSC 1500.

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28 Again, see *Manzi v Smith* [1975] HCA 36.

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30 See *Adnunat Pty Ltd v ITW Construction Systems Australia Pty Ltd* [2009] FCA 499.

31 [2007] FCA 1006.

32 See *Calverley v Green* [1984] HCA 81.

33 See *Voce v Deloraine* [2012] NSWSC 1187.

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35 See *Jukka Pekka Kemi v Peter Hedley Wood* [2013] NSWSC 180.

36 See *Ogilvie v Littleboy* (1897) 13 TLR 399.

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41 The letter of wishes is reproduced in the judgment and provides compelling reading for advisers in this area. Please make contact with the author if you would like access to the extract, without needing to read the entire case.

42 See *Dagenmont Pty Ltd v Lugton* [2007] QSC 272.

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44 Australian Taxation Office, *Paying superannuation death benefits*, QC 45254, 10 February 2023.

45 PBR 1052091672127.

46 PBR 1052097327812.

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48 Attributed to American statesman Benjamin Franklin.

49 Arguably attributed to most specialist advisers.

A Matter of Trusts

by Kseniia Gasiuk, Associate, Sladen Legal

Discretionary trusts in tax consolidated groups

In the constantly evolving realm of Australian taxation, this article delves into the strategic advantages, challenges and recommendations for using discretionary trusts within consolidated groups.

Introduction

In the dynamic world of Australian taxation, where the rules seem to change as often as the seasons, private groups are on a relentless quest for innovative solutions. Their mission? To find entity structures that can dance gracefully between the realms of tax efficiency and operational agility.

Discretionary trusts, those elusive chameleons, are a powerful choice, thanks to their innate flexibility and the tantalising promise of tax benefits. However, for consolidated private groups, the integration of discretionary trusts is far from a straightforward waltz – it's a captivating dance full of twists, turns and hidden complexities.

It may come as a relief that the primary purpose of this article does not intend to ensnare you in the complex dance of the consolidation regime; rather, it seeks to shed light on the strategic use of discretionary trusts within consolidated groups. The author's goal is to reveal potential pitfalls and hurdles and, more importantly, to provide prudent recommendations for successfully navigating these complexities.

Discretionary trusts in consolidated groups: benefits

Consolidation requires meticulous consideration before implementation. While the question of whether a discretionary trust can become a member of a consolidated group presents challenges, once a discretionary trust is a member, it can provide benefits to the group that are not available with corporate entities or unit trusts.

Discretionary trusts are remarkably adaptable in the constantly shifting landscape of consolidation, serving as both "bulwarks" for asset protection and catalysts for planning within these groups. Recognising their role in consolidated groups is key to comprehending the associated challenges.

In the following section, the author examines the intricacies of dividend traps and how discretionary trusts within consolidated groups can provide a shield against them, while also offering enhanced asset protection, flexibility in distributions, and tax-efficient income accumulation.

Mitigating the risk of dividend traps

A dividend trap, in the context of consolidated groups, is a situation where a company, typically within a complex corporate structure involving multiple subsidiary and intermediate holding companies, faces significant hurdles when attempting to distribute profits to its shareholders. This challenge arises due to the stringent criteria and corporate requisites that must be met before dividends can be paid out.

To comprehend the concept of a dividend trap, it is important to understand that, even though a group of wholly owned companies is treated as a single tax entity under tax consolidation, certain important corporate tests are still applied separately to each company within the group when paying dividends. Therefore, when a company wishes to pay dividends to its shareholders, each legal entity, as it returns profits within the corporate hierarchy, must successfully navigate and satisfy these specific tests.

Now, imagine a scenario where profits generated by trading subsidiaries need to traverse through a series of intermediary holding companies before ultimately reaching the primary parent company. Herein lies the potential for a dividend trap. If these intermediary holding companies have accumulated losses or their financial standing is less than optimal, it creates a precarious situation where the distribution of profits can be "trapped" at an intermediate level. This phenomenon is what is referred to as a "dividend trap" (see Diagram 1).

If an income-earning discretionary trust is a member of the consolidated group, the discretionary trust can strategically distribute income to the intermediary holding companies to offset losses or "top up" net assets in the company, causing the dividend trap (see Diagram 2).

Although this will not change the amount of tax payable by the head company, it can help to reduce dividend traps in the group or improve the balance sheets of group entities.

Enhanced asset protection

Discretionary trusts provide an extra layer of protection for the consolidated group's assets. Since the beneficiaries of a discretionary trust have no direct ownership of the trust's assets, those assets are less at risk from creditors or legal claims made against other members of the group. This protection is particularly crucial in industries that are at a higher risk of legal action, such as construction, manufacturing, healthcare and hospitality.

A notable exception to this is joint and several liability for tax debts unless there is a valid tax sharing agreement (TSA) in place. In a consolidated group, the head company is responsible for paying the income tax-related liabilities for the entire group.[1] If the head company fails to pay the tax

Diagram 1. Consolidated group without discretionary trust

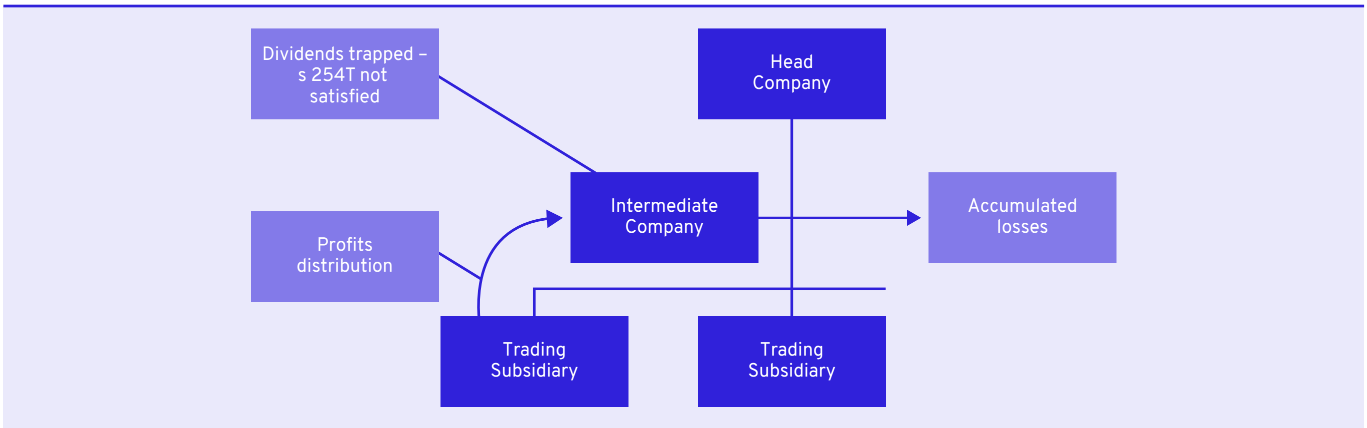
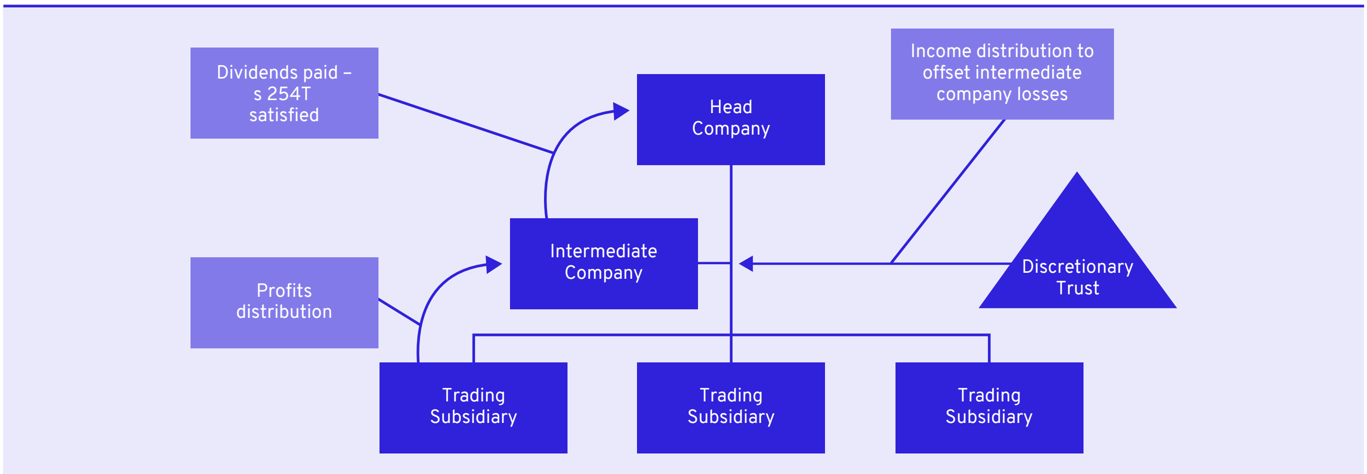


Diagram 2. Consolidated group with discretionary trust[2]



liability in full by the due date, the contributing members of the group become jointly and severally liable for the group liability. However, contributing members are not jointly and severally liable if they have a valid TSA.[3]

Flexible distributions

Due to the single entity rule, the income and assets of subsidiary members in the consolidated group are treated as if they are of the head company.

Income can be distributed, and assets transferred, within the consolidated group. In certain circumstances, a discretionary trust can provide flexibility in managing and distributing income and assets within the consolidated group.

Income accumulation

Normally, for a discretionary trust that is not part of a consolidated group, accumulating income (retaining profits within the trust instead of distributing them to beneficiaries) is not a common practice. The primary reason for this is that the trustee of the trust faces tax of 47% on the accumulated income.

In a standalone discretionary trust, income is usually distributed to beneficiaries and taxed at their marginal tax rates, which may be more favourable than the trustee's rate. However, if income is accumulated within the trust, it is subject to a tax rate of 47%.

To avoid the high tax rate on accumulated income, trustees may employ complex strategies, such as the use of corporate beneficiaries, together with unpaid present entitlements. These strategies involve distributing income to entities that are taxed at more favourable rates. These can lead to intricate tax issues and compliance requirements that this article does not explore further.

In contrast, when a discretionary trust is a member of a consolidated group, and if the trust's deed allows for it, the trust can accumulate income without facing the 47% tax rate.

Accumulated income in a discretionary trust within a consolidated group is taxed at a lower rate, usually 25% or 30%, depending on the circumstances of the group. This allows a discretionary trust that carries on a business to accumulate income, say for working capital purposes, without paying tax at 47% or utilising complex corporate beneficiary structures.

The key reason for these differences lies in the advantages provided by the single entity rule.

Discretionary trusts in consolidated groups: navigating pitfalls

In the realm of discretionary trusts within consolidated groups, potential pitfalls and complexities await those who venture.

Head company status

The head company must meet specific criteria, for example, it should be an Australian resident company (excluding prescribed dual residents), not a subsidiary member of a consolidated group, and have some taxable income taxed at the corporate tax rate.[4] This means that a discretionary trust cannot be the head company of a consolidated group.

Nevertheless, discretionary trusts are allowed to own shares in the head company. In this arrangement, franked dividends paid by the head company can be paid to the discretionary trust and subsequently distributed to the trust's shareholders, provided the trust deed permits such distributions.

The structure of a consolidated group owned by a discretionary trust, or trusts, allows the structure to accumulate profits within the consolidated group but, when the head company pays a dividend, the discretionary trust has the flexibility to distribute that dividend to a broad class of beneficiaries in accordance with the trust deed.

Subsidiary member considerations

The subsidiary member of a consolidated group must meet specific requirements, including:[5]

- it can only be a company, trust (excluding superannuation funds) or partnership;
- it must be fully owned by the head company, with a minor exception of up to 1% ownership held as employee share scheme interests;
- it should be an Australian resident unless it is a prescribed dual resident company; and
- if it is a company, it should have some of its taxable income, if applicable, taxed at the corporate tax rate.

An entity becomes a wholly owned subsidiary of the head company if all of its membership interests are beneficially owned by the head company or any other wholly owned subsidiaries of the head company.[6] The term "membership interests" is defined in the income tax law, referring to a member, with a member of a trust being a beneficiary.[7]

A discretionary trust can become a subsidiary member of a consolidated group if all of its beneficiaries are members of the consolidated group.[8] While it is relatively straightforward to set up a new trust deed tailored for a specific consolidated group, complications may arise when attempting to include an existing discretionary trust within the group.

In such cases, a thorough review of the discretionary trust deed is necessary to ensure that all beneficiaries are members of the consolidated group to qualify as a subsidiary member. Challenges can emerge when some beneficiaries are not group members, the trust deed lacks the power to amend, or it imposes restrictions on alterations. Modifying an existing discretionary trust with a broad class of beneficiaries to a more limited class can be complex and may trigger trust resettlement or CGT event E1.[9]

Capital gains discount

When a discretionary trust that owns assets eligible for the CGT discount joins a consolidated group, the trust's assets lose their eligibility for the discount. This is a notable negative consequence of the single entity rule,[10] which treats the assets of the joining entity as those of the head company. The head company calculates the "tax cost" of all of the underlying assets of the joining trust to determine its income tax position for future dealings involving those assets.

This change in tax treatment can have significant financial implications, particularly if the discretionary trust has assets with embedded gains that would be eligible for the CGT discount outside of a consolidated group.

Discretionary trust operating at a loss

When a discretionary trust operates at a loss, a beneficiary cannot use that loss to offset against other income. Instead, the loss remains inside the trust until the trust generates enough income to recoup the loss. In an unconsolidated private group, the existence of loss entities can lead to complex strategies for the group to use the loss. Those strategies can involve significant tax risk, given the existence of anti-avoidance rules such as s 100A and Pt IVA of the *Income Tax Assessment Act 1936* (Cth).

One of the principles of the consolidation regime is that a joining entity, on passing certain tests, can bring its losses into the consolidated group, with those losses being able to be used by the head company, typically subject to an available fraction.[11] Losses of a discretionary trust are no different, and from the joining date are available to the head company to offset against group profits.

Recommendations

As we draw the curtain on our exploration, we have unveiled the strategic choreography of discretionary trusts within consolidated groups. These versatile entities, when judiciously wielded, create a dance of harmony between tax planning and asset protection. Nonetheless, it is important to acknowledge that navigating the pitfalls can be a laborious and costly endeavour.

Despite this, a newly established discretionary trust in a consolidated group can provide benefits in terms of asset protection and distribution flexibility.

Success in this intricate performance hinges on expert counsel, meticulous trust deed examination, rigorous record-keeping, and vigilant progress tracking. These measures not only facilitate the navigation of intricacies, but also ensure regulatory compliance.

In conclusion, discretionary trusts can offer benefits in the realm of consolidated groups. By recognising this, taxpayers can master the multifaceted challenges and capitalise on the ever-evolving opportunities in this domain.

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References

1 If a consolidated group was validly formed under s 701-1 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97), the tax consolidated group is treated as a single entity. This is also known as the "single entity" rule.

2 Section 254T of the *Corporations Act 2001* (Cth) outlines rules that companies must follow before paying out dividends. A company must have positive net assets before and after the payment (the net assets test), ensure that the dividend is reasonable and fair to all shareholders, and ensure that paying the dividend will not affect the company's ability to pay its creditors. Interestingly, the net assets test has not replaced the profits test, which requires dividends to be paid from the company's profits. Instead, the net assets test has added to the historic requirement. See Minter Ellison, *How to pay a dividend in Australia – a guide*, 2 May 2018. Available at www.minterellison.com/articles/how-to-pay-a-dividend-in-australia-a-guide.

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Superannuation

by William Fettes and Daniel Butler, CTA, DBA Lawyers

Family law superannuation splitting notices

Family law superannuation splits must be properly documented and strategically managed to ensure that clients are not exposed to administrative penalties and the potential loss of CGT roll-over relief.

Where a relationship breakdown has occurred between spouses, the parties' superannuation entitlements may be subject to a family law property settlement. For ease of expression, we use the term "splitting orders" to include a split of superannuation provided for under court orders/ minutes of consent or a superannuation agreement as part of a binding financial agreement.

Many trustees and advisers incorrectly assume that having splitting orders in place will broadly conclude a split from a superannuation law and tax perspective. However, this is not the case as additional steps are required to comply with the superannuation legislation and to ensure that any applicable CGT roll-over relief applies as intended.

This article examines the legal mechanics of properly implementing a superannuation split in an SMSF, with a particular focus on what must occur after splitting orders have been obtained.

Who are the parties in a split?

As a preliminary matter, it is important to clarify a point on terminology. The superannuation splitting laws refer to the relevant parties as the member spouse (MS) and the non-member spouse (NMS), which can potentially be a source of confusion for a layperson.

The key point to remember about this terminology is that the MS is the party whose superannuation interest is subject to a split (ie they are the party giving up their superannuation in relation to a particular split). In contrast, the member who is the beneficiary of the split is referred to as the NMS.

Although it is often the case that an NMS will depart the fund after the split is carried out, the terminology of "non-member" and "member" is not based on membership status in the SMSF. Indeed, it is quite possible to have an MS departing the fund and an NMS remaining in the fund.

Note also that, if there is a split of each member's interest in the same SMSF, both parties will be an MS in respect of their own interest and an NMS in respect of their former spouse's interest (eg where a cross-split is being implemented).

The usual pathway for a split in an SMSF

As noted above, splitting orders must be implemented with regard to additional required steps under the *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA) and the *Superannuation Industry (Supervision) Regulations 1994* (Cth) **(**SISR). Set out below are the major steps that must be implemented once splitting orders are in place.

(It should be noted that this article outlines the key steps required in relation to the usual situation for an SMSF, which is a split implemented under Div 7A.2 SISR initiated by the NMS. We do not consider the trustee-initiated pathway in Div 7A.1A SISR for implementing a split as this is far less common in an SMSF context.)

Step 1

The NMS must provide the SMSF trustee with a copy of the splitting orders, together with a notice under the *Family Law (Superannuation) Regulations 2001* (Cth) regarding the split.

Step 2

The SMSF trustee must give each party a "payment split notice" to formally notify the parties that the interest of the MS is subject to a split under the terms of the splitting order.

Step 3

Subject to the governing rules of the fund and the requirements of the splitting order, the NMS must make a choice regarding how the split amount is to be treated and notify the SMSF trustee of that choice. In broad terms, the choices available to the NMS are as follows:

- **option 1:** the creation of a new interest in the name of the NMS;
- **option 2:** transferring or rolling over the amount to the NMS's nominated superannuation fund; and
- **option 3:** the payment of a lump sum. This option is only available where the split amount constitutes unrestricted non-preserved benefits split from the MS or where the NMS has otherwise met a relevant condition of release.

Note that the choice by the NMS must be exercised within 28 days from the payment split notice or such longer period as the trustee allows.

Naturally, sharing an SMSF after a relationship breakdown is not advisable. Therefore, option 1 is generally only implemented as part of preparatory work for one of the members to exit the SMSF.

Where a condition of release has not been satisfied, option 2 is one of the more common options, ie the split amount (known as "transferable benefits" in this context) is rolled over to another fund, such as a new SMSF or a large public offer superannuation fund.

Step 4

Once steps 1 to 3 are carried out, the SMSF trustee is broadly obliged to give effect to the choice of the NMS, subject to the governing rules of the fund and the splitting orders. The SMSF trustee must then calculate the amount to be transferred (see the commentary below regarding relevant base amount adjustments), determine the tax components and the preservation components, and notify each of the parties regarding the split being implemented.

Where relevant, a roll-over of any remaining member benefits would typically occur in conjunction with the transfer of the split amount using the prescribed ATO forms.

Also, the fund's records must be appropriately updated and relevant trustee resolutions prepared.

Base amount adjustment

If the splitting orders specify a base amount split, the base amount must be adjusted from the operative time until the date of transfer of the transferable benefits (see the definition of "transferable benefits" in reg 1.03 SISR) or the creation of the new interest. This is done by interest being calculated and added for the relevant period at the prescribed annual interest rate. The current rate for the 2023–24 year is 5.9%

Failure to implement documents under the SISA/SISR

Splitting orders are not self-executing and do not cover the additional obligations that apply to a superannuation split under the SISA and the SISR.

The giving of the various notices in relation to a Div 7A.2 split noted under steps 1 to 4 above is an operating standard for regulated superannuation funds under reg 7A.02 SISR. Thus, failure to give these notices will result in one or more contraventions of s 34(1) SISA, with each contravention attracting an administrative penalty equal to 20 penalty units.

The value of a penalty unit is currently $313 for the 2023–24 financial year. Accordingly, failure to implement appropriate Div 7A.2 documents after splitting orders are obtained will result in *each* individual trustee of an SMSF being liable (on a strict liability basis) for $6,260 per contravention.

If the fund has a corporate trustee, each director will be jointly and severally liable for a $6,260 penalty.

Additionally, the failure to implement appropriate splitting implementation documents under the SISR may result in further negative consequences, including claims being brought against advisers who were involved in the process, eg if the adviser failed to point out the SISR documents required to implement a split.

Unfortunately, many advisers, including experienced family law practitioners, are not fully aware of the SISR criteria and thus they may not point out these aspects to their clients or the client's other advisers (such as accountants and financial planners) who may also be involved with a split.

Impact on CGT roll-over relief

Splitting documents are also important in the context of the family law CGT roll-over relief provisions in the *Income Tax Assessment Act 1997* (Cth) (ITAA97).

For instance, under s 126-140(2) ITAA97, CGT roll-over relief can apply where an SMSF (or other small fund) transfers a CGT asset to another complying superannuation fund pursuant to a payment split for the benefit of an NMS. However, s 126-140(2)(c) requires that:

> "the transfer is under provisions of the [SISR] dealing with superannuation interests that are subject to payment splits ..."

This requirement means that a failure to have properly drafted splitting documents in place could jeopardise intended CGT roll-over relief.

Accordingly, the remaining member in the SMSF could be faced with a tax bill and possible penalties in connection with the relevant capital gain not being disregarded as intended. Naturally, the departing member may benefit from this outcome in relation to the cost base of the roll-over asset having a refreshed market value cost base, so it does depend on who you are acting for!

Superannuation splitting in an SMSF context is likely to give rise to other technical concerns, including restructuring the SMSF as a single-member fund, transfer balance account issues, income tax consequences including CGT liabilities, and stamp duty issues. We recommend that a suitable adviser should be engaged to assist with these aspects.

Conclusion

Many advisers are unaware that splitting orders in respect of an SMSF are not self-executing and must broadly be implemented in accordance with the steps set out above in accordance with the relevant criteria and documents required by the SISR.

Accordingly, to ensure that clients are not exposed to significant penalties and further negative risks, it is critical that advisers obtain appropriate advice regarding the proper process to follow so that the various notices and other steps are followed in accordance with the operating standards in the SISA and the SISR.

Note that the commentary in this article is a general summary only and is not intended to be relied on as legal advice.

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Events Calendar

Upcoming months

FEBRUARY
15–16
Thu–Fri

QLD

Private Business Tax Retreat

12 CPD hours

FEBRUARY
28
Wed

NSW

Women in Tax Congress

7 CPD hours

MARCH
7–8
Thu–Fri

WA

WA Tax Forum

12 CPD hours

MARCH
13
Wed

VIC

Not for Profit Tax Intensive

7 CPD hours

MARCH
14–15
Thu–Fri

NSW

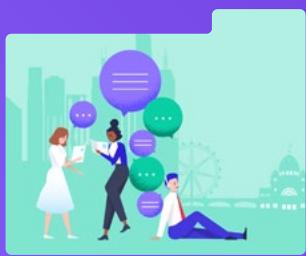
Financial Services Taxation Conference

11 CPD hours

MARCH
21–22
Thu–Fri

VIC

VIC Tax Forum



13 CPD hours

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

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Giving back to the profession

The Tax Institute would like to thank the following presenters from our November CPD sessions. All of our presenters are volunteers, and we recognise the time that they have taken to prepare for the paper and/or presentation, and greatly appreciate their contribution to educating tax professionals around Australia.

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Corrigendum

In the article "The CGT main residence exemption: tips and traps" by Neil Brydges and Edward Hennebry ((2023) 58(5) *Taxation in Australia* 254), the following paragraphs from the example on page 272 should read as follows (corrections are highlighted in bold):

"Sarah, Mike's daughter, inherited the dwelling following Mike's death. On inheriting the dwelling, Sarah rented it out. It was not her main residence at any time. On **15 October 2024**, Sarah signs a contract to sell the dwelling and settlement occurs on 12 December **2024**.

Sarah lives in France and is a foreign resident for the whole of the time she has an ownership interest in the dwelling.

Sarah is entitled to a partial CGT MRE for the ownership interest that she has in the dwelling at the time she sells it, being the exemption that accrued while Mike used the dwelling as his main residence (1 July 1987 until 10 June 2022). She is not entitled to any CGT MRE that she accrued in respect of the dwelling (10 June 2022 until 15 October **2024**). This is because she was a foreign resident on 15 October **2024**, the day on which she signs the contract to sell her ownership interest (the day on which CGT event A1 occurs)."

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